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# OFFICIAL TRANSCRIPT PROCEEDINGS BEFORE

THE SUPREME COURT OF THE UNITED STATES

**DKT/CASE NO.** 83-832

**TITLE** HAROLD T. PAULSEN, ET UX., Petitioners v. COMMISSIONER OF INTERNAL REVENUE

**PLACE** Washington, D. C.

**DATE** October 29, 1984

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1 IN THE SUPREME COURT OF THE UNITED STATES

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3 HAROLD T. PAULSEN, ET UX., :
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4 Petitioners :
:
5 v. : No. 83-832
:
6 COMMISSIONER OF INTERNAL REVENUE :
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7 - - - - - - - - - - - - - - - - - - - - - -x

8 Washington, D.C.

9 Monday, October 29, 1984

10 The above-entitled matter came on for oral

11 argument before the Supreme Court of the United States

12 at 11:54 a.m.

13 APPEARANCES:

14 WILLIAM R. NICHOLAS, Esq., Los Angeles, California; on behalf of the Petitioners.

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16 ALBERT G. LAUBER, JR., Esq., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of the Respondent.

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1 P R O C E E D I N G S

2 CHIEF JUSTICE BURGER: Mr. Nicholas, you may

3 proceed whenever you're ready.

4 ORAL ARGUMENT OF WILLIAM R. NICHOLAS, ESQ.,

5 ON BEHALF OF THE PETITIONERS

6 MR. NICHOLAS: Mr. Chief Justice, and may it

7 please the Court:

8 The issue for decision here today is whether

9 the owner of a share account in a federal mutual savings

10 and loan associations chartered by the federal

11 government has a proprietary interest in that

12 association. And the issue arises because of the merger

13 of Commerce Savings and Loan Association, which was a

14 guaranteed stock-type savings and loan association

15 organized under the laws of the State of Washington. It

16 merged with and into Citizens Federal Savings and Loan

17 Association, which was a federal stock -- nonstock-type

18 mutual savings and loan association which was owned

19 exclusively by the share account owners in the

20 association.

21 In the transaction, which qualified as a

22 merger under state law, the assets and liabilities of

23 Commerce were transferred to and merged with the assets

24 and liabilities of Citizens Federal. Citizens Federal

25 was the surviving corporation in the merger, and in


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1 accordance with the terms of the merger agreement,
2 Commerce went out of existence. However, Citizens
3 continued on carrying on the business -- that of loaning
4 money -- that it had done prior to the merger, and also
5 carried on the business that had been carried on by
6 Commerce prior to the merger.
7 The shareholders of Commerce, including the
8 Paulsens, who are the petitioners in this case,
9 exchanged their stock in Commerce for share accounts in
10 the mutual savings and loan association. The mutual
11 association has only one form of equity, and that is the
12 share memberships in its association, and that is what
13 was transferred to the Paulsens in this case. And they
14 were represented by passbook and certificate accounts in
15 Citizens Federal. Thus, after the merger, the business
16 of the two associations were carried on by one
17 organization, and the owners of the two associations
18 prior to the merger were the same owners of the merged
19 association at the completion of the transaction.
20 The two associations and the petitioners in
21 this case treated the merger as a tax-free
22 reorganization under the applicable provisions of the
23 Internal Revenue Code. Therefore, no gain was
24 recognized by Commerce on the transfer of its assets to
25 Citizens Federal, and no gain was recognized by the


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1 Paulsens on the transfer of their guaranteed stock in
2 Commerce in exchange for the share accounts in Citizens
3 Federal.
4 The reorganization provisions of the Internal
5 Revenue Code defer the recognition of gain on the
6 transaction that qualifies as a reorganization. Thus,
7 until such time as Citizens Federal sold the assets
8 which it acquired in the merger, it would not have any
9 gain on the transaction, and until such time as the
10 Paulsens liquidated their investment in Citizens
11 Federal, they would not recognize any gain on the
12 transaction.
13 QUESTION: Would there be any justification on
14 that latter point for taking the position that as soon
15 as the time expired so that the Paulsens could withdraw
16 the funds from the saving account that it would become
17 taxable, as opposed to when they actually withdraw?
18 MR. NICHOLAS: Yes. I don't think so, Your
19 Honor, because the withdrawal of the savings account or
20 what are termed savings account causes a loss of the
21 rights that are conferred upon the Paulsens by the
22 mutual savings and loan association; so that at the time
23 they withdraw, then they lose the right to share in any
24 further profits of the savings and loan association, and
25 they lose the right to vote and the right to share in

1 any proceeds upon the termination or liquidation of the
2 mutual association.
3 The respondent asserted a deficiency against
4 the petitioners, claiming that there was no
5 reorganization, and therefore that gain had to be
6 recognized by the Paulsens on the difference between
7 their basis in the shares of the guarantee stock
8 association which they exchanged for the passbook
9 accounts in Citizens Federal.
10 The case was taken to the tax court, and the
11 tax court agreed with the petitioners and held that the
12 merger of Commerce into Citizens was a reorganization
13 under the Internal Revenue Code, and any gain that the
14 Paulsens might have recognized would be deferred.
15 The tax court in analyzing the transaction --
16 QUESTION: Was that a decision of a single
17 judge, or was it reviewed by the court?
18 MR. NICHOLAS: It was the decision of a single
19 judge, Your Honor. Judge Featherstone made the decision.
20 The transaction the tax court analyzed met the
21 statutory requirements set forth in the Code, and under
22 the applicable provisions, a merger is included within
23 the definition of a reorganization under Section 368.
24 And turning to Section 7701 of the Code, which provides
25 the general definitions for application throughout the


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1 Code, the following terms are included.

2 Corporation includes association. Stock

3 includes shares in an association. And shareholder

4 includes members in an association. Thus, Commerce

5 transferred property to Citizens Federal, a mutual

6 association which under the terms of the Internal

7 Revenue Code is a corporation; and therefore, no gain

8 was recognized under Section 361 of the Code. Likewise,

9 the petitioners exchanged stock in Commerce for passbook

10 accounts in Citizens Federal, but under the definitions

11 in the Code, those passbook accounts are shares and

12 included in stock, and therefore would meet the

13 requirements of the Code.

14 CHIEF JUSTICE BURGER: We'll resume there at

15 1:00.

16 (Whereupon, at 12:00 p.m., the hearing in the

17 above-entitled matter was recessed for lunch, to be

18 reconvened at 1:00 p.m., the same day.)

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AFTERNOON SESSION

CHIEF JUSTICE BURGER: Mr. Nicholas, you may resume.

ORAL ARGUMENT OF WILLIAM R. NICHOLAS, ESQ.,

ON BEHALF OF THE PETITIONERS -- Resumed

MR. NICHOLAS: Mr. Chief Justice, and may it please the Court:

In connection with the reorganization, the petitioners, the Paulsens, in this case transferred their stock in Commerce for share accounts in the Citizens. Under Section 7701, those share accounts are treated as stock, and therefore, there was an exchange of stock for stock, and no gain is recognized under Section 354 of the Code. However, in addition to the statutory language, it was necessary to meet certain judicially imposed requirements in order for there to be a reorganization, and those judicially imposed requirements make sure that the spirit of the law is carried out as well as the letter.

One of those tests is the continuity of proprietary interest test which distinguishes between pure sales of assets and those where the seller has a continuing proprietary interest in the transferee. Thus, the owners of the acquired entity, Commerce, must have a continuing proprietary interest in the


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1 reorganized enterprise which is Citizens Federal.

2 It is this test that the petition -- that the

3 respondent in this case claims that the petitioners did

4 not meet. This Court, in a series of landmark decisions

5 nearly 50 years ago, defined what satisfies the

6 continuity of proprietary interest test, and these cases

7 are still used by the financial community today in

8 determining when a reorganization exists.

9 In Letulle v. Scofield there was a transfer of

10 assets for cash and notes, and the Court held that did

11 not satisfy the continuity of interest test, because the

12 only relationship the person transferring the assets to

13 the continuing corporation had was that of a debtor.

14 Likewise, in Pinellas Ice & Cold Storage Company, there

15 was a transfer of assets for cash and serial bonds which

16 were secured by the assets which were transferred. This

17 Court there held that there was not a sufficient equity

18 interest in the transferee corporation because there

19 still was only a debtor-creditor relationship.

20 However, in Minnesota Tea v. Helvering, the

21 receipt of voting trust certificates by this Court was

22 held to satisfy the proprietary interest, and thus, a

23 reorganization was allowed. In the Minnesota Tea case,

24 the respondent argued that the petitioner in that case

25 had given up common stock and only received back voting


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1 certificates, and therefore, there wasn't a good
2 reorganization. But the Court pointed out that the
3 statute does not require a transferor to receive back
4 the same equity interest that it gave up, as long as it
5 has an equity interest in the continuing operation.
6 And likewise, on the same day this Court in
7 John A. Nelson Company v. Helvering held that where a
8 petitioner had transferred common -- petitioner who had
9 common stock and ended up with preferred stock which was
10 nonvoting, redeemable, that there was a sufficient
11 continuity of proprietary interest in the corporation
12 which went on that there was a reorganization.
13 Thus, it is clear from these tests that an
14 equity interest satisfies the continuity of interest
15 test, and it must not be necessarily the same interest,
16 equity interest which was given up as that received.
17 Debt, however, will not satisfy the test. Therefore,
18 the question comes down to the point of whether the
19 interest received by the Paulsens in this case was an
20 equity interest in the continuing corporation which was
21 a Citizens -- which was Citizens Federal, which was a
22 federal mutual savings and loan association. If the
23 continuity of interest test is not met, the
24 reorganization fails, and it is not tax-free either at
25 the corporate level or at the shareholder level.

1 The tax court examined the nature of the
2 interest received in this case by the petitioners and
3 held that the petitioners had received an equity
4 interest, not debt, that satisfied the continuity of
5 interest test.
6 The tax court, in holding there was a
7 reorganization, recognized the congressional intent to
8 broadly apply the reorganization sections to encourage
9 combinations of corporations. Looking at the Senate
10 Finance Committee report accompanying the 1954 Act, it
11 shows that the Senate had rejected a narrow definition
12 of the term "stock" and instead intended to rely on the
13 term as accepted by the commercial community, and in
14 particular under Section 7701 of the Code which provides
15 the general definition.
16 It also looked back to the original Income Act
17 of 1921 and there found that Congress sought to
18 encourage combinations in reorganizations by allowing
19 shareholders to receive interest in the ongoing
20 corporation which had a readily realizable market
21 value. But so long as the transferring shareholder kept
22 his money invested in that ongoing corporation and did
23 not withdraw it, there was a valid reorganization.
24 The position of the respondent in this case is
25 contrary both to the reorganization provisions and


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1 certainly to the protection and encouragement of savings
2 and loan associations which Congress has sought to
3 encourage over the years. By changing his position in
4 1969, the respondent has discriminated against mutual
5 savings and loan associations by not allowing them to be
6 a party to a reorganization where a stock savings and
7 loan association is merged into a mutual savings and
8 loan association.
9 If reorganizations like this are not allowed,
10 it has a harmful effect on the savings and loan
11 industry, and, for instance, in this case if the
12 reorganization is taxable at the corporate level and at
13 the shareholder level, it takes away those funds which
14 have been invested by the shareholders in a mutual
15 savings and loan association and withdraws them from the
16 market which makes available to homeowners mortgage
17 loans.
18 The Ninth Circuit below reversed the tax court
19 and found that the interest received by the Paulsens in
20 this case constituted debt rather than a proprietary
21 interest. In doing so, the Ninth Circuit departed from
22 an unbroken line of cases that had previously examined
23 the issue. The court of claims in Capital Savings and
24 Loan Association held that such an interest was an
25 equity proprietary interest. The Sixth Circuit in the


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1 West Side Federal also held that such an interest was a
2 proprietary interest. And in Everett v. the United
3 States, the Tenth Circuit found not only was it
4 proprietary interest, but it constituted voting stock
5 under the more narrow definition as that term is used in
6 the so-called C reorganization under the Internal
7 Revenue Code.

8 The tax court, of course, in Paulsen had
9 reached the same result, and also in the subsequent case
10 of Owens had found that there was a valid
11 reorganization. Also, two district courts have held
12 that there had been a reorganization on the same facts
13 -- district courts in Wyoming and in the Northern
14 District of Ohio.

15 Also, the Ninth Circuit in the decision below
16 ignored the cases decided by this Court which had
17 examined the legal characteristics and the rights and
18 obligations of a shareholder in a mutual saving and loan
19 association. And lastly, the Ninth Circuit misapplied
20 the continuity of proprietary interest test set forth by
21 this test in Minnesota Tea and John A. Nelson when it
22 sought to compare the equity interest which the Paulsens
23 received with the equity interest which they exchanged
24 for their interest in Citizens Federal.

25 This Court is certainly no stranger to the


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1 legal character of share accounts in a mutual savings
2 and loan association. In 1967 in Tcherepnin v. Knight,
3 the issue was whether the owner of withdrawable share
4 accounts in a savings and loan association could bring
5 an action under the Securities and Exchange Act of 1934,
6 a so-called 10(b)(5) action.
7 There, the court of appeals, like the Ninth
8 Circuit and this Court, had found that the relationship
9 of the owner of the share accounts was more like a
10 debtor-creditor relationship than that of a
11 stockbroker. This Court, however, reversed that holding
12 and said that forms should be disregarded in substance
13 -- for substance, and emphasis should be placed on
14 economic reality.
15 It noted that in a mutual savings and loan
16 association, the petitioners, the investors in the
17 association were engaged in a common enterprise: that
18 of lending money. And they relied on the skill and
19 efforts of the management for return on their
20 investment; for if there are no earnings and profits in
21 the savings and loan association, there can be no
22 dividends paid.
23 The Court found in reaching that -- in making
24 its determination that the following factors were
25 present, and these factors are present in this case.

1 The share accounts carry with them a right to vote. The
2 shares represented all of the equity of the
3 association. The right to withdraw as a shareholder was
4 subject to certain conditions, and the application to
5 withdraw did not automatically make the withdrawing
6 shareholder a creditor of the association.
7 QUESTION: Mr. Nicholas.
8 MR. NICHOLAS: Yes.
9 QUESTION: Do you draw any distinction at all
10 between the certificates of deposit, on the one hand,
11 and the passbook savings account on the other?
12 MR. NICHOLAS: No, I do not, Your Honor. The
13 rights which are given to the holder of the certificate
14 in this particular case are exactly the same as those on
15 the passbook accounts.
16 QUESTION: If you prevail here, how is the
17 gain taxed?
18 MR. NICHOLAS: When the share account holder
19 withdraws the money from the association -- in other
20 words, takes out his investment -- then he must pay the
21 tax.
22 QUESTION: As a practical matter, how is that
23 enforceable?
24 MR. NICHOLAS: Well, I think that particularly
25 in these types of mergers, Your Honor, usually these

1 accounts are segregated, and of course, since it is a
2 reorganization, the organizations must file the
3 necessary information with the Commissioner under the
4 regulations under Section 368 that would tell that there
5 has been a reorganization.
6 QUESTION: But it certainly is unusual to --
7 when money cash is drawn out of say a passbook savings
8 account, to have gain realized thereby. I'm just
9 wondering how the Commissioner ever would -- would
10 enforce it if a taxpayer overlooked including it.
11 MR. NICHOLAS: I don't believe that that
12 really is an administrative problem, Your Honor. I
13 think that there are certainly ways to enforce that, and
14 it is certainly no more difficult than a share of stock
15 where one must keep track of his basis in that stock,
16 and the stock might split, or there are going to be
17 stock dividends, all of which affect the basis, and when
18 that stock is ultimately sold, the gain reported. It is
19 a self-assessment system, and --
20 QUESTION: Well, there is some -- there is
21 some difference. Certainly with stock one has a stock
22 certificate, and it has to be turned in. But with just
23 a savings account, a passbook savings account, your
24 client draws out $100, there's no other certificate or
25 title that gets passed the way there is with a stock


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1 certificate.

2 I realize the Solicitor General makes no point

3 of this. He merely mentions it as a -- with a passing

4 reference. But I'm a little concerned about the

5 practicalities of it, I guess.

6 MR. NICHOLAS: I think, Your Honor, as a

7 practical matter certainly the mergers that we have been

8 involved with when the decision has been made to

9 withdraw the accounts by the parties involved, the tax

10 has always been paid, and in particularly in these types

11 of situations where these accounts are segregated and

12 marked as exchange accounts. They are not the normal

13 type accounts in --

14 QUESTION: Well, it says between the bank,

15 though, and the -- and the account holder it is. He can

16 draw it out any time he wants to.

17 MR. NICHOLAS: Well, remember that in these

18 reorganizations, Justice White, first those accounts

19 could not be withdrawn for one year.

20 QUESTION: Yes.

21 MR. NICHOLAS: And so they were segregated in

22 that manner so that --

23 QUESTION: But after that he can draw it out

24 any time he wants.

25 MR. NICHOLAS: That is correct. He could go

1 in and --

2 QUESTION: You would know how much gain there

3 is, wouldn't you?

4 MR. NICHOLAS: Yes.

5 QUESTION: And in advance. So the first

6 dollar you draw out, is that all gain or just part?

7 MR. NICHOLAS: I think the basis would be

8 allocated over the full amount in each portion of --

9 QUESTION: So for every $100 there would be X

10 dollars.

11 MR. NICHOLAS: Yes, Your Honor.

12 QUESTION: And if he draws out $100 and then

13 he deposits $200 --

14 MR. NICHOLAS: Well, I think --

15 QUESTION: And then -- and it becomes an

16 active account, how would you ever know?

17 MR. NICHOLAS: I think from a practical

18 standpoint, Your Honor, that if he wanted to put any

19 additional money into a passbook savings account, he

20 would have to open a new account so that this could be

21 kept segregated.

22 QUESTION: Would that be a Treasury regulation

23 or what?

24 MR. NICHOLAS: Oh, I think -- I'm sure the

25 Commissioner has the authority to issue regulations that


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1 would cover this situation, and there would be no loss
2 to the FISC.
3 QUESTION: Well, suppose it doesn't? It
4 certainly is unusual to have basis in cash less than
5 face value, isn't it?
6 MR. NICHOLAS: Well, I don't think there is
7 basis in cash, Your Honor, and -- and I think that what
8 a passbook account holder has is an interest in that
9 savings and loan association. It is not the equivalent
10 of cash, and you can't take it out and buy a television
11 set with it. He has invested his money in that mutual
12 association, and if he wants to get out, he has to go
13 down and withdraw from that association and give up
14 rights connected with -- it is not a debtor-creditor
15 relationship such as with a bank.
16 QUESTION: When does he give up -- at what
17 stage does he give up those rights? Not until the last
18 dollar, does he?
19 MR. NICHOLAS: Well, his rights go down as he
20 withdraws your $100 -- the rights that he has are to
21 participate in the earnings of the -- of the
22 association, so that if he has $100, his rights are less
23 than if he has $1,000. So that as he withdraws, his
24 rights go down proportionally just as with all the other
25 share account holders in the association, relative


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1 rights in the association.

2 QUESTION: Do you think those additional

3 rights -- say he has a $100,000 account -- do you think

4 those additional rights make that account worth more

5 than $100,000?

6 MR. NICHOLAS: Oh, yes, they do. I -- I don't

7 think there's any question about it. At least in the

8 litigated cases it shows that mutual associations do

9 have a residual value. Even the respondent's own

10 regulations or published rulings show that in certain

11 situations --

12 QUESTION: Well, could he sell the account to

13 a third party for more than $100,000?

14 MR. NICHOLAS: Probably not, Your Honor.

15 QUESTION: If it had market value, I don't

16 know why not.

17 MR. NICHOLAS: Well, I think that perhaps in

18 certain circumstances that does exist, and there is a

19 much litigated case, the Federal Home Loan Bank Board v.

20 Elliot which involved a Long Beach savings and loan

21 association, and when it was going to liquidate and

22 there was a substantial surplus, there was a sudden

23 influx of large depositors. The Federal Home Loan Bank

24 Board felt that the board of directors of the company

25 was not stepping in fast enough. It came in and


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1 prohibited those large depositors from sharing in the
2 proceeds upon the liquidation, although it actually
3 subsequently changed to a -- a merger with a guaranteed
4 stock type association. But they were not allowed --
5 the Federal Home Loan Bank Board cut off as a certain
6 date the right to share in that -- in the residual
7 assets of the association when it was subsequently
8 merged into a stock-type association to prevent, in
9 effect, insider training, which is what happened in the
10 Elliot case.
11 Thus, in -- in Tcherepnin, even without the
12 guidance of a definition in the Securities and Exchange
13 Act such as there is in the Internal Revenue Code that
14 the shares do represent stock, this Court held that the
15 share account holder could bring an action under
16 10(b)(5) and that such shares were stock.
17 The respondent seeks to characterize, and the
18 Ninth Circuit unfortunately agreed, that the
19 petitioners' relationship to Citizens is that of a
20 depositor in a bank. However, as recently as 1982 this
21 Court rejected by that analogy in Marine Bank v. Weaver,
22 and in that case a depositor in a bank sought protection
23 under Section 10(b) of the Securities and Exchange Act
24 of 1934, and cited as precedent Tcherepnin. In that
25 case this Court pointed out that Tcherepnin was a

1 different situation. There, there was a mutual savings
2 and loan association, and the share accounts carried
3 with it the right to dividends based on profit, voting
4 rights, and it was a stock situation, not a
5 debtor-creditor relationship such as with a bank.
6 Other courts have also looked at the
7 relationship of a stock or a share account holder in a
8 savings and loan association. In Wisconsin Bankers,
9 decided by the D.C. circuit in 1961, an action was
10 brought by an association of bankers who claimed that
11 savings and loan associations were competing unfairly
12 with banks because they allowed the share account
13 holders to deposit money on what were called savings
14 accounts. However, the court said that they were more
15 concerned with the legal realities and not the
16 appearances, and even though these were called savings
17 accounts, they were really share accounts since the
18 represented the capital of the association, and
19 therefore, they were not violating or competing
20 illegally with the banks.
21 The Ninth Circuit in its opinion below did not
22 discuss one of these cases. However -- and dismissed in
23 its decision the right to vote as having no value. It,
24 directly contrary to the decisions and the discussion
25 relating to the cases in Tcherepnin, it said that the


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1 dividend payments were precisely like interest and not
2 distinguishable, and that the right to share
3 proportionally in the residual value of the association
4 had no value.
5 We believe that these points are all -- the
6 Ninth Circuit was mistaken on each one of those points.
7 The Ninth Circuit also misapplied the
8 continuity of interest test in the decision below.
9 QUESTION: When you say that the Ninth Circuit
10 was mistaken in determining that the right to share
11 residual value -- residual proceeds had no value, do you
12 rely on some sort of evidence or somewhere that that
13 type of thing does have a market value?
14 MR. NICHOLAS: Well, it has a value, Your
15 Honor. I think in Midwest Savings, a case that was
16 cited which involved the merger of two mutual savings
17 and loan associations, in order to equalize the value a
18 4 percent bonus dividend was declared by one of the
19 associations just prior to the merger. In the Federal
20 Home Loan Bank Board case versus Elliot there was a
21 residual value which was recognized where the insiders
22 tried to come in and claim a portion of that value.
23 Russell, in his volume on savings and loan
24 associations, talks about there being numerous
25 liquidations of savings and loan associations at or

1 above par during the thirty-year period. In Revenue
2 Ruling 69649 cited in the brief, the respondent in that
3 case -- it was the merger of a federal mutual savings
4 and loan association into a stock-type savings and loan
5 association -- and in that ruling the share account
6 holders in the mutual received face value accounts in
7 the stock-type association and then received guarantee
8 stock for the residual value for the undistributed
9 profits and the reserves.

10 So there is a value there. The share account
11 holders own that value and share proportionally in it if
12 there is a merger or liquidation.

13 The Ninth Circuit, we believe, also misapplied
14 the continuity of interest test in its decision below
15 when it looked to the change in the proprietary interest
16 received by the Paulsens in the reorganization to
17 determine whether the test was met. In its opinion the
18 court stated that there was little doubt that the
19 passbook accounts are equity, since they represent the
20 entire capital structure of the association. However,
21 after making that observation, the court went on to say,
22 "The critical question, however, is whether the position
23 of the shareholder in the reorganized entity has really
24 changed. Has his risk increased or decreased? Is his
25 investment more or less liquid? This, we suggest, is


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1 not the test. The only inquiry is whether a proprietary
2 interest was received, not what kind of a proprietary
3 interest was received."

4 As noted by this Court in Minnesota Tea and
5 John A. Nelson, the relationship to the assets can
6 change, but so long as there is a proprietary
7 relationship with the ongoing corporation, there is a
8 proprietary interest which meets the test.

9 The respondent, we believe, is also making the
10 same incorrect comparison if you examine his published
11 revenue rulings. In Revenue Ruling 69-3, which involved
12 the merger of two mutual savings and loan associations,
13 the respondent ruled that it was a tax-free
14 reorganization under Section 368(a)(1)(A). This is the
15 same interest that the petitioners received in this
16 case. If that ruling is right, how can this be stock
17 for one purpose and not for another? In other words,
18 the position of the respondent right now is that if
19 there is a mutual -- a merger of a mutual association
20 into a mutual association, it is tax free; but if there
21 is a merger of a stock association, such as in this
22 case, into a mutual and the shareholders of the stock
23 association exchange their stock for the only equity the
24 mutual association can give the share accounts, it is
25 not tax free. We think this is inconsistent and wrong.


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1 Thus, the only question to be decided is
2 whether the petitioners continued as owners of the
3 reorganized enterprise. Since passbook accounts by the
4 Court's own concession are equity, we think this
5 question has to be answered in the affirmative.
6 I'd like to reserve any remaining time, Your
7 Honor.
8 CHIEF JUSTICE BURGER: Mr. Lauber.
9 ORAL ARGUMENT OF ALBERT G. LAUBER, JR., ESQ.,
10 ON BEHALF OF THE RESPONDENT
11 MR. LAUBER: Mr. Chief Justice, and may it
12 please the Court:
13 What happened here is that petitioners sold
14 their stock for the equivalent cash. We think they
15 should be required to pay tax on their gain just as
16 anybody else would have to do.
17 It might be helpful to begin with an analogy.
18 Imagine a wise investor who buys stock in a corporation
19 like IBM when it's still a new company. The company
20 prospers, and the investor finds over time that his
21 stock has quadrupled in value. At that time our wise
22 investor might well decide that he had a great deal of
23 wealth tied up in that relatively risky equity
24 investment, that what has gone up might well come down,
25 and that it would be prudent to take his profits and


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1 convert that relatively risky equity investment into a
2 safer and more liquid form.
3 Now, if our investor chose to do that by
4 selling his stock on the open market for cash, he'd have
5 to pay tax on his gain. And the result would be the
6 same if instead of selling his stock for cash, he sold
7 it for short-term notes or bonds issued by an individual
8 or by a corporation.
9 That's basically what happened here.
10 Petitioners bought stock in Commerce when it was a very
11 new savings and loan company. The company prospered.
12 By 1976, petitioners found that their stock, which they
13 had paid $50,000 for, was now worth about $200,000.
14 They may have thought this was a good time to sell their
15 stock. Interest rates had been declining for about two
16 years at this period -- at this period. Savings and
17 loans were doing very well.
18 Now, if petitioners chose to sell their stock
19 for cash or for promissory notes to an individual or a
20 corporation, they would have had to pay tax on their
21 gain; and it would make no difference if they chose as a
22 mechanism for selling their stock a statutory merger.
23 For example, if Commerce had merged into an ordinary
24 corporation and petitioners gave up their stock and got
25 back corporate bonds or promissory notes, they'd have to

1 pay a tax on their gain. If Commerce had merged into a
2 commercial bank and petitioners gave up their stock and
3 got back bank deposits, or savings accounts or CDs,
4 they'd have to pay tax on their gain. And if Commerce
5 had merged into a stock savings and loan association,
6 and petitioners gave up their stock and got back not
7 stock, which would have been a relatively risky
8 investment, but savings accounts, they would have had to
9 pay tax on their gain.
10 The only question here, therefore, is whether
11 the result should be different merely because the
12 vehicle petitioners chose to cash out their investment
13 was a merger not with a bank or with a stock savings and
14 loan, but with a mutual savings and loan whose savings
15 accounts happened to carry with them certain proprietary
16 features like the right to vote.
17 We submit such a difference in outcome is
18 unjustifiable because those proprietary interests simply
19 have no value. We think the entire case boils down to
20 one simple proposition. It's clear that if petitioners
21 had sold their stock for bank deposits, it would have
22 had to pay tax. There's no reason why the result should
23 be different, that they should be able to avoid paying
24 tax because they sold their stock for bank deposits plus
25 something else where that something else has no economic


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1 value.

2 QUESTION: Well, Mr. Lauber, had the taxpayer

3 obtained stock in a -- or obtained the interest obtained

4 in this case on a merger with another mutual, assuming

5 the ownership had been in a mutual to begin with, there

6 would have been a tax-free reorganization apparently?

7 MR. LAUBER: That's right. Our -- our

8 position is that we had a mutual merging into another

9 mutual. Nothing really happens. The mutual account

10 holders get back their exact same account with a

11 different obligor on the passbook. The name of the

12 obligor changes.

13 QUESTION: And if there'd been a mutual into a

14 stock type savings and loan --

15 MR. LAUBER: There again, typically the mutual

16 --

17 QUESTION: -- it would be a tax-free

18 reorganization?

19 MR. LAUBER: We agree with that as well,

20 Justice O'Connor.

21 QUESTION: Or a stock type into a stock type.

22 MR. LAUBER: That would also be tax free, or

23 it could be done tax free.

24 QUESTION: So it's just this one instance

25 where it's a stock type into a mutual --


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1 MR. LAUBER: Right.

2 QUESTION: -- that IRS takes a contrary view.

3 And that's a little hard to understand.

4 MR. LAUBER: Well, the reason is it's only in

5 this stock into mutual regime where you have

6 shareholders cashing out an equity investment. In the

7 other examples, mutual into mutual or mutual into stock,

8 the old account holders remain account holders. There's

9 simply a different name on the passbook of the obligor.

10 It's not an appropriate occasion for taxing anybody.

11 QUESTION: Well, is our proper inquiry, since

12 it meets technically the statutory requirements for a

13 tax-free reorganization, is our inquiry in -- should it

14 be directed to whether it's a continued proprietary

15 interest? Is that our whole focus here?

16 MR. LAUBER: That's one of our two

17 submissions; that there is no continuing proprietary

18 interest because the value of the proprietary interest

19 obtained is very close to zero, and that is not a

20 substantial interest within the meaning of Minnesota Tea

21 and this Court's other cases.

22 QUESTION: Well, does this mean that in the

23 future you would be urging that we would apply a similar

24 analysis to all hybrid instruments -- for instance,

25 preferred stock received on a reorganization?



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MR. LAUBER: Well, preferred stock has always been treated by the Commissioner as stock. Convertible bonds --

QUESTION: Well, but you can make the same kind of an argument. If you're going to open it up into looking into hybrid instruments in the way you suggest, I suppose a lot of exchanges in the future would be at risk that hadn't been questioned so far.

MR. LAUBER: I don't think that's true, Justice O'Connor, because this interest here on its face is not stock; it's a savings account. And I think it's not we but petitioners who are trying to recharacterize this as something other than it is. And the normal case of preferred stock would never be recharacterized -- typically would not be recharacterized as that unless it were a very, very shaky corporation. And I don't think this position we're taking here is inconsistent, because the point of the continuity of proprietary interest test is to find out if the shareholder has cashed out or continued his equity investment. Here, these people clearly cashed out their investment.

QUESTION: Mr. Lauber, isn't the Government's position as simple as this: that there can never be a tax-free measure of a stock S&L into a mutual S&L?

MR. LAUBER: That is our position. But I

1 would -- I would --

2 QUESTION: Do you think Congress intended that

3 in the Reorganization Act?

4 MR. LAUBER: I think, Justice Powell, that

5 Congress never really spoke to that. Congress plainly

6 recognized on different occasions that a merger that

7 takes the form of a merger could be characterized as a

8 sale, even where S&Ls are involved.

9 But I would like to point out that the fact

10 that Commerce could not merge into Citizens the way they

11 did it doesn't mean that Commerce could not have

12 effected a merger. Commerce could have found a stock

13 savings and loan and merged with it.

14 QUESTION: You're not assuming that one who

15 wishes to merge always can find precisely the partner

16 that would be desirable, most desirable? In other

17 words, mergers are the result of a great many

18 considerations.

19 MR. LAUBER: Well, that's right.

20 QUESTION: Let me ask another question.

21 MR. LAUBER: Well, may I finish answering your

22 first one?

23 QUESTION: Yes, sure.

24 MR. LAUBER: The other alternative Commerce

25 had was to have Citizens convert from a federal mutual


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1 association into a federal stock association. That
2 conversion --
3 QUESTION: Or they couldn't have merged at all.
4 MR. LAUBER: Right. But if they wanted to
5 merge with that company, they could have converted
6 Citizens from a mutual into a stock organization. The
7 IRS has ruled that that conversion would be tax free.
8 Following the conversion, Commerce could have merged
9 into Citizens on a stock-for-stock exchange, and that
10 would have been tax free.
11 Now, the only down side to that would be that
12 petitioners would have had to take back stock rather
13 than savings account, and could therefore not have
14 cashed out their equity investment. But that down side
15 is a down side the Revenue Code imposes when people sell
16 their stock for cash. So the Commissioner here is not
17 obstructing mergers. And relevant to the petitioners'
18 concerns about the health of the S&L industry, I should
19 make the point what the effect of this cashing out
20 process is on the balance sheet of the corporation and
21 therefore on its financial health.
22 When petitioners owned stock in Commerce,
23 their stock investment was reflected on the balance
24 sheet as a large retained earning shareholder's equity
25 account. That account functioned as a reserve or


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1 cushion that protected the organization and the deposits
2 against the risk of loss.
3 As a result of the merger, petitioners gave up
4 their equity interest and got back garden variety
5 savings accounts. Now, the effect of that was to
6 convert what used to be a cushion, a shareholder's
7 equity, into a short-term debt obligation of the
8 organization; and therefore, the effect of this by
9 cashing these people out was, relatively speaking, to
10 diminish rather than enhance the well-being of the
11 society. And the point is --
12 QUESTION: Well, doesn't that assume the
13 answer to say what they got back was a garden variety
14 savings account? The whole question is whether an
15 account in a mutual organization is a garden variety
16 account.
17 MR. LAUBER: Well, let's analyze that --
18 QUESTION: It carries characteristics that may
19 make it equivalent to a proprietary interest. That's
20 the whole point. And you keep sliding over that and
21 treating it as something different.
22 MR. LAUBER: Well, let me address it more
23 directly then, because that is the key question in the
24 case.
25 I think one reason the courts of appeals have

1 occasionally had trouble seeing the common sense truth
2 of our position is that the mutual savings account are
3 kind of a freak of nature in modern American society,
4 because they are -- you have one piece of paper that has
5 the dichotomous qualities of debt and equity at the same
6 time. And it might be helpful if we could imagine
7 splitting up that one piece of paper into two discrete
8 instruments; that is, imagine here that petitioners gave
9 up their stock in Commerce and got back two pieces of
10 paper. The first piece of paper, let's say, would be a
11 corporate IOU. I owe you $200,000 payable on demand,
12 plus interest. That would be a garden variety bank
13 deposit.
14 They also got back a second piece of paper
15 which we might call a membership certificate in Citizens
16 that said you're hereby a member, and you can vote and
17 so forth. The question is is that second piece of paper
18 worth anything; would anybody pay you any money for that
19 second piece of paper? I think the answer is clearly no.
20 QUESTION: Well, what do you say in response
21 to your opponent's contention that the Elliot case and
22 some others have recognized the fact that there is a
23 residual value that the owners have?
24 MR. LAUBER: Well, some -- it's possible that
25 some merger deals might be constructed where you might


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1 be able to kick out a little bit of bonus money to the
2 mutual shareholders, but that was not done here. The
3 facts of this merger agreement show that the parties who
4 negotiated the deal placed absolutely no economic value
5 on these residual proprietary interests.
6 QUESTION: But in those other cases I take it
7 that the residual value may not have appeared until
8 liquidation. Might not the same thing happen here, that
9 if they decide to liquidate, perhaps there would be some
10 residual value?
11 MR. LAUBER: Well, it's possible, although
12 this Court in Society for Savings v. Bowers
13 characterized that residual interest in the liquidation
14 as being so remote a contingency as to reduce to the
15 vanishing point on the theory that the solvent
16 liquidation of an S&L is very unlikely.
17 QUESTION: But that's a question of fact,
18 isn't it? I mean certainly this Court can't just by
19 picking out law books and citing precedents know whether
20 something like that does have a value or not.
21 MR. LAUBER: Well, I could point out that the
22 Federal Home Lank -- Home Loan Bank Board, which must
23 approve liquidation, has never approved liquidation of a
24 solvent federal savings and loan. And that fact is
25 recorded in the York case of 1980 and Revenue Ruling

1 80-105. So, in fact, these things -- maybe there have
2 been liquidations of state S&Ls, but not of federal S&Ls
3 like Citizens.
4 QUESTION: Mr. Lauber.
5 QUESTION: Mr. Lauber, may I ask this
6 question? Do you agree that your position is contrary
7 to that taken by two courts of appeals, and the court of
8 claims, and two district courts?
9 MR. LAUBER: It is contrary to all those
10 courts.
11 QUESTION: And is it your suggestion that all,
12 what is it, five of those failed to exercise common
13 sense and good judgment?
14 (Laughter.)
15 MR. LAUBER: I think they were just -- they
16 were just bamboozled by the form of the thing and --
17 QUESTION: Bamboozled by whom?
18 MR. LAUBER: They never looked to the
19 substance of it. But to go back to my example --
20 QUESTION: Wait just a minute. Let me ask you
21 another question. What about the problem of being fair
22 to taxpayers generally? I realize the reputation of the
23 Internal Revenue Service is very technical and not
24 necessarily always fair, and I would understand that.
25 But here you have a case where since 1971 if a lawyer

1 were advised or asked to advise a client, he would find
2 that cases uniformly have taken a position contrary to
3 the one you take here today.
4 I realize the Commissioner has never
5 acquiesced in it, but what do people do when they wish
6 to consider a measure, counsel tells them that five
7 courts, including -- well, the tax court would make six
8 -- have said that they may do so on a tax-free basis?
9 And here they come along, and the Government says you've
10 got to pay us some taxes. Is that fair?
11 MR. LAUBER: Well, we didn't just come along
12 now. We were on the public record in 1969 as ruling
13 that a stock into a mutual merger where the old
14 shareholders are cashed out does not qualify for
15 tax-free treatment. That ruling antedated all the court
16 of appeals cases, and we kept litigating it in court
17 after court; and now we finally won one, and that's why
18 we're in this court, and you're the Supreme Court. And
19 the fact that people may have relied on lower court
20 opinions in the face of our obvious resistance doesn't
21 set up any estoppel of alliance interest they can rely
22 on. They knew there was a risk that the Commissioner
23 would always contend that this merger was not a tax-free
24 reorganization. And they took that --
25 QUESTION: Well, Mr. Lauber, had the


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1 Commissioner taken a contrary position prior to 1969?

2 MR. LAUBER: I don't think --

3 QUESTION: It was my understanding that the

4 Commissioner treated it differently and thought it was a

5 proprietary interest to have an account in a mutual

6 before that time. So was the earlier Commissioner

7 bamboozled, do you suppose?

8 MR. LAUBER: Well, as I understand it, the

9 Commissioner had not taken any public ruling position on

10 the question before 1969. There was an in-house

11 position which may have been reflected in some private

12 letter rulings to the -- to support the petitioners'

13 position. But what happened in 1968 is that the

14 Commissioner received a huge barrage of requests for

15 private letter rulings as to the tax results of this

16 kind of merger. People wanted him to bless one of these

17 mergers in advance. The reason for that, I think, is

18 that between October of 1966 and August of '68 the value

19 of savings and loan stocks as reflected in Standard &

20 Poor's S&L index quintupled in value. So you had an

21 awful lot of shareholders in stock S&Ls with a huge

22 unrealized gain on their stock. They wanted to merge

23 and cash out their investment.

24 The Commissioner got this huge influx of

25 requests for private rulings, and the rulings branch of


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1 the IRS realized that the Commissioner had not looked at
2 this area for a long period of time. During the
3 interim, up until '69, as we note in our brief, there'd
4 been a long series of congressional amendments to the
5 both banking and regulatory and tax treatment of S&Ls.
6 They were tax exempt until 1951, and Congress gradually
7 began an incremental process changing the way they were
8 treated. At the same time, their economic function
9 changed. They became less and less like true mutual
10 organizations and more and more like banks. That's
11 reflected in the legislative treatment.
12 So what happened was the Commissioner got this
13 huge bunch of ruling requests and decided it was a good
14 time to review the area authoritatively in light of all
15 the changes that had occurred on the congressional
16 front, and he did so and issued the three rulings in
17 question. And I think that this is simply a reasoned
18 response to changes in the economy and in the way
19 Congress treated these organizations. They are really
20 not like -- like true mutual organizations. They're
21 like banks that pay rate of return like banks pay
22 interest, and they're just fungible with other financial
23 institutions.
24 QUESTION: May I ask you a question about --
25 you mentioned that the value of the stock before the


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1 merger, the stock in Commerce, was set up on the balance
2 sheet as a retained -- equivalent to the retained
3 earnings. Are the balance sheets in the record of the
4 merging companies?
5 MR. LAUBER: I don't believe they are, because
6 the case --
7 QUESTION: Do you know what, for example,
8 their fixed assets were?
9 MR. LAUBER: I don't think that's in the
10 record, because the case is stipulated on the tax court,
11 and there's a very brief set of stipulated facts.
12 QUESTION: I gather it's your position that
13 the stock, in effect, represented sort of the net worth
14 of the company, the excess of assets over liabilities.
15 MR. LAUBER: In Commerce, that's right.
16 QUESTION: And why wouldn't it be possible
17 that after the merger you would have a new company that
18 had some kind of big -- a couple of buildings and maybe
19 owned some real estate and one thing and another, in
20 which there would be fixed assets in which the various
21 depositors would have a prorata share just as if they
22 owned stock? And if so, why wouldn't it be the same
23 kind of proprietary interest?
24 MR. LAUBER: It would probably be peanuts
25 really, because when you think about it, the --

1 QUESTION: Well, I've been in some pretty big
2 savings and loan company buildings that are pretty
3 fancy-looking buildings.
4 MR. LAUBER: But the bulk of their assets are
5 mortgage loans, not, you know, bricks and mortar and
6 typewriters. I mean --
7 QUESTION: But the net worth sometimes is
8 partially represented by their fixed assets.
9 MR. LAUBER: That -- there could be -- could
10 be some. But it's clear that the parties who negotiated
11 the merger here didn't think it was worth anything,
12 because the merger agreement says that -- places a value
13 of $12 a share on the Commerce stock petitioners gave
14 up. In exchange for that, each share, they got a $12
15 deposit in a Citizens passbook account. That $12
16 deposit consisted of the right to withdraw $12, which
17 was worth $12, plus these membership rights.
18 QUESTION: Yes, but also, I suppose if they
19 struck oil just after the merger in the new company,
20 that passbook would give you an interest in the oil
21 well, wouldn't it?
22 MR. LAUBER: I suppose if they struck oil
23 right after the -- after the merger, and they were then
24 to liquidate the company, the shareholders --
25 QUESTION: Which might be advisable under


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1 circumstances.

2 MR. LAUBER: -- might get -- might find --

3 might get some -- something beyond their savings account.

4 QUESTION: Well, sometimes a bond is issued at

5 a discount. I don't know that it's necessarily always

6 factually true that a promissory note from a particular

7 obligor is always worth the face value at the time it's

8 issued, which is your assumption, I take it.

9 MR. LAUBER: Well, if we assume that these

10 people negotiated the merger at arm's length and that

11 the savings accounts -- or an arm's length rate of

12 interest, as they must have done, the right to withdraw

13 $12 from a federally-insured savings and loan -- this is

14 a federally-insured deposit we're talking about -- must

15 be equal, more or less, to $12. And if that's so, and

16 the stock they gave up is worth $12, there's nothing

17 left -- there's no value left to assign any value to

18 those proprietary interests they got.

19 QUESTION: But that -- that's a very abstract,

20 hypothetical type of argument you're making; that

21 because -- and, you know, you can certainly argue that,

22 but we're not a fact-finding tribunal. Has there ever

23 been a specific finding of fact by any court that

24 purported to find facts in this case that there was or

25 was not a value to the so-called equity interest?

1 MR. LAUBER: Well, the court of appeals -- I
2 guess it wasn't really a finding of fact; it was a
3 characterization -- said that the proprietary interest
4 had no value; and they relied on a number of -- of
5 reasons for that. And it's clear if one looks at what
6 those interests are that they don't have a great deal of
7 value. I mean the right to vote in a savings and loan
8 has no value on its face, and in practice, most S&L
9 account holders sign away their right to vote when they
10 open their account by executing a proxy to management in
11 favor of management to vote their votes on behalf of
12 them.
13 I doubt if there's anybody in this room who's
14 ever voted in a savings and loan association. It's just
15 not the kind of thing people would pay money for. And
16 the right to share in the liquidation proceeds again was
17 extremely contingent and speculative, because you would
18 have to get Federal Home Loan Bank Board approval for a
19 liquidation, and they've never approved liquidation of a
20 solvent S&L.
21 So if you kind of break the rights down on a
22 piece-by-piece basis, it's clear that no one would pay
23 any money for those interests; and that fact is
24 reflected in the -- in the merger agreement.
25 QUESTION: Well, what if this outfit were to

1 merge into some other outfit?

2 MR. LAUBER: If Citizens were to merge into

3 another organization?

4 QUESTION: Yeah.

5 MR. LAUBER: Well, it would depend on how that

6 merger were -- were constructed. If it were a mutual to

7 mutual merger, the Citizens people would just get back

8 another savings account in the same amount --

9 QUESTION: What if it were mutual to stock?

10 MR. LAUBER: If it was a mutual to stock, the

11 way those deals are done in practice, as I understand

12 it, is that the mutual account holder will get back

13 another account in the same dollar amount from the new

14 enterprise. And beyond that, he will get what's called

15 a liquidation account equal to his residual interest in

16 the ultimate liquidation value.

17 The way these deals are done in practice, a

18 liquidation account is simply a balance sheet entry.

19 The -- the account holder cannot sell it, exchange it or

20 cash in on it in any way.

21 QUESTION: Of course, your -- your opponent

22 disagrees with you, and I wonder if these aren't

23 arguments that should be made to a fact-finding tribunal

24 to a tribunal that simply decides questions of law.

25 MR. LAUBER: Well, Justice Rehnquist, I think


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1 all these arguments are simply directed to show that the
2 interest these people got beyond the interest of account
3 holders as proprietors was not substantial. Whether it
4 was zero or one-tenth of one percent or two percent, it
5 was not substantial. And this Court set out the
6 relevant test in Minnesota Tea where it said that the
7 shareholders of the old enterprise must get a
8 proprietary ownership interest that represents a
9 substantial part of the value of the thing transferred.
10 The thing transferred here was the Commerce stock. The
11 value of the thing tranferred was $12 per share. And I
12 think it's clear --
13 QUESTION: On that substantiality question,
14 may I just interrupt because I'm trying to think this
15 thing through. Presumably the assets -- I notice there
16 are noncompetition agreements in the merger here.
17 Presumably the assets have some earning capacity and
18 which is somewhat higher than if they just deposited the
19 money at flat interest rates. And to the extent that
20 that's true, isn't that the amount of equity, you might
21 say, that they have here, and isn't it precisely the
22 same amount it would have been if it had been a
23 stock-for-stock transaction? So why is one substantial
24 and the other insubstantial?
25 MR. LAUBER: But the thing is the petitioners

would never get anything beyond the -- what was, in effect, a passbook rate of interest. I mean given the marketplace and the competition among banks and different kinds of S&Ls, they're all paying competitive rates of interest; and it's not the case that the mutual S&L because between earnings will pay a higher rate of interest. They all pay the same thing. And therefore, the account holder can never cash in on the earnings power, because all he ever gets, all he's entitled to is that basic rate of interest, the market rate of interest. So although he has a notional interest in --

QUESTION: If it were a stock-for-stock transaction, could he sell the stock separately without selling his account after a merger? Say this had been a stock-for-stock transaction, wouldn't he also just have to sell that when he closed out the account? Isn't that how these things work?

MR. LAUBER: I don't think -- no, as I understand it, there usually isn't any linkage between stock ownership and depositor status in a stock S&L. In fact, usually the two groups of people are totally separate. And I think normally it would be possible if you had a stock-for-stock deal and got stock back, you could keep your deposit and sell your stock or vice-versa. There'd be no automatic linkage between the


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1 two.

2 I'd like to make one final kind of argument

3 that -- directed to petitioners' contention that their

4 concern is with the health of the savings and loan

5 industry. They point out that the S&L industry is

6 currently in a depressed situation, that Congress has

7 often voiced the intention to help them out, and that

8 the Commissioner should not be able to come along and

9 throw a big tax monkey wrench into the deal and prevent

10 an otherwise desirable S&L merger.

11 I'd like to point out first of all that the

12 Commissioner has publicly ruled that the vast majority

13 of S&L mergers can be done tax free; that is, mutual to

14 mutual, mutual to stock, and stock into stock.

15 Furthermore, Commerce here, had they wanted to merge tax

16 free, could have had Citizens convert to a stock form of

17 organization, which would have been tax free, and then

18 do a stock-for-stock transaction. That would have been

19 bad for petitioners, because they would have had to get

20 back stock rather than cash and therefore pay tax in

21 order to avoid paying tax.

22 QUESTION: Mr. Lauber?

23 MR. LAUBER: Yes.

24 QUESTION: May I ask you one more question?

25 Assume that the consideration received by the

1 stockholders of Commerce in the merger had been ten-year
2 notes, nothing else, and the notes had the same equity
3 interest that the CDs and the savings account had in
4 this case; that is, a right to vote and the right in the
5 event of litigation -- of liquidation to participate.
6 Would that make any difference to your position?
7 MR. LAUBER: It would not, Justice Powell,
8 because in that event it would --
9 QUESTION: So it -- it's immaterial how long
10 they -- they had the right to vote, for example.
11 MR. LAUBER: Right. Because in order for this
12 to be --
13 QUESTION: You would -- you would concede
14 that's normally an equity interest, wouldn't you?
15 MR. LAUBER: No, we would not say a long-term
16 bond is equity.
17 QUESTION: If it had the right to vote?
18 MR. LAUBER: No, that would not be equity
19 either. In fact, we're ruled that convertible bonds are
20 --
21 QUESTION: It's a proprietary right. Don't
22 the cases say that?
23 MR. LAUBER: Well, the right to vote is
24 normally -- is something stockholders normally have, so
25 that people who --

1 QUESTION: Yes. If you're a stockholder in
2 Commerce and you end up with only the right to vote that
3 is in the mutual company, don't you -- haven't you
4 retained that identical right?
5 MR. LAUBER: Well, the fact that you have a
6 right to vote doesn't mean you have stock. I mean I
7 have the right to vote in charities that I give money
8 to, but that doesn't make me a stockholder.
9 QUESTION: What's the difference? As a
10 practical matter, what's the difference?
11 MR. LAUBER: Well, what you need to have an
12 equity interest is more than a right to vote in an
13 organization. You need to have some real stake in the
14 -- some risky stake --
15 QUESTION: If you had a common stock
16 ownership, what would you have other than the right to
17 vote? You'd have the possibility of appreciation but
18 also the possibility of substantial depreciation.
19 MR. LAUBER: That's right. And here there is
20 no bottom -- no real down side risk because they had --
21 these people got a federally-insured savings account. A
22 stockholder in a normal corporation has unlimited down
23 side risk and unlimited up side potential, plus the
24 right to dividends --
25 QUESTION: Suppose you had a capitalization


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1 for the very small issue of prior preferred stock
2 outstanding with a very substantial common equity
3 underneath it so your preferred stock let's say matured
4 in five years with a right to vote. Would that be an
5 equity interest?
6 MR. LAUBER: Could you give that to me again?
7 I'm sorry. I didn't take --
8 QUESTION: Preferred stock, prior preferred
9 stock that -- that had to be surrendered in ten years or
10 could be redeemed within five or ten years, but a right
11 to vote accompanied it. Would that be a proprietary --
12 MR. LAUBER: That would --
13 QUESTION: Would that be a proprietary
14 interest?
15 MR. LAUBER: The Commissioner has probably
16 ruled on that kind. I don't know what the ruling is. I
17 would suspect that that would held -- would be held to
18 be stock, because there is a risk of nondividends for
19 the entire period of the ownership prior to redemption,
20 and the risk the company could go bankrupt, and you'd
21 get nothing at all. So I would suspect that would be
22 stock.
23 QUESTION: May I ask one other factual
24 question? Prior to the transaction at issue in this
25 case, supposing the petitioners -- they own, I think,


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1 17,500 shares -- could they have sold 1,000 of those
2 shares to somebody for cash without changing their --
3 their -- their borrowing account -- I mean, no, their
4 deposit accounts at the institution? In other words,
5 was the stock in Commerce transferrable independent of
6 the bank account?
7 MR. LAUBER: I don't think the record reflects
8 that. I would -- I'd suspect the normal practice is
9 that it would be transferrable independently.
10 QUESTION: Because if it -- if -- if it were,
11 then it would be -- that would be a difference between
12 the character of the ownership before the merger and the
13 character afterward -- the character of the ownership
14 interest and the equity in that institution. But you
15 say the record doesn't tell us that.
16 MR. LAUBER: I don't think it reflects whether
17 the shares were freely transferrable before the merger.
18 QUESTION: Because if they're not, they're
19 kind -- they're really not much different from -- from
20 mutual ownership.
21 MR. LAUBER: Well, I mean if -- if it were the
22 case they had to simply withdraw their money from the
23 account in order to sell their stock, that wouldn't be a
24 terribly onerous burden really. I mean it wouldn't be
25 like a restrictive stock agreement where you couldn't

1 sell at all.

2 QUESTION: No, but it would -- would prevent

3 the stock from having an independent value from the

4 accounts. It'd be a prorata interest in the business

5 that was exactly proportionate to the prorata interest

6 in total deposits, which is what you've got now.

7 MR. LAUBER: No. I think the -- if that were

8 true beforehand, that you couldn't sell your stock

9 unless you also withdrew your money from the

10 institution, you could simply withdraw your money and

11 sell your stock. I mean it wouldn't be -- you wouldn't

12 have to satisfy anybody of anything before you did that.

13 QUESTION: Well, you say the record doesn't

14 tell us.

15 MR. LAUBER: I don't -- I don't believe it

16 does.

17 CHIEF JUSTICE BURGER: You have one minute

18 remaining, Mr. Nicholas, if you have anything further.

19 ORAL ARGUMENT OF WILLIAM R. NICHOLAS, ESQ.,

20 ON BEHALF OF THE PETITIONERS -- REBUTTAL

21 MR. NICHOLAS: Thank you.

22 I would just like to point out in closing that

23 the test of the proprietary interest received should not

24 be how risky it is. It is whether it is a proprietary

25 interest that should control. And once one gets down --



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1 started down the line of whether there is a risk, then
2 how do you take into account preferred stock, how do you
3 value the equity interest, how can you separate the
4 equity interests from the other interests that one has?
5 I think it's a dangerous way to go, and I -- I
6 would urge this Court that if we are going to depart
7 from the line of cases that have held what the rights
8 and obligations are of a share account owner in a
9 savings and loan association, it is something that
10 should be addressed to Congress.
11 QUESTION: Mr. Nicholas, is there anything in
12 the record to respond -- enable you to respond to
13 Justice Stevens' last question?
14 MR. NICHOLAS: I do not believe there is
15 anything in the record, Justice O'Connor. My
16 understanding is that they are separate; they could be
17 transferred from a guarantee stock type association.
18 QUESTION: They could be sold separately.
19 MR. NICHOLAS: Yes.
20 QUESTION: But you didn't bring that out in
21 the record. I wonder why.
22 MR. NICHOLAS: Thank you, Your Honor.
23 CHIEF JUSTICE BURGER: Thank you, counsel.
24 The case is submitted.
25 We will hear arguments next in Webb against


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1 the County Board.

2 (Whereupon, at 1:56 p.m., the case in the

3 above-entitled matter was submitted.)

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BY Paul A. Richardson

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