

**THE CREATION OF A GROUNDLESS EXCEPTION TO THE  
DORMANT COMMERCE CLAUSE: AN EXPANSION ON THE  
DISSENTING OPINION IN *DEPARTMENT OF REVENUE V. DAVIS***

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**Abstract**

Most states exempt from state taxable income interest earned on in-state bonds. Some of those states, however, do not afford the same treatment to out-of-state bonds. This differential taxation scheme was the subject of the Supreme Court Case, *Department of Revenue v. Davis*, in which the Court upheld the disparate treatment of state-issued bonds.

This article analyzes the Court's rationale for upholding the differential tax system in light of prior precedent interpreting the dormant Commerce Clause of the Constitution. It is the author's contention that the doctrine created in, *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt.*, the "government-entity" exception to the dormant Commerce Clause, and applied in, *Davis*, was created under a false distinction and therefore should never have come to light. Had the "government-entity" exception not existed, the differential tax scheme most likely would have been

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struck down as a violation of the dormant Commerce Clause.

## INTRODUCTION

Many have argued that the Court reached a proper conclusion in *Department of Revenue v. Davis*<sup>1</sup>, based on the detrimental effect a contrary holding—that differential bond schemes were unconstitutional—would have had on the national bond market.<sup>2</sup> This is an outcome driven line of reasoning which fails to stand up to scrutiny. This article will analyze the *Davis* case, and its only precedential support in *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*<sup>3</sup> It will demonstrate how both *Davis*, and *United Haulers*, and the “government-entity” exception created and upheld in those two cases, are contrary to prior precedent interpreting the dormant Commerce Clause jurisprudence of the Court and the underlying free-market tenets which the Commerce Clause was designed to protect.

Part I provides a factual foundation of the *Davis* case. Part II examines the history of the dormant Commerce Clause and offers an explanation of the modern dormant Commerce Clause analysis, including the threshold determination of whether a law is discriminatory or not, and the separate analyses which depend on that determination. Details of the exceptions to the dormant Commerce Clause for discriminatory laws are also analyzed, including the newly created government-entity exception created in *United Haulers*. It was the government-entity exception created in *United Haulers*, which allowed the Court in *Davis*, to uphold the Commonwealth of Kentucky’s differential bond taxation scheme. As such, the government-entity exception and its underlying rationales are the subject of the remainder of the article.

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<sup>1</sup> *Dep't of Revenue v. Davis*, 128 S. Ct. 1801 (2008).

<sup>2</sup> The Supreme Court, 2007 Term - Leading Cases, 122 HARV. L. REV. 276 (2008) (comment on *Dep't of Revenue v. Davis*).

<sup>3</sup> *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (2007).

Part III analyzes the *Davis* case, focusing on the Court's decision to uphold Kentucky's differential bond scheme, in spite of precedent which would seem to find the tax scheme unconstitutional. After discussing Justice Souter's majority opinion, specific attention is given to Justice Kennedy's dissent and the cases he cites interpreting the dormant Commerce Clause, which stand in direct contrast to the government-entity exception. Part IV is a concession of sorts, to the effect that the Court may have reached a proper outcome in *Davis* from a practical standpoint when considering the effect the opposite finding would have had on the bond market. This concession is tempered by the conclusion that the outcome, even though proper from a practical standpoint, was not proper based on judicial precedent prior to *United Haulers*.

#### **FACTUAL BACKGROUND**

The Commonwealth of Kentucky exempts interest on bonds sold by it or any of its political subdivisions from state taxable income.<sup>4</sup> This treatment is neither unique nor novel to Kentucky. Of the states that impose an income tax on gross income, forty-one afford similar treatment to in-state bonds in the computation of state taxable income, and have done so for nearly a century.<sup>5</sup> Kentucky does not offer reciprocal treatment to out-of-state bonds. While all state bonds are exempt from federal income tax,<sup>6</sup> Kentucky, along with most of the other forty-one states that exempt in-state bond interest, requires that interest earned on out-

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<sup>4</sup> KY. REV. STAT. ANN. § 141.010(9) (West 2007).

<sup>5</sup> In the opinion, Justice Souter cited the following statistics. “. . . Kentucky and 36 other States . . . have schemes that are nearly identical to Kentucky's. . . . Of the remaining States, Utah exempts its own bonds, and extends reciprocal treatment to the bonds of States that do not tax Utah bonds. Indiana exempts all municipal bonds); and the balance have no personal income tax.” Dep't of Revenue v. Davis, 128 S. Ct. 1801 (U.S. 2008).

<sup>6</sup> 26 U.S.C. § 61 (2006).

of-state bonds be added back to federal adjusted gross income to calculate state taxable income.<sup>7</sup>

This tax regime goes to both the benefit and detriment of a Kentucky resident, depending on the type of bonds purchased. On the one hand, Kentucky residents who purchase in-state bonds enjoy the benefit of tax-free interest income. On the other hand, Kentucky residents who elect to purchase out-of-state bonds must include interest earned on those bonds in state taxable income on their Kentucky tax return. George and Catherine Davis were Kentucky residents who fell in the latter category. They purchased out-of-state bonds and were required to include the corresponding interest in state taxable income.<sup>8</sup> After paying taxes on their out-of-state bond interest income, the Davises challenged Kentucky's differential tax scheme.<sup>9</sup>

In April 2003, the Davises filed a class action suit against the Department of Revenue of Kentucky for refund of taxes paid on the out-of-state bond interest on the grounds that Kentucky's differential taxation of bond income impermissibly discriminated against interstate commerce in violation of the Commerce Clause of the Constitution.<sup>10</sup> Three months later, in July of 2003, the Department filed a motion for summary judgment arguing that the differential tax scheme was constitutional.<sup>11</sup> In April of the following year, the Kentucky trial court granted the Department's motion for summary judgment, relying partly on the "market participant" exception to the dormant Commerce Clause limit on

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<sup>7</sup> KY. REV. STAT. ANN. § 141.010(10)(c) (West 2007).

<sup>8</sup> *Davis*, 128 S. Ct. at 1807.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* Dep't of Revenue of Ky. v. Davis, 197 S.W.3d 557 (Ky. Ct. App. 2006), cert. granted, 2007 WL 1461084 (U.S. May 21, 2007) (No. 06-666). The Davises also included a claim of violation of the 14<sup>th</sup> Amendment's Equal Protection Clause. *Davis*, 197 S.W.3d at 560.

<sup>11</sup> *Davis*, 197 S.W.3d at 561. The Department also moved for summary judgment on the grounds that the Davises lacked standing to challenge the constitutionality of the differential tax regime. *Id.*

state regulation.<sup>12</sup> The Davises appealed to the Kentucky Court of Appeals.<sup>13</sup>

The Kentucky Court of Appeals reversed the trial court's decision, finding that facts in this case were distinguishable from those in the Supreme Court's line of cases establishing the "market participant doctrine."<sup>14</sup> It concluded that it had "no choice but to find that Kentucky's system of taxing only extraterritorial bonds runs afoul of the Commerce Clause."<sup>15</sup> The Supreme Court of Kentucky denied the Commonwealth's motion for discretionary review.<sup>16</sup>

## **DORMANT COMMERCE CLAUSE**

### **Definition**

The dormant Commerce Clause stands for the notion that state and local laws are unconstitutional if they place an undue burden on interstate commerce.<sup>17</sup> Substantively, the dormant Commerce Clause is an inference from the Commerce Clause's affirmative grant of power to Congress to regulate commerce among the states.<sup>18</sup> The Court has established this conjecture based on the rationale that if Congress has not acted, that is, even where its Commerce Clause power lies dormant, states can still violate the Commerce Clause by enacting laws that unduly impede interstate commerce.<sup>19</sup>

The practical effect of the dormant Commerce Clause is that state laws will be held unconstitutional if they place an undue

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<sup>12</sup> *Davis*, 128 S. Ct. at 1807.

<sup>13</sup> *Id.*

<sup>14</sup> *See Davis*, 197 S. W. 3d, at 564.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> Chemerinsky, *Constitutional Law: Principles and Policies*, 419, (3d ed. 2006).

<sup>18</sup> U.S. Const. art. I, §8; *Id.* at 419.

<sup>19</sup> Chemerinsky, *supra*, Note 17 at 419.

burden on interstate commerce. The process for determining whether an undue burden on interstate commerce is caused by a particular state law is discussed in the “Current Analysis and Exceptions” section, *infra*.

### Historical Progression

The historical precedent for the dormant Commerce Clause can be traced to the case of *Gibbons v. Ogden*.<sup>20</sup> In that case, the State of New York granted a monopoly for operating steamboats in New York waters.<sup>21</sup> This monopoly had the effect of cutting off passage to steamboats with federal licenses to traverse New York waterways.<sup>22</sup> Chief Justice John Marshall, using an expansive reading of the Commerce Clause, held that the power of commerce among the several states is vested in Congress as absolutely as it would be in a single government.<sup>23</sup> Therefore, the New York law granting a monopoly violated federal law as an impermissible restriction on interstate commerce.<sup>24</sup>

Chief Justice Marshall went on to establish an independent limit on the states’ power to enact laws, even where Congress has not acted. The Chief Justice distinguished between laws which were valid exercises of the state’s police power and laws under which a state overreaches its power and impedes Congress’s federal power over commerce. Thus, Chief Justice Marshall concluded that the Commerce Clause granted Congress the power to regulate both the “commerce of the United States,” as well as “the commerce of the several states.”<sup>25</sup>

Chief Justice Marshall’s approach to the dormant Commerce Clause left things anything but clear moving forward. The most troublesome proposition under his analysis was his

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<sup>20</sup> *Gibbons v. Ogden*, 22 U.S. 1 (U.S. 1824).

<sup>21</sup> *Id.* at 6.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 197.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 195.

categorizing state laws as either valid exercises of police power or laws which violated the commerce clause. This left unanswered the question of what to do with laws that were valid exercises of police power which also unduly burdened interstate commerce.<sup>26</sup>

After years of grappling with questions left unanswered in *Gibbons*, the Court shifted its analysis to one weighing national against local subject matter, in *Cooley v. Board of Wardens*<sup>27</sup>. After this test proved just as vexing, in 1924, the Court defined a new test in *DiSanto v. Pennsylvania*,<sup>28</sup> by which it drew distinctions between state laws that directly interfered with interstate commerce, and thus were invalid, and those state laws that only had an indirect effect on interstate commerce, and were upheld as valid.<sup>29</sup>

### **Current Analysis and Exceptions**

Eventually, the test in *DiSanto* proved to be just as unworkable an approach to the dormant Commerce Clause, in large part because of its rigidity. Over time, the Court developed what is the modern dormant Commerce Clause analysis by drifting from rigid categorization to a balancing of the benefits of a law against the burdens that it imposes on interstate commerce.<sup>30</sup>

Under the modern dormant Commerce Clause the crucial initial question is whether a state law discriminates against out-of-staters or whether it treats all alike regardless of residence.<sup>31</sup> Laws that do not discriminate are usually held to be constitutional, and will only be struck down if it is determined that they place a burden on interstate commerce that outweighs the benefit of the law.<sup>32</sup> Laws that discriminate against out-of-staters are subject to strict

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<sup>26</sup> Chemerinsky *supra* note 17 at 419.

<sup>27</sup> *Cooley v. Bd. of Wardens*, 53 U.S. 299 (U.S. 1852).

<sup>28</sup> *Di Santo v. Pennsylvania*, 273 U.S. 34 (U.S. 1927).

<sup>29</sup> *Id.* at 44.

<sup>30</sup> Chemerinsky *supra* note 17 at 428.

<sup>31</sup> Chemerinsky *supra* note 17 at 430.

<sup>32</sup> *Id.*

scrutiny and are only upheld if they are deemed necessary to achieve an important governmental purpose.<sup>33</sup> Thus, in many, if not most cases, the determination of whether a law discriminates against interstate commerce is decisive in determining whether a law is Constitutional under the dormant Commerce Clause.<sup>34</sup>

Where a state law is determined to not discriminate against interstate commerce, the Court balances the law's burdens on interstate commerce against its benefits. The law will be found unconstitutional if the court decides that the burdens from the law exceed the benefits.<sup>35</sup> This balancing test was adopted in *Pike v. Bruce Church, Inc.*,<sup>36</sup> in what has become known as the *Pike* Balancing Test. "Where the statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."<sup>37</sup>

Unlike nondiscriminatory laws, the determination that a state law is discriminatory creates a presumption that it is a burden on interstate commerce. Such a law will be upheld only if it is proved that the law is necessary to achieve an important government purpose.<sup>38</sup> Thus, the analysis is one of strict scrutiny with respect to any "purported legitimate local purpose and of the absence of nondiscriminatory alternatives."<sup>39</sup> This strong presumption against state laws that discriminate against out-of-staters means that usually such laws are declared unconstitutional

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<sup>33</sup> *Id.*

<sup>34</sup> Chemerinsky *supra* note 17 at 431.

<sup>35</sup> *Id.* at 437.

<sup>36</sup> *Pike v. Bruce Church*, 397 U.S. 137 (U.S. 1970).

<sup>37</sup> *Pike*, 397 U.S. at 142.

<sup>38</sup> Chemerinsky *supra* note 17 at 432.

<sup>39</sup> *Hughes v. Oklahoma*, 441 U.S. 322, 337 (U.S. 1979).

under the dormant Commerce Clause, unless some exception can be found to save them.<sup>40</sup>

Prior to the *United Haulers* case, there were two exceptions whereby a law that otherwise was discriminatory and in violation of the dormant Commerce Clause would be allowed. The first was the Congressional Approval exception, under which if Congress approved the discriminatory state law, even if it were clearly unconstitutional, it would still be allowed under Congress's power to regulate commerce among the states.<sup>41</sup>

The second exception was the "market participant exception" under which a state is permitted to favor its own citizens in receiving benefits from government programs or in dealing with government-owned businesses.<sup>42</sup> Put another way, if the state is literally a participant in the market, such as with a state-owned business, and not a regulator, the dormant commerce clause does not apply.<sup>43</sup>

Until *United Haulers*, these were the only exceptions to the dormant commerce clause and typically the only means by which an otherwise discriminatory law could survive dormant Commerce Clause scrutiny. The Court in *United Haulers*, however, saw fit to except additional state laws from the harshness of strict scrutiny further by creating a new "government-entity" exception under which a discriminatory law would be excepted from the dormant Commerce Clause if it favored a governmental entity or interest and treated all private parties the same.

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<sup>40</sup> Chemerinsky *supra* note 17 at 445. Note that a law can survive without an exception, but the cases are rare. See *Maine v. Taylor*, 477 U.S. 131 (U.S. 1986).

<sup>41</sup> Chemerinsky *supra* note 17 at 449.

<sup>42</sup> *Id.* at 451.

<sup>43</sup> *Id.*

### ***United Haulers*—The New “Government-Entity” Exception**

**Majority Opinion.** *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*,<sup>44</sup> involved a “flow control” ordinance which required trash haulers to deliver waste to a particular processing facility.<sup>45</sup> In 1994, in *C & A Carbone, Inc. v. Clarkstown*,<sup>46</sup> the Court struck down as a violation of the Commerce Clause a nearly identical ordinance requiring haulers to deliver waste to a particular private processing plant.<sup>47</sup> The only purported difference between the ordinance in *Carbone*, and the ordinance in *United Haulers*, was that the ordinance in *United Haulers* required haulers to deliver waste to facilities owned and operated by a state-created public benefit corporation.<sup>48</sup>

As a springboard to upholding the local ordinance in *United Haulers*, the Court cited an ambiguity, it argued, was left unresolved by the Court in *Carbone*.<sup>49</sup> There, the majority opinion held that the local ordinance violated the commerce clause on the grounds that it discriminated against interstate commerce by hoarding solid waste, and the demand to get rid of it, for the benefit of a preferred processing facility.<sup>50</sup> Justice Souter, dissenting in *Carbone*, noted that the processing plant in *Carbone*, was a governmental municipal facility, which distinction should have saved the ordinance because favoring local government is by its nature different from favoring a particular private company.<sup>51</sup> The

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<sup>44</sup> *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (U.S. 2007).

<sup>45</sup> *Id.* at 334.

<sup>46</sup> *C & A Carbone, Inc. v. Clarkstown*, 511 U.S. 383, 399 (1994).

<sup>47</sup> *Id.*

<sup>48</sup> *United Haulers*, 550 U.S. at 334.

<sup>49</sup> *Id.* at 339.

<sup>50</sup> *Id.*

<sup>51</sup> *Id.* (citing *C & A Carbone, Inc.* 511 U.S. 383 at 410 (Souter, J., dissenting)). This dissenting opinion is very much a foreshadow of the “government-entity” exception created in *United Haulers*, and applied in *Davis*.

majority opinion in *Carbone*, however, failed to address the dissent's public-private benefit distinction, in theory, leaving an ambiguity for the Court in *United Haulers*, to exploit.

The *United Haulers* Court interpreted the majority's silence in *Carbone*, as a concession that the entity in question there was a private one, in spite of its municipal function. Therefore, argued the *United Haulers* Court, the *Carbone* Court could not properly address whether ordinances favoring public facilities were in violation of the dormant Commerce Clause, because that issue was not before the Court.<sup>52</sup> The Court went on to clarify this perceived ambiguity, and thus distinguish *Carbone* from *United Haulers*, noting that all the Court's prior holdings striking down similar ordinances involved state or local laws benefiting a private enterprise.<sup>53</sup>

Taking this analysis further, the Court drew a distinction between local laws that benefit private enterprises and those which benefit public facilities or interests and held that local laws that benefit public companies while treating all private companies the same do not discriminate against interstate commerce under the dormant Commerce Clause.<sup>54</sup> The Court justified its disparate treatment between public and private entities on the grounds that states are not businesses; they are governmental entities that have responsibilities to protect the health, safety, and welfare of its citizens. As such, argued the Court, they should not be held to the same scrutiny as laws favoring private industry.<sup>55</sup>

**Justice Alito's Dissent.** In his dissent, Justice Alito was unwilling to create a distinction between private and public entities when determining whether an ordinance discriminates against interstate commerce.<sup>56</sup> The foundation of Justice Alito's contention was one

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<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 341

<sup>54</sup> *Id.* at 343

<sup>55</sup> *Id.*

<sup>56</sup> *United Haulers*, 550 U.S. at 356 (Alito, J., dissenting).

of *stare decisis*; principally, that the Commerce Clause is no respecter of private or public entities. That is, if the ordinance in *Carbone* was impermissible under the dormant Commerce Clause as it applied to a private/quasi-public entity, then almost the exact same statute, levied with respect to an entity that is more clearly public, must also be struck down.

Justice Alito carefully dissected the majority opinion, noting that the only difference between the ordinance at issue in *United Haulers*, and the one at issue in *Carbone*, the majority itself described as “salient.”<sup>57</sup> In other words, the only meaningful distinction between the cases was that the ordinance invalidated in *Carbone* discriminated in favor of an alleged privately owned facility, whereas the laws at issue in *United Haulers*, discriminated in favor of facilities owned and operated by a state-created public benefit corporation.<sup>58</sup> Thus, the public-private benefit distinction, created by the Court, and the “government-entity” doctrine derived from that distinction as an exception to the dormant Commerce Clause, are both “illusory and without precedent.”<sup>59</sup>

Of singular importance, Justice Alito’s rebuttal to the majority’s reasoning was the marginal distinction between the entity deemed private in *Carbone*, and the one deemed a public in, *United Haulers*. The entity in *Carbone*, was much more public in nature than the majority in *United Haulers* was willing to admit. The only real difference between the entity in *Carbone*, and the entity in *United Haulers*, was that title to the facility in, *Carbone*, had not yet passed to the municipality. Otherwise, it is quite clear that the entity was a municipal facility.<sup>60</sup> Thus, the distinction drawn in *United Haulers*, to reach a result different than the one required by *Carbone*, was without merit.<sup>61</sup>

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<sup>57</sup> *Id.* at 357.

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 361.

<sup>61</sup> An examination of the governmental nature of the entities in *Carbone*, and *United Haulers*, is considered in more detail, *infra*.

In the heart of the dissent, Justice Alito cited case after case, going through a history of the dormant Commerce Clause, demonstrating that there is no precedent for an exception from the dormant Commerce Clause for state-owned entities.<sup>62</sup> Nor is there precedent for a relaxation of scrutiny in the face of a law which only discriminates in favor of a state-owned entity.<sup>63</sup> The dormant Commerce Clause jurisprudence, Justice Alito concluded, clearly establishes that if the legislative means are discriminatory, then regardless of how legitimate and nonprotectionist the underlying legislative goals may be, the legislation is subject to strict scrutiny.<sup>64</sup>

#### ***United Haulers' Impact on Davis***

It is critical to understand the majority opinion in *United Haulers*, to grasp the Court's rationale in *Davis*. The Court in *Davis*, relied heavily on *United Haulers* to justify its holding that Kentucky's differential bond treatment did not violate the dormant Commerce Clause. Justice Alito's critique of the decision in *United Haulers* casts doubts on the validity of the decision in *Davis* as will be explored, *infra*. Moving forward it is important to note that *United Haulers* created an exception to the dormant Commerce Clause without any precedent for doing so. And it was only able to rationalize this exception by relying on a marginal distinction between the entities in *Carbone*, and *United Haulers*.

### **DEPARTMENT OF REVENUE V. DAVIS—APPLYING THE NEW "GOVERNMENT-ENTITY" EXCEPTION**

#### **Majority Opinion**

Justice Souter wrote the majority opinion in *Davis*, upholding Kentucky's differential bond scheme. It is somewhat

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<sup>62</sup> *United Haulers*, 550 U.S. at 361.

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* at 366.

ironic that Justice Souter would be the first to apply the government-entity exception post-*United Haulers*. Justice Souter found the “government-entity” exception to be dispositive in *Davis*. Yet that exception was created only by finding that Justice Souter’s dissent in *Carbone* was flatly without merit. Justice Souter adamantly contended for the creation of a “government-entity” exception in *Carbone*, arguing that the entity there was publicly owned and therefore should be exempt from the dormant Commerce Clause.

Fourteen years later, Chief Justice Roberts, in *United Haulers*, created the government-entity exception argued for by Justice Souter in *Carbone*, by reaching the exact opposite conclusion—that the character of the entity in *Carbone*, was clearly private and therefore distinguishable from the public-entity in *United Haulers*. How inconsistent it would have been if Justice Souter had written the *United Haulers* opinion, in which he in fact joined. From his dissent in *Carbone*, it is clear he was in favor of the creation of a government-entity exception from the dormant Commerce Clause all along. But to have created the government-entity exception in *United Haulers*, he would have directly contradicted his own dissent in *Carbone*. Thus, the irony is that the doctrine Justice Souter desired was created only by finding that his dissent in *Carbone*, was completely wrong.

Justice Souter was joined by seven of the nine justices in his opinion, except for part III-B, the portion of the opinion which justified the decision on the alternative grounds of the “market-participant exception,” which did not gain majority support.

The rest of the opinion, which did gain majority support, rested on the government-entity exception created in *United Haulers*. After providing an overview of the modern dormant Commerce Clause analysis, the Court shifted its focus to exceptions to the dormant Commerce Clause’s prohibition on laws that discriminate against interstate commerce. This included the “market-participant” exception, and the newly created “government-entity” exception.

The Court held that “[i]t follows *a fortiori* from *United Haulers* that Kentucky must prevail.”<sup>65</sup> Citing language in *United Haulers* which explained that a government function is not susceptible to standard dormant Commerce clause scrutiny, the Court concluded that even more deference was warranted in *Davis*, where the law favored state municipal bonds, given that the issuance of debt securities pays for public projects, and thus feeds what is “quintessentially” a public function.<sup>66</sup> Justice Souter further rationalized the reduced level of scrutiny on the notion that a government function is likely motivated by “legitimate objectives distinct from the simple economic protectionism the Clause abhors.”<sup>67</sup>

Much as the Court did in *United Haulers*, Justice Souter justified his reasoning, that laws discriminating in favor of government entities are justified, on the state’s obligations to protect the health, safety, and welfare of its citizens.<sup>68</sup> Justice Souter concluded that the differential tax scheme at issue in Kentucky paralleled the ordinance upheld in *United Haulers*, because both benefited a public entity while treating all private entities the same.<sup>69</sup>

Justice Souter went on in Part III-B of the opinion to hold that the “market participant” exception to the dormant Commerce Clause was “another means” of finding Kentucky’s differential tax scheme Constitutional.<sup>70</sup> He described Kentucky as participating in the market for investment dollars when it exempted bond interest, and characterized Kentucky’s tax structure as “one of the tools of competition.” This section of the opinion did not garner majority support.

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<sup>65</sup> Dep’t of Revenue v. Davis, 128 S. Ct. 1801, 1810 (U.S. 2008).

<sup>66</sup> *Id.* at 1810.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* at 1811.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

### Analysis

The lack of majority support for Part III-B's analysis of the market-participant doctrine as an alternative means to justify Kentucky's differential tax scheme aptly demonstrates the shoddy footing of the Court in its "government-entity" exception to the dormant Commerce Clause. One of the underpinnings of the holding in *United Haulers* was that the State was anything but a business. The Court relied heavily on the State's role as a governmental entity and its duties as such to provide for the health and welfare of its citizens. It was its very nature as a government that allowed the court to justify applying a diminished scrutiny in the face of discrimination under the dormant Commerce Clause and creating a "government-entity" exception.

On almost the exact opposite rationale, Justice Souter cited the "market-participant" exception to the dormant Commerce Clause, holding that Kentucky's participation in the bond market was sufficiently like any other bond-market participant issuing bonds that the activity went beyond traditional state action and therefore was not within the scope of the dormant Commerce Clause.

Thus, to justify the "government-entity" exception, the Court relied on the public nature of a state as a government designed to protect the people. On the other hand, to justify the "market-participant" exception, Justice Souter relied on the state's role as the equivalent to a private bond issuer. It would appear then that these contradicting rationales—that states are both too public and acting in a function that is too private to warrant dormant Commerce Clause scrutiny—shelter states from ever violating the dormant Commerce Clause, so long as the law discriminates in favor of the state and not in favor of a private individual or entity.

This seemingly contradictory result can be traced to the *United Haulers* decision which relied on a marginal variation in the nature of the governmental entity favored by the discriminatory law to distinguish the facts there from the facts in *Carbone*.

Without this distinction, *Carbone* would have been directly on point and dictated a result in favor of the United Haulers and it is unclear how the Court would have come out in *Davis* given that there was not majority support for the market-participant doctrine. The apparent conflicting rationales of the “market participant exception” and the “government-entity” exception” are explored further, *infra*.

### Justice Kennedy’s Dissent

Justice Kennedy picked up his dissent where Justice Alito left off in *United Haulers*. Justice Kennedy, however, took his argument to a broader level, emphasizing the role free markets play in the United States.<sup>71</sup> The undertone of the entire opinion was based on the notion that “free trade in the United States, unobstructed by state and local barriers, [is] indispensable . . . to ensure the liberty and progress of the whole Nation.”<sup>72</sup> Thus, the Commerce Clause doctrine created by the Court has been a tool creating a free market without borders.

While emphasizing a need to return to a market with proper form, free of artificial restraints, Justice Kennedy went on to continue Justice Alito’s criticism in *United Haulers* of the Court’s logic in creating the government-entity exception, specifically describing the Court’s analysis in *Davis* as “unsatisfactory, brief and circular.”<sup>73</sup> On this footing, Justice Kennedy analyzed a specific line of precedents which, had they been applied in *Davis*, would have yielded a result in favor of the taxpayers. These cases stand for the proposition that laws with either the purpose or effect of discriminating against interstate commerce in order to protect local trade are void.<sup>74</sup> The remainder of this article will analyze

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<sup>71</sup> *Id.* at 1822.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.* at 1823.

<sup>74</sup> *Id.* at 1814.

this particular line of cases and apply the precedents established therein to the facts of *Davis*. The purpose of this analysis is to demonstrate that the “government-entity” exception in *United Haulers*, on which the *Davis* decision was decided, is an anomaly without precedential support, and had the Court applied the dormant Commerce Clause line of cases properly, it would have reached a different result in both *United Haulers* and *Davis*.

**Kansas City Southern R. Co. v. Kaw Valley Drainage Dist.**

One of the principle rationales cited by both the *United Haulers* Court and the *Davis* Court for the “government-entity” exception was the State’s responsibility to fulfill its traditional government functions of protecting health, safety and welfare. Justice Kennedy described this as a formulation of the state’s police powers.<sup>75</sup>

The case of, *Kansas City Southern R. Co. v. Kaw Valley Drainage Dist.*,<sup>76</sup> stood for the proposition cited by Justice Kennedy that a state enacting laws under its “police power” (it would be difficult to identify a law that has not been enacted under the state’s police power) does not exempt it from the Commerce Clause analysis.<sup>77</sup>

In that case, the Supreme Court of the State of Kansas required the Kansas City Southern Railway Company to remove bridges passing over the Kansas River, after the river overflowed its banks and caused great loss.<sup>78</sup> The bridges’ low elevation played a part in the river overflowing its banks.<sup>79</sup> The Court found that these bridges were necessary lines of commerce by rail among the states and as such were under the exclusive control of Congress.<sup>80</sup> The state could do nothing which would directly

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<sup>75</sup> *Id.* at 1824.

<sup>76</sup> *Kansas City S. R. Co. v. Kaw Valley Drainage Dist.*, 233 U.S. 75 (U.S. 1914).

<sup>77</sup> *Davis*, at 1824.

<sup>78</sup> *Kaw Valley Drainage Dist.*, 233 U.S. at 78.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

burden or impede the interstate traffic of the railroads or which would impair the usefulness of their facilities for such traffic.<sup>81</sup>

In an attempt to justify the removal of the bridges as ordered by the Supreme Court of Kansas, it was argued that the order should be upheld on the grounds that such removal of the bridges was an act under the police power of the state for the local welfare of its citizens.<sup>82</sup> The Court dismissed the notion that a state's police power can trump the Commerce Clause. "[A] state cannot avoid the operation of [the Commerce Clause] by simply invoking the convenient apologetics of the police power."<sup>83</sup> It has repeatedly been said or implied that "a direct interference with commerce among the States [can] not be justified in this way."<sup>84</sup> Thus, the Court reversed the order of the Supreme Court of the State of Kansas requiring the railroad company to take down its bridge.<sup>85</sup>

This case largely undercuts the prime rationale for the "government-entity" exception. One of the principle reasons for which the Court in *United Haulers* excepted the local ordinance from the standard of strict scrutiny under the dormant Commerce Clause analysis for discriminatory laws favoring the state itself was based on the notion that States acting in their capacity as states, fulfilling traditional functions for the welfare of their citizens, should not have to withstand the normal gauntlet of strict scrutiny reserved for laws which discriminate against interstate commerce. The court in *Davis*, similarly justified Kentucky's differential tax scheme on the grounds that it serves a traditional government function and concerns the "cardinal civil responsibilities" of protecting health, safety, and welfare.<sup>86</sup>

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<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> *Id.* at 79.

<sup>85</sup> *Id.*

<sup>86</sup> *Davis*, 233 U.S. at 1824 (Kennedy, J., Dissenting).

Had the Court acknowledged and applied the rule established in *Kaw Valley Drainage*—that a state cannot avoid operation of the Commerce Clause by simply invoking the convenient apologetics of the police power—the case for affirming *United Haulers*, and upholding Kentucky’s differential tax scheme would have been seriously weakened. Thus, the Government-entity exception created in *United Haulers* and which was completely dispositive in *Davis*, according to Justice Souter, was not only based on a marginal distinction between the entities involved, but also rationalized under a theory (police power) that the Court itself has already said cannot trump traditional Commerce Clause scrutiny.

**Boston Stock Exchange v. State Tax Comm'n.** The dormant Commerce Clause line of cases stands for the rule that a state has no authority to use its taxing power to erect local barriers to out-of-state products or commodities.<sup>87</sup> Justice Kennedy noted that nothing in that line of cases even suggests that this rule is inapplicable simply because the State uses a discriminatory tax to favor its own enterprise.<sup>88</sup> Thus, Kentucky’s differential tax scheme is an explicit discrimination against out-of-state bond issuances for admitted protectionist purposes.<sup>89</sup>

The case of *Boston Stock Exchange v. State Tax Comm'n.*<sup>90</sup> affirms this conclusion. At issue in that case was a New York transfer tax which imposed a higher tax on in-state transfers of securities resulting from out-of-state sales than those resulting from in-state sales. The stated purpose of the law was to provide relief from the competitive disadvantage thought to be created by the transfer tax from New York stock exchanges, as against out-of-state exchanges.<sup>91</sup> A number of stock exchanges challenged this

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<sup>87</sup> *Id.* at 1825.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Boston Stock Exchange v. State Tax Comm'n.*, 429 U.S. 318 (1977).

<sup>91</sup> *Id.*

law alleging that it unconstitutionally discriminated against interstate commerce by imposing a greater tax burden on securities transactions involving out-of-state sales than on transactions of the same magnitude involving in-state sales.<sup>92</sup>

The Court unanimously held that the discriminatory tax designed to favor New York was invalid.<sup>93</sup> Under the New York tax regime, the choice of exchange was not made based solely on the basis of nontax criteria. To wit, a seller could not escape tax liability by selling outside of New York, but could greatly reduce his tax liability by selling in the state of New York.<sup>94</sup> Because the New York law imposed a greater tax liability on out-of-state sales than on in-state sales, the law fell short of the “even handed treatment demanded by the Commerce clause.”<sup>95</sup> The court concluded that “in the process of competition no state may discriminatorily tax the products manufacture or the business operations performed in any other state.”<sup>96</sup>

Applying the line of reasoning in *Boston Stock Exchange*, Kentucky’s differential tax scheme would not have survived dormant Commerce Clause scrutiny. By its very nature, the law which exempts in-state bonds and taxes out-of-state bonds requires a Kentucky resident to make a decision based substantially on tax criteria. Thus, the criteria that should be at the center of a potential bond-purchaser’s consideration in electing a bond in which to invest—the interest rate and corresponding rate of return—are marginalized by the tax consequences on the Kentucky resident’s Kentucky State tax return. The practical effect of the differential tax scheme is that Kentucky is able to sell bonds with lower interest rates than out-of-state bonds, because the after-tax consequences to the buyer are more favorable under the Kentucky bond exempt status. Thus, the affirmation by the *Boston Exchange*

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<sup>92</sup> *Id.*

<sup>93</sup> *Id.* at 599.

<sup>94</sup> *Id.* at 607.

<sup>95</sup> *Id.* at 608.

<sup>96</sup> *Id.* at 599.

Court, that “in the process of competition no state may discriminatorily tax the products manufactured or the business operations performed in any other state,”<sup>97</sup> is turned on its head as Kentucky is able to impose a discriminatory tax on out-of-state bonds while exempting bonds issued by the Commonwealth.

**Bacchus Imports, Ltd. v. Dias.** As part of the Court’s rationale for holding that Kentucky’s differential tax scheme did not violate the dormant Commerce Clause, it claimed that Kentucky’s bonds do not compete with other state or local government bonds and therefore there is no discriminatory effect.<sup>98</sup> The case of *Bacchus Imports, Ltd. v. Dias*,<sup>99</sup> calls this assertion into question.

At issue in, *Bacchus*, was another discriminatory tax. The state of Hawaii imposed a 20% excise tax on sales of liquor at wholesale. In order to encourage the development of the Hawaiian liquor industry, the law exempted certain locally produced alcoholic beverages from the tax. Liquor wholesalers challenged the Constitutionality on, *inter alia*, grounds that it violated the Commerce Clause.<sup>100</sup>

In defense of the law, Hawaii argued that the exempted Hawaiian alcoholic beverages did not compete with the other products sold by the wholesalers.<sup>101</sup> Even the Hawaii Supreme Court concluded that the exempted products posed no competitive threat to other liquors elsewhere produced and consumed in Hawaii.<sup>102</sup> The Court found that there was at least some competition between the local Hawaiian liquors and those sold by the wholesalers.<sup>103</sup> The court went on to invalidate the Hawaiian

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<sup>97</sup> *Boston Stock Exchange*, 429 U.S. at 337.

<sup>98</sup> *Davis*, 233 U.S. at 1826.

<sup>99</sup> *Bacchus Imps. v. Dias*, 468 U.S. 263 (U.S. 1984).

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 269.

<sup>102</sup> *Id.* at 269.

<sup>103</sup> *Id.*

law holding that as long as there is some competition between the locally produced exempt products and nonexempt products from outside the State, there is a discriminatory effect.<sup>104</sup>

Justice Kennedy went on to refute the assertion made in the majority opinion that Kentucky's bonds do not compete with bonds from other state or municipal governments contending that the presence of competition is proved by the need to exempt the bond income from in the first place.<sup>105</sup> He also noted that nothing in *Bacchus* suggested its conclusion that the Hawaiian law violated the dormant Commerce Clause was based on the private nature of the local alcohol products it favored. Indeed, the court rejected the notion that the promotion of "local industry" was a valid exception to the Commerce Clause. It noted, contrary to the holding in *Davis*, and *United Haulers*, that the determination of constitutionality does not depend on the benefited or the burdened party.<sup>106</sup>

*Bacchus*, thus undercuts another rationale for the "government-entity" exception established in *United Haulers*, and relied upon in *Davis*. Kentucky is competing in the bond market with every other state and municipal bond issuer. A Kentucky resident in Louisville can purchase a Kentucky bond, or she can drive ten minutes north and buy an Indiana bond, or drive an hour-and-a-half northeast and buy an Ohio bond. Thus competition is much more prevalent here than it was in *Bacchus*. Yet in *Bacchus*, the limited amount of competition between local liquors and national liquor wholesalers was sufficient to warrant full dormant Commerce Clause scrutiny. On the same token, while the law was not designed to favor a state entity, the legislative history of the law indicated it was designed to spur local industry. The Court concluded that the status of the benefited or burdened party did not

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<sup>104</sup> *Id.* at 270.

<sup>105</sup> *Davis*, 233 U.S. at 1826 (Kennedy, J., Dissenting).

<sup>106</sup> *Bacchus*, 468 U.S. at 273.

determine the Constitutionality of the law.<sup>107</sup> Rather, the discriminatory effect on products outside the state from those within the state is the dispositive threshold question under the dormant Commerce Clause.<sup>108</sup>

Given the Court's reasoning, it would be difficult to argue that the *Bacchus* Court would have concluded that a state law did not violate the dormant Commerce Clause if, for example, the law was designed to favor a state-sponsored liquor store. Yet, the opinions in *Davis*, and *United Haulers*, would suggest that had the tax in *Bacchus* been levied on out-of-state liquor while in-state liquor purchased from state-run liquor stores remained tax exempt, such a law would be upheld under the "government-entity" exception to the dormant Commerce Clause. This inference demonstrates the dangerous precedent set by *United Haulers*, and *Davis*: that in the name of police power and acting in its traditional role as a protector of its citizenry, States may enact laws that flatly discriminate in favor of public entities, so long as they serve some sort of traditional government function designed to enhance the greater public good.

**Fulton Corp. v. Faulkner.** In *Fulton Corp. v. Faulkner*,<sup>109</sup> Justice Kennedy explained, that the Court had little difficulty in holding a discriminatory tax invalid.<sup>110</sup> In that case, North Carolina imposed an "intangibles" tax on the value of corporate stock owned by North Carolina residents. The deduction scheme under which the tax was calculated favored those who purchased stock in local companies, by, in effect, taxing at a higher rate those who owned stock in out-of-state companies.<sup>111</sup> The court found that the intangibles tax "violated the commerce clause in that the tax discriminated on its face against interstate commerce by taxing

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<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Fulton Corp. v. Faulkner*, 516 U.S. 325 (U.S. 1996).

<sup>110</sup> *Davis*, 233 U.S. at 1826 (Kennedy, J., Dissenting).

<sup>111</sup> *Fulton Corp.*, 516 U.S. at 327-328.

stock only to the extent that its issuing corporation participated in interstate commerce.”<sup>112</sup> This is another example of a discriminatory tax law not withstanding constitutional muster with respect to the Commerce Clause.

After citing the above discriminatory tax laws which were struck down for violating the Commerce Clause, Justice Kennedy expanded the analysis from tax cases to other regulations that violated the commerce clause by favoring local interests. Included in this line of cases was *C & A Carbone, Inc. v. Clarkstown*, the case with almost an identical fact pattern to the facts of *United Haulers*. Considering that the Court distinguished *United Haulers* from *Carbone* thus, creating the “government-entity” exception from the dormant Commerce Clause and that it was the “government-entity” exception established in *United Haulers* which served as the only rationale earning the support of a majority of the court for validating Kentucky’s differential tax scheme, further analysis of *Carbone* is warranted. Special attention will be given to the nature of the favored entity involved and whether it was public or private.

**C & A Carbone, Inc. v. Clarkstown.** An analysis of *Carbone* brings this article full circle in its dormant Commerce Clause analysis. The facts of *Carbone* are examined, *supra*, as well as the majority opinion and the dissent to the extent they were discussed in *United Haulers*. What is most pertinent for discussion now is the nature of the entity that benefited under the local ordinances in *Carbone*, relative to that which benefited under the local ordinance in *United Haulers*. That the two entities are distinguishable—the one in *Carbone*, being private, and the one in *United Haulers*, being public—is the foundation on which the government-entity exception was created in *United Haulers*, and which provided the sole rationale for finding for the Commonwealth of Kentucky in *Davis*.

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<sup>112</sup> *Id.*

The facts of *Carbone* are nearly identical to the facts in *United Haulers*. The issue before the court was the Constitutionality of a flow control ordinance which mandated that all solid waste be processed at a designated transfer station before leaving the municipality.<sup>113</sup> A local private contractor agreed to construct the facility and operate it for five years, after which the town would buy it for \$1.<sup>114</sup> During the course of the five years, the city promised the private contractor a minimum waste flow of 120,000 tons per year, for which the contractor could charge a tipping fee of \$81 per ton.<sup>115</sup>

A noteworthy aspect of this agreement was an indemnity provision under which, if the station received less than 120,000 tons of waste per year, the town would make up the tipping fee deficit to the general contractor.<sup>116</sup> The purpose of this provision was to amortize the cost of the transfer station.<sup>117</sup> Thus, the five year agreement was really a financing arrangement which allowed the city to “purchase” the facility over the course of five years, making yearly payments with funds earned in the course of managing waste-flow.<sup>118</sup>

So that the levels of waste flowing through the new transfer station exceeded 120,000 tons each year, thus, ensuring the town was able to make its “payment” to the private contractor in the form of tipping fees, the town enacted a flow control ordinance which required all nonhazardous solid waste within the town to be deposited at the transfer station.<sup>119</sup> Non-compliance with this ordinance was punishable by as much as a \$1,000 fine and up to 15 days in jail.<sup>120</sup>

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<sup>113</sup> *C & A Carbone*, 511 U.S. at 386.

<sup>114</sup> *Id.* at 387.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *See id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

C & A Carbone, Inc., along with other related companies and persons, operated a recycling plant in the town. They were required under the ordinance to bring nonrecyclable residue to the transfer station.<sup>121</sup> Carbone and similarly situated recycling plants were prohibited from shipping the nonrecyclable waste themselves out of the town, and by being required to take all nonrecyclable waste to the transfer station, were required under the ordinance to pay tipping fees on trash they had already sorted.<sup>122</sup>

In time, the town discovered that Carbone was shipping tractor-trailers of nonrecyclable waste to disposal sites in other states, thus violating the town's ordinance.<sup>123</sup> The town sued Carbone in state court seeking and eventually obtaining an injunction requiring Carbone to ship all nonrecyclable waste to the town's transfer station.<sup>124</sup> This decision was affirmed by the appellate level court.<sup>125</sup>

The Supreme Court reversed the state appellate court's decision and found that the ordinance violated the Commerce Clause of the Constitution.<sup>126</sup> The Court found that because the ordinance had the effect of hoarding solid waste, and the demand to get rid of it for the benefit of the transfer station, it was discriminatory and therefore unconstitutional.<sup>127</sup> In so doing, the Court cited a plethora of prior decisions holding that local processing requirements were invalid under the Commerce Clause.<sup>128</sup>

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<sup>121</sup> *Id.*

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at 391.

<sup>128</sup> *Id.* See *Minnesota v. Barber*, 136 U.S. 313, 34 L. Ed. 455, 10 S. Ct. 862 (1890) (striking down a Minnesota statute that required any meat sold within the State, whether originating within or without the State, to be examined by an inspector within the State); *Foster-Fountain Packing Co. v. Haydel*, 278 U.S. 1,

In his dissenting opinion Justice Souter, joined by Justices Rehnquist and Blackmun, argued that the majority ignored a crucial aspect of the town ordinance in *Carbone* which distinguished it from prior local processing regulations which had been held unconstitutional: namely that the ordinance “bestows no benefit on a class of local private actors, but instead directly aids the government in satisfying a traditional governmental responsibility.”<sup>129</sup>

Thus, in the view of Justice Souter, the majority overlooked the fact that the “one proprietor favored is essentially an agent of the municipal government, which . . . must ensure the removal of waste according to acceptable standards of public health.”<sup>130</sup> Thus, in Justice Souter’s view, the entity in *Carbone* was, in essence, a governmental entity, or at least a quasi-governmental entity, which was carrying out a governmental function. And as such, the ordinance favoring it should not have been subject to strict scrutiny under the Commerce Clause.

The majority had no response to Justice Souter’s assertion that the transfer station was really a “government-entity” carrying out a governmental function for the benefit of its citizens. The Court in *United Haulers*, as discussed *supra*, used this silence as a facilitator to distinguish the ordinance in *United Haulers* from the

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73 L. Ed. 147, 49 S. Ct. 1 (1928) (striking down a Louisiana statute that forbade shrimp to be exported unless the heads and hulls had first been removed within the State); *Johnson v. Haydel*, 278 U.S. 16, 73 L. Ed. 155, 49 S. Ct. 6 (1928) (striking down analogous Louisiana statute for oysters); *Toomer v. Witsell*, 334 U.S. 385, 92 L. Ed. 1460, 68 S. Ct. 1156 (1948) (striking down South Carolina statute that required shrimp fishermen to unload, pack, and stamp their catch before shipping it to another State); *Pike v. Bruce Church, Inc.*, *supra* (striking down Arizona statute that required all Arizona-grown cantaloupes to be packaged within the State prior to export); *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82, 81 L. Ed. 2d 71, 104 S. Ct. 2237 (1984) (striking down an Alaska regulation that required all Alaska timber to be processed within the State prior to export).

<sup>129</sup> *Id.* at 411 (Souter, J., dissenting).

<sup>130</sup> *Id.* at 416.

ordinance in *Carbone*, upholding the ordinance in *United Haulers*, and creating a new “government-entity” exception. The *United Haulers* Court implied from the silence of the majority in *Carbone*, that the entity in question there was private.<sup>131</sup> Indeed, it made this assumption without even the slightest concession that the matter was up for debate in the *Carbone* decision. But could not the majority’s silence in *Carbone*, just as easily have been used to reach the opposite conclusion: that the entity was clearly governmental in nature, just as Justice Souter so adamantly argued in his dissent, yet it does not matter, because the dormant Commerce Clause analysis does not hinge on the governmental nature of the entity and whether the interest it favors is governmental?

Even concluding, however, as the Court eventually did in *United Haulers*, that the dormant Commerce Clause applies a less strict standard of scrutiny to discriminatory laws favoring governmental interests, how distinguishable were the entities in *United Haulers* and *Carbone*? Before answering this question, it is worth noting that such a marginal distinction is what makes the dormant Commerce Clause such an unpredictable and difficult doctrine to apply. In the heartland of the Commerce Clause, analysis is generally predictable. However, on the fringes, the slightest of nuances can shift the Court’s analysis for or against an ordinance or law’s constitutionality. Thus, a prior Court decision in *Carbone* can be distinguished in *United Haulers* based on a marginal difference between the favored entities’ governmental or nongovernmental status.

In *United Haulers* the favored entity was the Oneida-Herkimer Solid Waste Management Authority.<sup>132</sup> It was created at the request of various counties in the State of New York by the New York Legislature and Governor, to more efficiently handle the

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<sup>131</sup> *United Haulers Ass'n v. Oneida-Herkimer Solid Waste Mgmt. Auth.*, 550 U.S. 330 (U.S. 2007).

<sup>132</sup> *Id.* at 336.

counties' solid waste disposal.<sup>133</sup> In *Carbone*, the favored entity was also created at the behest of a governmental entity—the town of Clarkstown, New York. After entering into an agreement with the New York State Department of Environmental Conservation, the town closed its publicly run landfill to build a new solid waste transfer station on the same site. The cost of new transfer station was \$1.4 million.<sup>134</sup> Rather than have the municipality shoulder the entire cost of the construction and management of the new facility, the city contracted with a private contractor to build and run the station for a period of five years. Under this agreement, the private contractor built the transfer station for free and, as compensation for building and running it, the private contractor was to receive the tip fees that period, after which time the City would purchase the station for \$1.<sup>135</sup>

Thus, allowing the private contractor to run the transfer station and collect tip fees was merely a component of an unorthodox financing agreement. A financing agreement which the Court noted, allowed the town of Clarkstown to “amortize the cost of the transfer station: The town . . . financed its new facility with the income generated by the tipping fees.”<sup>136</sup>

The private contractor's consideration for building the transfer station on behalf of the city was to be able to collect proceeds from it for a period of five years. From the standpoint of substance over form, the town of Clarkston really owned the entity, and hired the private contractor to build and run it, and subsequently compensated him with the tip fees collected. The substance of this transaction is even clearer when considered in light of the nominal consideration of \$1 for which the municipality was to “purchase” the transfer station from the private contractor at the end of the five years.

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<sup>133</sup> *Id.*

<sup>134</sup> *C & A Carbone*, 511 U.S. at 387.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

In his dissent in *United Haulers*, Justice Alito emphasized the governmental nature of the transfer station in *Carbone* and the lack of distinction between it and the entity created by Oneida-Herkimer Solid Waste Management Authority in *United Haulers*. He characterized the majority's assertion that the transfer station in *Carbone* was private as "misleading."<sup>137</sup> He also argued that the majority's assertion in *United Haulers*, that the majority in *Carbone*, was silent as to whether the entity was public or private was incorrect. To support this, he cited an observation of the majority in *Carbone*, which described the financing arrangement between the town and the private contractor under which, [t]he town would finance *its new facility* with the income generated by the tipping fees."<sup>138</sup>

According to Justice Alito, the majority in *Carbone*, considered the transfer station to be a public entity belonging to the town of Clarkstown and therefore the facts of *United Haulers* are identical to the facts of *Carbone*. Thus, the ordinance upheld in *United Haulers* should not have survived constitutional scrutiny under *Carbone*.

The majority in *United Haulers*, however, disagreed and found the two entities were distinguishable—one being private and the other being public. On a thorough examination of the facts though, any honest distinction between the facility in *Carbone*, and the facility in *United Haulers*, is razor thin. Again, this razor thin marginal difference demonstrates the Commerce Clause's uncertain parameters outside of the heartland and how two nearly identical fact patterns can produce different results based on a the slightest of nuances.

Therefore, it was on the slightest of nuances that *United Haulers*, was distinguished from *Carbone*, and the "government-entity" exception was created. The Court in *Davis*, relied exclusively on the "government-entity" exception in upholding

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<sup>137</sup> *United Haulers*, 550 U.S. at 358 (Alito, J., Dissenting).

<sup>138</sup> *Id.* (citing *C & A Carbone*, 511 U.S. at 393 (majority)).

Kentucky's differential bond scheme. Thus, but for the Court in *United Haulers*, being able to distinguish the entity at issue there from the entity at issue in *Carbone*, it is uncertain, as will be examined in the next section, how the Court would have come out in *Davis*.

### **Market Participant Exception and the “government-entity” Exception**

Justice Souter included an analysis of the market participant exception to the Dormant Commerce Clause in the majority opinion of *Davis*, in addition to the “government-entity” exception, to justify finding Kentucky's differential tax scheme constitutional. This section of the opinion, however, did not earn the vote of a majority of the court. As examined, *supra*, the market participant exception allows a discriminatory state law to survive the strict scrutiny of the dormant commerce clause, on the grounds that a state is permitted to favor its own citizens in receiving benefits from government programs or in dealing with government-owned businesses.<sup>139</sup>

Applying this doctrine, Justice Souter found that the differential tax scheme made sense “only because Kentucky is also a bond issuer.”<sup>140</sup> As such, it is proper to “disaggregate” Kentucky, the regulating state, and Kentucky, the bond issuing market participant.<sup>141</sup> Thus, the state is deemed to have two roles and we “pretend that in exempting the income from its securities, Kentucky is independently regulating or regulating in the garden variety way that has made a State vulnerable to the dormant Commerce Clause.”<sup>142</sup> But when Kentucky exempts its bond interest, it is competing in the market for limited investment dollars, alongside private bond issuers and its sister States, and its

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<sup>139</sup> *Id.* at 451.

<sup>140</sup> *Davis*, 233 U.S. at 1812.

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

tax structure is one of the tools of competition.<sup>143</sup> Thus, the differential tax scheme falls outside the purview of the dormant Commerce Clause because its direct participation favors, “not local private entrepreneurs, but the Commonwealth and local governments.”<sup>144</sup>

It is unclear why the market participant exception earned only a plurality of the vote of the Court. Perhaps some found the *United Haulers* government-entity exception dispositive and therefore there was no need to even consider the market-participant doctrine. Others, however, may have found that it flatly did not apply on these facts. Assuming a sufficient number of members of the court adhered to the latter rationale, it is interesting to question how the court would have come out if *United Haulers*’ “government-entity” exception were not there in *Davis* to command a majority of the court.

It is also compelling to examine the underlying rationales of the market participant doctrine, compared to the rationales of the newly created government-entity exception in *United Haulers*, which was alluded to, *supra*. On the one hand, a state falls under the market participant exception where it assumes a dual role of both market participant and regulator. To the extent its regulation favors the State and not local private interests, the state law is excepted from the dormant commerce clause. Thus, the dormant commerce clause does not apply as a state acts like a business.

It is odd, and somewhat contradictory, that the “government-entity” exception was created on almost the exact opposite rationale. That is, the “government-entity” exception exists because states are so unlike businesses. The Court in *United Haulers*, declared:

“States and municipalities are not private businesses--far from it. Unlike private enterprise,

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<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at 1814.

government is vested with the responsibility of protecting the health, safety, and welfare of its citizens. The states traditionally have had great latitude under their police powers to legislate as to the protection of the lives, limbs, health, comfort, and quiet of all persons. These important responsibilities set state and local government apart from a typical private business. Given these differences, it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism.”<sup>145</sup>

Given these incongruous rationales—which would appear to allow the Court to have its cake (the dormant Commerce Clause does not apply to discriminatory state laws which favor the state as a participant in the market) and eat it too (the dormant Commerce Clause does not apply to discriminatory state laws which favor the state in the fulfilling of its governmental obligations)—it is difficult to surmise a discriminatory law that favors the state, under which the strict scrutiny of the dormant Commerce Clause would apply, so long as all others are left on equal footing. Of course this will depend on how broadly the “government-entity” exception is construed in future cases.

But conceivably, a state will either be excepted under the market participant exception because it is so much like a business, or it will be excepted under the “government-entity” exception because it so unlike a business and is a government protecting the welfare of its people. Thus, it would appear that a *de facto* safe harbor has been developed for state laws that do not favor private parties. So long as the sole benefactor is the state, it can discriminate with its laws either because it is acting as a business, or because it is not acting as a business, but as a state.

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<sup>145</sup> *United Haulers*, 550 U.S. at 343.

### **JUDICIAL PHILOSOPHY AND THE OUTCOME IN *DAVIS***

Whether the distinction was proper or not, it was certainly marginal between the entities in *Carbone* and *United Haulers*. Yet perhaps more was at play than simply trying to decide how public the entity in *United Haulers* was, and how private the entity in *Carbone* was.

Certainly a finding that the two entities were distinguishable allowed the court to reach a different conclusion in *United Haulers*, based on practically identical facts in *Carbone*. But this finding also may have been a product of the judicial philosophy of the court with respect to the dormant Commerce Clause in 2007 compared to its philosophy in 1994. The following quote from *United Haulers*, appears to indicate the Court's post-*United Haulers* philosophical interpretation of the dormant Commerce Clause in the context of a discriminatory law favoring a governmental entity.

“ . . . [T]reating public and private entities the same under the dormant Commerce Clause would lead to unprecedented and unbounded interference by the courts with state and local government. The dormant Commerce Clause is not a roving license for federal courts to decide what activities are appropriate for state and local government to undertake, and what activities must be the province of private market competition.”

Thus the *United Haulers* Court was concerned with the notion of federalism and its interplay with the dormant Commerce Clause—in essence seeking to reign in the Commerce Clause's use as a means of impeding States from enacting laws.

On the contrary, the Court's philosophy regarding the dormant Commerce Clause in 1994 seemed to be without regard to the effects the dormant Commerce Clause might have on the individual States' power—much more of a free-market line of

analysis. The Court in *Carbone* simply applied the dormant Commerce Clause jurisprudence, without consideration as to the public or private nature of the entity that benefited under the discriminatory law. Indeed, this seems to be the proper explanation for the *Carbone* Court's silence with respect to the public or private nature of the entity there: it simply did not matter. The Court seemed to imply that the Commerce Clause jurisprudence has been established and must be applied accordingly, regardless of its public or private nature.

### **The Impact of an Alternative Decision**

Without regard to the Court's philosophy with respect to federalism and free markets, there is no question that a finding that Kentucky's differential bond scheme was unconstitutional would have substantially impacted the bond market. The municipal bond market is valued at \$2 trillion and serves as a primary revenue generator for most states.<sup>146</sup>

Consequently, states were monitoring closely the outcome of *Davis*, as the great majority of them have differential tax schemes similar to Kentucky's. Among those expressing apprehension at the prospect of the Court upholding the Kentucky Court of Appeals' decision was Joel Michael, a legislative analyst at Research Department of the Minnesota House of Representatives.

Mr. Michael commentated that taking away the States' ability to exempt from state taxable income interest paid on its own bonds would nationalize the municipal bond market.<sup>147</sup> As a direct effect of the differential bond scheme employed by most states, most in-state investors purchase in-state bonds and have large in-state bond holdings.<sup>148</sup> According to Mr. Michael, this trend is

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<sup>146</sup> Michael, "Kentucky v. Davis: Implications for State Tax Policy and Dormant Commerce Clause Doctrine," *State Tax Notes*, Sept. 4, 2007 p. 754.

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 755.

consistent throughout the states, without regard to their size or relative presence in the national financial market.<sup>149</sup>

Thus, had the *Davis* Court struck down Kentucky's differential tax scheme as a violation of the dormant Commerce Clause, the states would have been forced to either exempt interest on all bonds, without respect to the state by which they were issued, or to tax them in a way that does not discriminate based on the issuer's state.<sup>150</sup> Although Mr. Michael thought this effect may be better for the states in the long-run and lead to the development of more efficient means of generating revenue, there is no question that the states' most competitive advantage with respect to its own residents as potential bond customers would be completely eliminated.

States would all be operating on the same playing field—a national playing field. Investors would be making decisions to purchase bonds with respect to which state bonds' offered the highest yields, not the potential tax benefit from choosing in-state over out-of-state bonds.

From a tax policy standpoint, this is the epitome of tax efficiency and free-market functionality: tax consequences are completely removed from the equation and the investors make their decisions based on purely economic consequences. If all states were identical, operating under the same financial constraints, serving the same number of citizens, perhaps this outcome would be ideal. This is not the case though. Smaller states are competing against larger states with drastically different budgets and potential revenue streams. Disallowing the states the ability to sweeten the deal for its own residents could have conceivably crippled a state's bond market, forcing it to rely on other revenue generators, most likely raising state taxes and fees.

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<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 756.

### **An Ends-Driven Analysis**

The facts in *Davis* provided an example of perhaps what the Court did not want to do under the dormant Commerce Clause. The Davises were asking the court to strike down a system employed by 41 different states for the past century. In spite of the precedent prior to *United Haulers* indicating that the scheme was likely unconstitutional, the court held true to its affirmation of Federalism in *United Haulers*, and refused to grant itself a license to decide whether one of the states' more significant revenue generators—municipal bonds—was unconstitutional. Perhaps the true exception here is not the “government-entity” exception. The “government-entity” exception, at least in the context of *Davis*, may have been just a means to the true exception that the current Court is unwilling to use the dormant Commerce Clause as a tool to upend a century-old system relied upon by a majority of the states to generate revenue. Thus, as a matter of judicial philosophy, in very much an ends-driven analysis, after considering the ramifications of finding Kentucky's differential tax scheme unconstitutional would have had on the national bond market as whole, and on the individual states, the Court simply found a way in *Davis*, by means of the *United Haulers* “government-entity” exception, to reach the right practical outcome. Consequently, however, an out-come based decision was generated which created a judicial doctrine which contradicts years of prior precedent and goes directly against the free-market tenets the Commerce Clause was designed to protect.

### **CONCLUSION**

So where does the dormant Commerce Clause stand after *United Haulers* and *Davis*? As a result of these decisions and the creation of the government-entity exception, the dormant Commerce Clause has now had its teeth nearly completely extracted as it relates to laws which discriminate in favor of the states and leave all private parties on the same level. Federalism, at least in this context, has trumped the benefit of having a free-

market. From a practitioner's view, the chances of prevailing under the Commerce Clause in challenging a state law which discriminates in favor of the state, but keeps all others on level footing are between slim and none. The state now, seemingly, is protected from all angles of attack. If the state is acting in its capacity as a governmental entity, it can discriminate in its own favor. At the same time, if the state is acting without its state power and as a member of a market, it can also discriminate in its own favor. As such, state laws are now nearly completely immune from attacks under the dormant Commerce Clause with respect to laws which discriminate in favor of the states.

This result from *United Haulers*—complete immunity from dormant Commerce Clause scrutiny for the states so long as they discriminate in their own behalf and keep others on a level playing field—is not the result that precedent, from *Carbone*, back through decades of commerce clause jurisprudence, required. Applying precedent, the Court in *United Haulers*, should have been bound by the precedent in *Carbone*, and the government-entity exception should never have been conceived.

Had the government-entity exception never been conceived, the Court in *Davis*, applying the precedent available to it, would have either been required to uphold the Kentucky Court of Appeals, or shoe-horn the case into the Market Participant exception. Since a majority of the court was unwilling to support Justice Souter's exposition on the Market Participant exception in *Davis*, it is very much unclear how the Court would have ruled. Had the Court been true to the precedent discussed, *supra*, it most certainly would have struck down Kentucky's differential tax scheme as a violation of the dormant Commerce Clause.

As it stands, however, based on a razor thin, if not improper distinction of the two entities in *Carbone*, and *United Haulers*, the Court had the government-entity exception to fall back on, and how the court would have upheld Commonwealth of Kentucky's differential tax bond scheme in its absence will remain a mystery.