

# TRANSCRIPT OF PROCEEDINGS

In the Matter of:

STATE OF SOUTH CAROLINA,

Plaintiff,

V.

JAMES A. BAKER, III, SECRETARY OF  
THE TREASURY OF THE UNITED STATES.

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SUPREME COURT, U.S.  
WASHINGTON, D.C. 20543

No. 94 Orig.

Pages: 1 through 36

Place: Washington, D.C.

Date: December 7, 1987

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1 IN THE SUPREME COURT OF THE UNITED STATES

2 -----X  
3 STATE OF SOUTH CAROLINA, :

4 Plaintiff, :

5 V. :

No. 94 Orig.

6 JAMES A. BAKER, III, SECRETARY OF :

7 THE TREASURY OF THE UNITED STATES :

8 -----X

9 Washington, D.C.

10 Monday, December 7, 1987

11 The above-entitled matter came on for oral argument  
12 before the Supreme Court of the United States at 11:02 a.m.

13 APPEARANCES:

14 JOHN P. LINTON, ESQ., Charleston, South Carolina;

15 on behalf of the Plaintiff.

16 LEWIS B. KADEN, ESQ., New York, New York:

17 on behalf of the National Governors' Association,

18 as Plaintiff-In-Intervention.

19 CHARLES FRIED, ESQ., Solicitor General, Department of

20 Justice, Washington, D.C.;

21 on behalf of the Defendant.

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

2 (11:02 a.m.)

3 CHIEF JUSTICE REHNQUIST: Mr. Linton, you may proceed  
4 whenever you are ready.

5 ORAL ARGUMENT OF JOHN P. LINTON, ESQ.

6 ON BEHALF OF PLAINTIFF

7 MR. LINTON: Mr. Chief Justice, and may it please the  
8 Court.

9 South Carolina invoked the original jurisdiction of  
10 this Court to protect its sovereign right to borrow money.  
11 South Carolina seeks to issue its general obligation bonds  
12 which pledge the full faith credit and taxing power of the  
13 State without intrusion by the National Government. Because  
14 the future of State revenues are pledged to retire the debt  
15 represented by the bond, the power to borrow here is  
16 inextricably linked with the obligation to tax to retire that  
17 debt.

18 Twenty-two States have joined South Carolina as  
19 amicus and the National Governors Association has sought to  
20 intervene as a plaintiff.

21 Congress, by TEFRA Section 310(b) asserts the right  
22 to tax the general obligations of the State of South Carolina.  
23 Thus, Congress claims the right to tax the State revenue. It  
24 claims the right to interfere with the State of South Carolina  
25 to borrow. Congress thus asserts a right in an impermissible

1 area and in an impermissible manner. The sanction and the  
2 registration requirement interfere with the States' right to  
3 borrow and it operates as a tax upon the tax revenues.

4 I would like to point out a few findings of the  
5 Master which I believe are critical to the correct disposition.  
6 The Master found that the loss of the tax exemption threatened  
7 is a penalty of such severity that the States have no choice.  
8 The Master pointed out that prior to TEFRA, every State issued  
9 its bonds in bearer form and that since the Statute has been  
10 passed, no State has issued its bonds in bearer form. They  
11 have all surrendered the right to issue their instruments  
12 because of the sanction that's been imposed.

13 QUESTION: Yes, but Mr. Linton, the Master also found  
14 that there was very little economic loss to the States as a  
15 result of that choice, didn't he?

16 MR. LINTON: The Master did find that, Your Honor.  
17 And I'll turn to one other finding of the Master that I think  
18 that is adverse to us that is of interest to the Court. The  
19 Master said that the interest of the States in bearer bonds  
20 goes to the form and not to the substance. We except to that  
21 finding. It's incorrect.

22 The issue on the registration requirement and the  
23 matter in which the States issue its bonds is the right of the  
24 States to determine what conditions in their bond instruments  
25 the State feels would appeal to the marketplace. It's the same



1 interest expressed by this Court in Bland v. Free in dealing  
2 with the savings bonds of the United States. This Court held  
3 that if the States could interfere with a survivor ability  
4 clause in that instance, it would threaten the right of the  
5 United States and its ability to borrow money. That's the same  
6 right that we are asserting here.

7 QUESTION: But is it a purely dignitary kind of  
8 interest, that is, do you concede that there's no economic harm  
9 to the State of South Carolina that results from the TEFRA  
10 Section 310?

11 MR. LINTON: Absolutely not, Your Honor.

12 QUESTION: What then is the economic harm?

13 MR. LINTON: Well, first of all, the Master found  
14 that in certain circumstances there would be economic harm.  
15 The Master found that 76 percent of the bonds issued in this  
16 country are under \$10 million and that registration requirement  
17 would cause extra expense to the State.

18 We don't measure the issue here, Your Honor, though  
19 by the cost in the registration. It's the sanction. And we  
20 sought original jurisdiction here because the sanction  
21 threatens the right of the States in an impermissible way and  
22 in an impermissible area.

23 QUESTION: You know, a long time ago, Chief Justice  
24 Marshall and I think it was the M'Culloch against Maryland,  
25 said the power to tax is the power to destroy, and Justice

1 Holmes came along a hundred years later and said, the power to  
2 tax is not the power to destroy while this Court sits. And it  
3 seems to me you're making an argument that probably would have  
4 appealed a great deal to Chief Justice Marshall but perhaps  
5 hasn't weathered too well in later opinions of the Court.

6 MR. LINTON: Your Honor, we think it has weathered  
7 well, and if I may point out one other finding of the Special  
8 Master, he noted the significance in the State constitutions  
9 when it comes to the issuance of State bonds pledging general  
10 obligations. And the Master said, the power of taxation and  
11 spending associated with that right to raise funds through debt  
12 issuance are essential to the exercise of sovereignty.

13 Now, Your Honor, I'll turn to the New York decision  
14 because I recognize that in both Massachusetts and New York,  
15 you have discarded the rhetoric of the power to tax is the  
16 power to destroy. But what justice Frankfurter recognized in  
17 New York was that if you have a commercial enterprise that you  
18 may tax the State there and we're not just going to have a  
19 label. But he also said this: there is an irreducible core of  
20 federalism and there are certain attributes of States that  
21 partake of special relationships. He said only a State can own  
22 a state house. Only a State can raise funds by pledge of  
23 taxation.

24 And that's what we have here is the authority of  
25 Congress to claim that it could tax us as a sanction. Congress

1 says that it has the right to tax the general tax revenues --

2 QUESTION: Mr. Linton, do we look at this as a tax or  
3 as a regulation? There seems to be some disagreement on that  
4 precise point.

5 MR. LINTON: Yes, Your Honor. We believe the proper  
6 inquiry is the question of whether the Congress can assert as a  
7 sanction the right to tax the States. That is an impermissible  
8 assertion by Congress. And at the jurisdictional arguments,  
9 the solicitor --

10 QUESTION: Is that because it's sort of a threat  
11 based on an unconstitutional sanction in your view that the  
12 government can't regulate the nature of the bond issue by  
13 threatening the imposition of an unconstitutional sanction?

14 MR. LINTON: That is at the core of it, Your Honor.  
15 And the other aspect of it is that part of the right of the  
16 States recognized in this immunity from taxation by the  
17 National Government as to debt which is backed up by its  
18 general obligation taxing power is to tailor that instrument in  
19 a manner in which the State feels is most appropriate to  
20 market.

21 QUESTION: Well, what if we accept all of the  
22 Master's findings of fact, which, as the Chief Justice  
23 suggests, indicate basically that in this particular instance,  
24 it's not a terrible burden economically on the States. Now,  
25 what if we accept that?



1           You want us to rely primarily on the old Pollock case  
2 and intergovernmental tax immunity, is that right?

3           MR. LINTON: Well, we ask you to rely on the Pollock  
4 case to the extent that it is still the law of this Court. But  
5 we also point to the Massachusetts case in which what the Court  
6 said is that we're not going to get caught up in a question of  
7 whether immunity applies to a user fee. But the Court there  
8 recognized that there's certain interests of the States there  
9 not to be regulated by the National Government when it comes to  
10 the taxing power.

11           QUESTION: Well, at bottom what does it rest on  
12 textually in the Constitution do you think?

13           MR. LINTON: The tax immunity doctrine, Your Honor?  
14 The tax immunity doctrine is bottomed on not only the Tenth  
15 Amendment but the nature of the compact. There was an  
16 agreement whereby the National Government and the States were  
17 to maintain sovereignty.

18           QUESTION: Can States today tax the interest income  
19 on Federal government issuances of securities?

20           MR. LINTON: No. The answer is, no, and under the  
21 Rockford case, I think the issue that was decided by this Court  
22 last June so long as the interest on those bonds is a pledge of  
23 the United States, we would not be able to tax those revenues.

24           QUESTION: So you take the position that all these  
25 State municipal bonds pledge the credit of the States or the

1 municipalities?

2 MR. LINTON: The issue that we invoke the  
3 jurisdiction on is a general obligation bond which pledges the  
4 full faith credit and taxing power of the State of South  
5 Carolina.

6 QUESTION: Mr. Linton, are you saying that any  
7 Federal regulation of the States' authority to raise money by  
8 issuing bonds is unconstitutional?

9 MR. LINTON: A regulation that interferes with the  
10 right of the State to borrow.

11 QUESTION: And you're saying interfering with the  
12 right of the State to borrow here even though only tiny  
13 economic consequences may flow.

14 MR. LINTON: Of course, the issue is not the economic  
15 consequences. The issue, as far as the registration goes, is  
16 the invasion of the right of the State to determine the terms  
17 of the debt instrument. And that's, this Court recognized in  
18 Bland v. Free as applied to the United States was incidental to  
19 the right to borrow, and not to be interfered with by the  
20 States.

21 QUESTION: Yes, but of course the United States and  
22 the States do not operate on a totally two-way street in our  
23 system.

24 MR. LINTON: Your Honor, we recognize that. But what  
25 this Court said in New York was there's an irreducible core of

1 federalism. And there, Justice Frankfurter was particularly  
2 concerned with the rights of the States when you're dealing  
3 with taxation. Justice Frankfurter went on to say that there  
4 are unique characteristics of the States. And even a non-  
5 discriminatory tax would violate the States' rights if it  
6 happens to tax the States as States. That's the sanction  
7 sought to be imposed here.

8 QUESTION: But it doesn't tax the States. I mean,  
9 formally, the tax is not laid upon the States. If we had a  
10 statute that says, any issuer of debt securities shall pay a  
11 tax of X dollars, then we would have a tax on the State. This  
12 is a tax upon the receipt of income by an individual, so it's  
13 one step removed from a formal tax on the State, and therefore  
14 it seems to me the only way you can get at it is to say, well,  
15 it's not formally a tax on the State, but it's effect is such  
16 that -- and then you get into discussions about indeed how  
17 severe is the effect, and it's acknowledged that it's pretty  
18 negligible.

19 MR. LINTON: Your Honor, you're correct in one sense,  
20 that you said that it's a tax on the bond proceeds of the  
21 owner, but from the standpoint of the way this Court deals with  
22 that, you have held that it is a tax on the State and it is an  
23 interference with the right of the State to borrow.

24 That's not just going back to Pollock. Last June,  
25 this Court decided the Rockford Life case, the test that you

1 used for a debt instrument that was guaranteed by the United  
2 States was as far as the interest payments, you said that would  
3 be on the United States. Now, in that case, you did not  
4 resolve the issue adverse to the United States because it was  
5 not the issuer, it was only the guarantor.

6 QUESTION: What about a sales tax, the burden of  
7 which is borne by the purchaser. Would you say that an  
8 individual who is purchasing something with the income that he  
9 has received from a State bond cannot be charged that sales tax  
10 because after all, the only purpose of getting the money from  
11 the State bond is to spend it, and if you tax that spending,  
12 you trace it back to the money coming from the State, you're  
13 burdening the State.

14 Would you say that?

15 MR. LINTON: No, sir. And the Court's rejected that  
16 argument, but the Court has accepted the proposition that when  
17 you interfere with the right of the State to borrow, you  
18 interfere impermissibly with the State.

19 QUESTION: Why doesn't that interfere with the right  
20 to borrow? That's what I'm saying. That interferes with the  
21 right to borrow. We're saying the only reason you loan the  
22 State money is to get the interest. The only reason you want  
23 the interest is to spend it. And you're interfering with my  
24 right to spend it.

25 MR. LINTON: The Court makes the distinction between

1 the attenuated effect on the sales tax example, or on the tax  
2 of employees versus the States obligation to tax in the future.  
3 The States, that effects on the bond aspect, when you're  
4 dealing with general obligations, is the obligation of the  
5 State to tax its citizens to retire that debt, it interferes  
6 with the power of the State to borrow.

7 QUESTION: May I ask you, supposing Congress passed a  
8 statute that said all bonds in issues over over \$2 or \$3  
9 million, something like that, must be registered. That would  
10 impose the same burden on the State that you have here, only in  
11 a different way.

12 MR. LINTON: It would be unconstitutional because it  
13 invades the right --

14 QUESTION: Insofar as it was enforced against the  
15 State, it would be unconstitutional?

16 MR. LINTON: Yes, sir. It would be unconstitutional  
17 because it invades the right of the State to determine the form  
18 of its instrument and to tailor it to the marketplace.

19 But in this case of course, it's unconstitutional as  
20 well because of the sanction that it seeks to impose, it robs  
21 the States of any meaningful alternative. That's what the  
22 Master found. The United States is not excepted to it.

23 QUESTION: Well, Mr. Linton, what if Congress said in  
24 their commerce power that no one who buys one of these bonds  
25 may transfer it without registration, and the practical effect



1 of that is to also make the States have to register their  
2 bonds.

3 MR. LINTON: Your Honor, Congress was not exercising  
4 its commerce power here.

5 QUESTION: Well, I'm saying, what if. Can Congress  
6 do that?

7 MR. LINTON: We think that a different test applies  
8 under the taxing power. If Congress did that under the  
9 commerce power if it had the effect of regulating the States  
10 where there was no meaningful choice, I think we would be back  
11 to the issue that was addressed in the dissent in New York by  
12 Justice Douglas that these tax regulations have a tremendous  
13 regulatory effect and they would rob the States of the ability  
14 to govern their own citizens.

15 QUESTION: Well, I understood even your intervenor,  
16 National Governors' Association, thought Congress could do what  
17 I suggested. But you take issue with them?

18 MR. LINTON: I think you introduced a predicate that  
19 if it was so coercive that they had absolutely no choice.

20 QUESTION: Well, I said the practical effect of it is  
21 going to be that States are going to have to register their  
22 bonds.

23 MR. LINTON: Well, Congress could do, perhaps under  
24 the Commerce Clause without invading the sovereignty of the  
25 States, because then the States would have chosen to go into an

1 area that is regulated under the Constitution, interstate  
2 commerce is regulated exclusively by Congress.

3 Under the taxing clause, that's not true, because we  
4 go back to Hamilton's words that the taxing power was not  
5 coextensive with the commerce power. I think the Solicitor  
6 General has acknowledged that this Court has not passed upon  
7 that in page 25 of its brief.

8 Thank you.

9 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Linton.

10 We'll hear now from you, Mr. Kaden.

11 ORAL ARGUMENT OF LEWIS B. KADEN, ESQ.

12 ON BEHALF OF PLAINTIFF-IN-INTERVENTION

13 MR. KADEN: Mr. Chief Justice, and may it please the  
14 Court.

15 The National Governors' Association does not think it  
16 necessary to reach the tax immunity issue which Mr. Linton  
17 argued. Rather, we submit that the question squarely presented  
18 in this case is whether Congress can enlist the State  
19 legislatures to its service in order to achieve a national  
20 goal.

21 That principle, the principle that Congress may not  
22 so enlist the State legislature has survived through all the  
23 twists and turns of federalism jurisprudence in this Court, and  
24 has been most recently reaffirmed in the case of FERC v.  
25 Mississippi. The principle is a simple one: whatever else

1 Congress may do pursuant to the delegated powers, it may not  
2 reach out into the circle of authority reserved to the States  
3 and conscript the State legislative machinery and put it to use  
4 to advance a national goal.

5 QUESTION: You will come to how this conscription has  
6 been effected?

7 MR. KADEN: Yes, indeed.

8 When Congress in this case said to the States, you  
9 must register your bonds by December 31, 1982, the consequence  
10 of that was that each State had to adjust the agenda of its  
11 legislative and regulatory bodies in order to accommodate its  
12 laws to this new requirement.

13 And the record shows, for example, that in Kansas, 47  
14 statutes had to be amended. In Illinois, the question of  
15 adjustment of their statutes to the registration requirement  
16 had to be put on a special agenda of the legislature, and then  
17 the legislature had to come back to make a further adjustment.

18 QUESTION: Under threat of the people who having the  
19 bonds not having the tax deduction?

20 MR. KADEN: Yes.

21 QUESTION: What about the 55-mile speed limit?

22 MR. KADEN: This was no condition that gave the  
23 States an option, as this Court found in the South Dakota case  
24 to comply or not. This statute indicates from the legislative  
25 history through the stipulation of the parties through the

1 Master's report that this was a requirement that the States  
2 register their bonds.

3 QUESTION: Well, the States could fully not register  
4 the bonds. The only consequences would be tax consequences to  
5 the holders of the bonds, just as the States could have  
6 declined to adopt the 55 mile speed limit, and the only  
7 consequence would have been their loss of highway funds.

8 MR. KADEN: I think the difference in the measure of  
9 coercion is significant here.

10 QUESTION: You're talking about the degree of  
11 coercion, that's the --

12 MR. KADEN: That's right. And that coercion is  
13 reflected, as I indicated, in the fact that the legislative  
14 history indicates no intent to raise money and no effect of  
15 raising revenue. The combination of the two, as this Court  
16 said in Kahriger means it's not a tax.

17 Further and pursuant to that Congressional finding,  
18 the parties stipulated before the trial that this was a  
19 requirement, and the Master so found and the Solicitor General  
20 agrees that that's the better way to view it.

21 Now, viewing it as a requirement --

22 QUESTION: May I just interrupt for a second?

23 MR. KADEN: Yes.

24 QUESTION: You said degree of coercion. Wouldn't the  
25 amount of money lost in highway funds exceed in monetary value

1 the economic loss of the cost of registration?

2 MR. KADEN: No, I think far from it. The penalty in  
3 the South Dakota case, if I remember correctly, was five  
4 percent of available highway funds. Here, the increase in cost  
5 if the States failed to register an issued taxable bond would  
6 be 28 to 32 percent of their total borrowing cost, billions of  
7 dollars a year.

8 QUESTION: No, but I thought the Master found that  
9 the economic cost of compliance was really rather trivial.

10 MR. KADEN: Exactly. The economic cost of compliance  
11 was trivial, but the economic effect of the sanction was  
12 enormous and the coercive effect comes from that.

13 But in addition to the coercive effect, you have the  
14 finding and the stipulation.

15 QUESTION: You can coerce them but not effectively,  
16 that's the principle?

17 MR. KADEN: Here the effect was complete.

18 QUESTION: I mean, that's a strange constitutional  
19 principle, isn't it. I mean, it's okay to apply the coercion  
20 but not enough to be effective.

21 MR. KADEN: No, I don't think so. Here, the coercion  
22 was completely effective. No State has issued non-registered  
23 bonds since the effective date of this statute.

24 QUESTION: But Mr. Kaden, every time Congress gets  
25 into the act with one of its programs that it wants the States



1 to help them out with, you have the same kind of a problem.  
2 The States have to crank up their machinery and do something  
3 about it.

4 MR. KADEN: You don't have the compulsion to pass  
5 laws. In circumstances where the State has attached a  
6 condition to its spending power, as this Court has found, you  
7 have a realistic option not to participate. Here, if you  
8 accept the stipulation that this was a requirement, you also  
9 have the compulsion to pass laws, and it is the nature of that  
10 intrusion, not its weight, not the economic effects, but the  
11 nature of the requirement that that legislature in Illinois  
12 convene itself, adjust its agenda, and pass these laws that  
13 gives rise to the constitutional infirmity.

14 That is a very different question than using the  
15 constitution as a shield from a generally applicable  
16 regulation, such as was the issue in Garcia. There is all the  
17 world of difference between telling the State that it must pay  
18 a minimum wage to its employees, the same as General Motors  
19 must to its, and telling the State that it must get its  
20 legislature in session and create its own labor standards board  
21 modeled after the Federal design to perform that regulatory  
22 function that Congress prescribed.

23 QUESTION: What about EEOC and it defers for 90 days  
24 to State Equal Employment Commission proceedings if the State  
25 creates one. Now, that certainly provides a strong incentive

1 for a State to create one, and by legislation?

2 MR. KADEN: I think that provides an option in what  
3 is otherwise a generally applicable regulation. What EEOC did  
4 was said to the States that they must apply the same  
5 antidiscrimination provisions with respect to the elderly that  
6 a private individual did, quite different than saying to the  
7 States --

8 QUESTION: But Congress also said in the EEOC that if  
9 a State creates its own Board, the Federal Commission will  
10 defer proceedings for 90 days or something.

11 MR. KADEN: Exactly, which is analogous to saying in  
12 the Hodel case that if the State chooses to set up a regulatory  
13 machinery for surface mining, it can play that role, otherwise,  
14 it will be preempted and fall under the Federal regulatory  
15 machinery. Again, I would suggest, quite different from the  
16 command to the State to use its resources in service of the  
17 Federal goal. This may be a small kind of intrusion, but in  
18 nature, it goes to the heart of what troubles the States about  
19 the protection afforded their federalism, that Congress may,  
20 from time to time, narrow the circle of authority reserved to  
21 the States.

22 But it is quite another matter, as Justice Blackmun  
23 recognized in the beginning of his opinion in FERC v.  
24 Mississippi, to reach into the remaining circle and enlist the  
25 State apparatus in the service of the Federal cause. That goes

1 to the heart of the power of choice of the ability to set a  
2 political agenda that is so crucial to State autonomy. We know  
3 that State autonomy won't be eliminated in one large swoop.  
4 The Court has not had to confront the case where Congress tells  
5 the State legislature to have only fifty members, or meet every  
6 December, or choose the members of its Supreme Court according  
7 to Federal design.

8 But what the Congress does, with increasing  
9 frequency, is achieve its regulatory goals by reaching over and  
10 having the State do it. That was the issue, for example, in  
11 EPA v. Brown, where the Federal government set environmental  
12 standards, but until they retreated and the case was mooted in  
13 1977, the device of enforcing those regulatory objectives was  
14 through the States. And that's what caused the circuit courts  
15 that considered that to find it an invasion of the Tenth  
16 Amendment autonomy interest.

17 And similarly in FERC, ultimately the Court narrowly  
18 divided on whether the intrusion was too much. But there, it  
19 wasn't the legislative apparatus that was being commandeered,  
20 it was a quasi adjudicative body, just being asked to consider  
21 the Federal standards, given the option of getting out of the  
22 field of regulating those utility rates entirely.

23 And here, many people have had the reaction, well,  
24 why are the governors and the mayors and the counties and the  
25 State legislatures bringing this particular case before this

1 Court, occupying this Master for two or three years, when it  
2 seems so inconsequential. But the fact is, as I indicated,  
3 never has the Court sanctioned a compulsion to the State to  
4 pass laws. And yet, in this case, that's precisely what the  
5 legislatures, as this record unequivocally shows, of Kansas,  
6 New Jersey, --

7 QUESTION: Well, Mr. Fried argues that the State has  
8 the choice of course of issuing bearer bonds and letting people  
9 pay the tax.

10 MR. KADEN: Well, he doesn't really argue that with  
11 any conviction. In fact, at page 39 of his brief, he concedes  
12 that looking at this as a registration requirement is really  
13 the better way to do it. He will take advantage of the  
14 conditional approach, if need be, and he goes on to argue the  
15 tax immunity issue, because if it is conditional, then you have  
16 to consider the sanction. But when you look at what Congress  
17 did and what Congress said, there was no option being conveyed.  
18 The option was simply the technique.

19 They meant to require registration, the parties so  
20 stipulated, and the Master so found, both on page 2 and in the  
21 first sentence of his conclusion. It's the right way to look  
22 at it.

23 QUESTION: Well, could Congress have achieved the  
24 same goal exactly by some other means that you would accept?

25 MR. KADEN: Yes, indeed. Congress, if it had in mind

1 curbing tax evasion by creating a record of ownership of  
2 municipal bonds could have required that those bonds be sold or  
3 bought through brokers. Brokers file information returns.  
4 They know the amounts of those trades. And that kind of  
5 regulation would not have implicated the States at all and the  
6 States would have had nothing to do with it.

7           They could have told the holders of those bonds in  
8 the secondary market that when you seek to buy or sell those  
9 bonds, go to a broker and the broker will file an information  
10 return with the Federal Government. And indeed, that would  
11 have been a more effective -- we're not arguing that the method  
12 adopted was ineffective -- but that would have been more  
13 effective than the device of requiring registration. Because  
14 in fact, as you know, transfer agents don't file those  
15 information returns. You can negotiate a registered bond  
16 transferring beneficial ownership without going through a  
17 transfer agent and so the registration system doesn't really  
18 work very well to curb tax compliance.

19           But that's not the gist of our argument. Given that  
20 alternative means of protecting the tax compliance interest --  
21 which certainly the governors and the mayors share with the  
22 National Government -- to do it in a way that commandeered the  
23 legislative apparatus of the States was unnecessary and  
24 contrary to something that is very deeply held in the structure  
25 of federalism established under the Constitution.



1 QUESTION: Excuse me. You think that the 55 mile  
2 speed limit requirement would have been bad if the sanction for  
3 the States' failure to observe it had been high enough. All  
4 highway funds eliminated. That would have done it?

5 MR. KADEN: It would have depended on a finding by a  
6 fact finder of whether it was coercive. That's the test this  
7 Court established in Stewart and reaffirmed in South Dakota.

8 Chief Justice Marshall said long ago in the M'Culloch  
9 case that not only must the end of what Congress does be  
10 legitimate, but the means must be appropriate and consistent  
11 with the spirit of the Constitution. And what has happened  
12 here in this relatively insignificant little matter of  
13 registering municipal bonds is that Congress has adopted a  
14 technique that amounts, for the first time, to commanding the  
15 State legislature to adjust its agenda to suit the Federal  
16 regulatory purpose. That gives rise to the Constitutional  
17 infirmity that we assert.

18 Thank you.

19 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Kaden.

20 We'll hear now from you, General Fried.

21 ORAL ARGUMENT OF CHARLES FRIED, ESQ.

22 ON BEHALF OF DEFENDANT

23 MR. FRIED: Thank you, Mr. Chief Justice, and may it  
24 please the Court.

25 The plaintiffs and their amici the States National

1 Governors' Association raise with considerable heat, and I  
2 believe, considerable sincerity, important Constitutional  
3 principles of federalism. I must confess to a certain  
4 puzzlement about how to respond to those concerns in this case.  
5 And I would like at the outset to suggest a kind of  
6 jurisprudential framework for considering those concerns.

7 I'd take as my touchstone, the words of Justice  
8 Frankfurter in his separate opinion in Graves against New York.  
9 There, Justice Frankfurter said, "since two governments have  
10 authority within the same territory, neither through its power  
11 to tax can be allowed to cripple the operation of the other.  
12 The arguments on which M'Culloch v. Maryland rested had their  
13 roots in actuality, but they have been distorted by sterile  
14 refinements unrelated to affairs. These doctrines have, until  
15 recently, been moving in the realm of what Lincoln called  
16 pernicious abstractions. The web of unreality spun from  
17 Marshall's famous dictum was swept away by one stroke of Mr.  
18 Justice Holmes' pen. The power to tax is not the power to  
19 destroy while this Court sits."

20 QUESTION: Mr. Fried, do you think that subjecting  
21 all interest income from municipal bonds to Federal income tax  
22 could be said to interfere with essential State or local  
23 functions?

24 MR. FRIED: That is a very serious question. It's a  
25 very serious question which this Court, although it has in the

1 Gerhardt case and in the Graves case itself, removed the  
2 theoretical underpinning of the Pollock doctrine by overruling  
3 Collector against Day, it's very striking that in case after  
4 case, this Court has declined to draw the general conclusion  
5 which you refer to.

6 QUESTION: Right. So how do you answer me?

7 MR. FRIED: Well, if I may answer you at a little bit  
8 of length. Congress has declined to press that issue. This  
9 Court has declined to press that issue. And that is because  
10 what is at stake there is a matter of great sensitivity to the  
11 States. And I would think that just as this Court has been  
12 circumspect in that regard, and just as Congress has been  
13 circumspect in that regard, and I think they have been  
14 circumspect in this very legislation, so if you would permit  
15 me, I would like to be circumspect in that regard, and not  
16 pronounce or even venture a position of the Government on  
17 something which everybody has sought to back away from and to  
18 avoid turning into a confrontation.

19 QUESTION: So you're not going to answer my question  
20 of whether there is any constitutional limit to the removal of  
21 freedom from Federal income tax of these bonds?

22 MR. FRIED: I suspect there very well may be a  
23 constitutional limit.

24 QUESTION: And on what would it rest?

25 MR. FRIED: I think it would rest on the Tenth

1 Amendment. I think it would rest on principles of federalism.  
2 It would not rest on the theory of the Pollock case. Because  
3 the theory of the Pollock case was the theory of immunity at  
4 the source and that theory has been specifically repudiated by  
5 this Court on two occasions.

6 So we would have to find a new basis, and I would  
7 think it would be rather imprudent of me, but if you press me,  
8 I shall proceed on that imprudent course to try to devise  
9 extemporaneously what such a theory might be. But there's a  
10 great deal of --

11 QUESTION: Well, there's a concern, because I'm not  
12 sure to what extent we have to address in this case the  
13 intergovernmental tax immunity problem. The States are urging  
14 that we must address it, and it is a concern.

15 MR. FRIED: It is a concern, but I believe that a  
16 concern of that degree of seriousness should not be addressed  
17 and need not be addressed in a case where what is at stake is,  
18 to speak frankly, utterly trivial. I think it would be a great  
19 mistake to precipitate this Court, the United States Government  
20 and the Congress into a confrontation on a matter of the  
21 highest Constitutional moment where so little is at stake.

22 QUESTION: You're not asking us to overrule what's  
23 left of Pollock?

24 MR. FRIED: No, because there's no occasion to do so,  
25 Justice Blackmun.

1           With great respect to learned counsel from South  
2   Carolina and the Governors' Association, I suggest that they  
3   seek to move us away from arguments having their roots in  
4   actuality and it is they who urge on us instead sterile  
5   refinements unrelated to affairs.

6           As I've indicated, the United States will make no  
7   argument today which opens the door to a taxing power large  
8   enough to cripple the operation of the States, nor which  
9   invites this Court to relax its vigilance lest the power to tax  
10   become the power to destroy.

11          But if we are going to avoid sterile abstractions, we  
12   must get a somewhat firmer grasp on the actualities, on what  
13   really is at stake here, for we are dealing in general  
14   principles about federalism and not in taboos. We're not even  
15   talking about procedural or jurisdictional requirements. And  
16   these general principles, unlike for instance, the axioms of  
17   mathematics which, if true, are true to the last decimal place,  
18   they just give out at the margins.

19          As was recognized in the Fry case, principles of  
20   federalism just cannot stand the pressure of extreme  
21   emergencies. I would suggest that also at the other end of the  
22   spectrum where practical consequences are too slight, they also  
23   give out, and just become indeterminate.

24          Let's turn for a moment at what really is at stake.  
25   Congress had no hidden agenda in this case, no imperial designs



1 on State autonomy. On the contrary, Congress was demonstrating  
2 a perhaps over nice delicacy about not using the heaviest  
3 weapons in its arsenal. Its concerns were that bearer bonds of  
4 all issuers, Federal issuers, corporate and municipal issuers,  
5 have served as a kind of interest bearing large denomination  
6 currency for tax evaders and others whose sources of wealth do  
7 not bear looking into. And they are much more attractive than  
8 cash in the mattress or gold bullion in a safe deposit box.  
9 And municipals are particularly attractive to those who are up  
10 to no good because once you get your cash into this safe  
11 harbor, there's no longer any legal obligation to pay tax on  
12 the interest or even to report it in some circumstances.

13 Congress might simply have forbidden the transferring  
14 or holding of bearer bonds. Instead, they chose what they  
15 thought was a less intrusive measure for corporates and  
16 municipals with the thought that this way, they would force  
17 these holdings out into the open, create a paper record, making  
18 them far less attractive for nefarious practices.

19 QUESTION: Well, Mr. Fried, suppose one thought  
20 indeed as I may that there is a constitutional prohibition  
21 against the Federal government taxing income from these  
22 municipal bonds. May the Congress just use that form of  
23 imposing a tax as a means of regulation and we should close our  
24 eyes to the form chosen?

25 MR. FRIED: I would think in this circumstance if

1 that was your premise, you would still I think not have cause  
2 for worry because, as the Special Master found -- and his  
3 findings are entirely consistent with the intentions of  
4 Congress -- the Special Master found that this form of tax in  
5 no way, in no way burdened the ability of the States to raise  
6 revenues through borrowing, and indeed in no way affected how  
7 they borrowed, what form they borrowed, except in that holy  
8 question begging sense that of course they could no longer  
9 borrow in bearer form.

10 But as far as their ability to enter the market, the  
11 terms on which they entered the market, whether long term or  
12 short term and at what interest rates and for what purposes  
13 they borrowed, the Special Master found that this simply had no  
14 effect whatsoever. And that being so, I don't see why these --

15 QUESTION: You don't think the means selected should  
16 be proper? Is there no other way the government could have  
17 accomplished its goal?

18 MR. FRIED: There are other ways, certainly.

19 QUESTION: Sure.

20 MR. FRIED: But there is nothing improper about this  
21 means. The reason there is nothing improper about this means  
22 even on your premise which you offer on a hypothetical basis  
23 because the doctrine of intergovernmental tax immunity,  
24 whatever its present status, is not some kind of a taboo; it's  
25 a principle. And if in actuality the ability of the States to

1 borrow which such a doctrine is intended to protect is in no  
2 way affected, then surely that has some bearing on how one  
3 considers the matter.

4 QUESTION: Mr. Fried, if I understand your argument,  
5 it would be constitutional for Congress to pass a statute that  
6 says if any State shall issue unregistered bonds, the governor  
7 of the State shall be deemed to have violated a Federal  
8 criminal statute and shall be sentenced to prison for three  
9 years. If the sanction is a plainly unconstitutional sanction,  
10 you say it really doesn't matter because all we were trying to  
11 do is something that's perfectly trivial, if you accept Justice  
12 O'Connor's premise, that is.

13 What's the difference between that case and the one I  
14 posit?

15 MR. FRIED: I'm taken aback by your hypothetical, I  
16 must admit. It's not one that in our hours of preparation had  
17 occurred to us. The reason that I answered Justice O'Connor as  
18 I did was that what concerns her is after all an important  
19 constitutional principle, intergovernmental tax immunity. And  
20 that principle is a principle -- and that is why I vouched in  
21 Justice Frankfurter's words -- is a practical principle which  
22 must be applied in a practical way.

23 If nothing is at stake and that is the case here,  
24 nothing is at stake, then it doesn't seem to me important to  
25 enter into the sterile refinement of whether --

1 QUESTION: Nothing is at stake if they comply.

2 MR. FRIED: Nothing's at stake if they comply.

3 QUESTION: So that in my example, you'd say you can  
4 threaten them with anything, threaten the governor with capital  
5 punishment.

6 MR. FRIED: Well, there would be a clear Eighth  
7 Amendment problem in that context.

8 QUESTION: It would be a very narrowly defined class  
9 of persons and a very definitely defined aggravating  
10 circumstance that happened very rarely.

11 QUESTION: It's an Eighth Amendment case. I, I  
12 hadn't realized that.

13 MR. FRIED: When one considers that the financial  
14 burden involved here is practically nil in terms of the  
15 transactions cost even for an issue as small as a million  
16 dollars which in terms of dollar volume is less than one  
17 percent of all municipals, although in terms of the number of  
18 securities issued, it's a great deal larger, the cost to the  
19 State, the increased cost to the State is \$165 a year over the  
20 life of a 20-year bond. And if you go to larger denomination  
21 borrowing, it is cheaper in registered form.

22 When you consider the interest rate differential, I  
23 think that has been more or less abandoned, as well it might be  
24 because interest rate differentials can be only a function of  
25 market preference. And if we abstract from the market

1 preference of tax evaders, there is no rational basis for a  
2 market preference for bearer bonds. Registered bonds are  
3 easier to deal with, they are more secure to deal with, and in  
4 any event, only about 10 to 12 percent of municipals are held  
5 personally by individuals in any event. There is no rational  
6 basis.

7 QUESTION: Well, General Fried, if that was the case,  
8 why did all the States issue their bonds in bearer form before  
9 this Section 310 was enacted?

10 MR. FRIED: Well, the Master found that that is  
11 simply custom and habit. Corporations also issued their bonds  
12 in bearer form and being somewhat more flexible, long before  
13 TEFRA, they had moved virtually universally to registered form.  
14 And the Master found, I think quite reasonably, that this is a  
15 change which the municipal market would have gone to of its own  
16 in any event, except for the slight problem of the very great  
17 facility that bearer municipals gave to people who were up to  
18 no good.

19 Now turning to the regulatory burden, I find that a  
20 puzzling argument. I think back to the FERC case and the FERC  
21 case was troublesome because there what happened is Congress  
22 was dealing with what in terms of politics and policy was  
23 surely a hot potato: how consumer electric rates will be  
24 calculated and how they're going to be allocated -- a very  
25 difficult political question. And Congress sought to involve,



1 if not to enlist, at least sought to involve the State  
2 regulatory mechanism there. And that was said to be all right,  
3 although not everybody on this Court so believed.

4 In this case, by contrast, what you have is a purely  
5 technical requirement. There is no political or policy hot  
6 potato being thrown to the States to somehow deal with within  
7 their own political boundaries. This is no more of a  
8 regulatory burden than if the Congress had said that all checks  
9 issued in the United States including those issued by States  
10 must have a certain format and be encoded in a particular way.

11 And indeed Congress long ago required the States to  
12 issue W-4s, W-2s, and 1099s in terms of reporting to the IRS  
13 when there was a State tax refund. These, as far as regulatory  
14 burdens, though they may have had technical difficulties, from  
15 a policy and a political point of view were simply trivial.  
16 And that is why I think we are dealing at a level of triviality  
17 which makes it dangerous for this Court, dangerous, to allow  
18 itself to be drawn into what are really serious questions.

19 The questions that troubled you, Justice O'Connor,  
20 are serious questions. And I am disturbed that this Court  
21 should be precipitated into a confrontation with those  
22 difficult questions where frankly nothing is at stake.

23 QUESTION: General Fried, does Congress require  
24 States, as employers, to withhold for Federal income tax?

25 MR. FRIED: It does indeed, to withhold, to remit and

1 to send W-2s and W-4s, yes it does. And presumably, depending  
2 on the structure of the State statutes, that may or may not  
3 require some kind of adjustment including perhaps even some  
4 legislation. But this is not legislation such as we had in  
5 FERC, where what was involved was the State political machinery  
6 coming to grips with a difficult political choice.

7 I think there's less at stake here than even the  
8 dignitary interests that troubled the Court in Coyle against  
9 Smith. I think there's less at stake here than if Congress  
10 dictated the designation of a State flower. There is simply  
11 nothing of significance at stake at all. And that is why I say  
12 that these high constitutional principles simply like electrons  
13 which escape detection, the high constitutional principles  
14 simply become indeterminate when they are deployed against this  
15 problem.

16 If there are no further questions, I thank the Court  
17 for its attention.

18 CHIEF JUSTICE REHNQUIST: Thank you, General Fried.

19 Mr. Linton, you have one minute remaining.

20 ORAL ARGUMENT OF JOHN P. LINTON, ESQ.

21 ON BEHALF OF PLAINTIFF - REBUTTAL

22 MR. LINTON: Mr. Chief Justice, the interest asserted  
23 by South Carolina is that Congress assumes the right to tax a  
24 State and rather than being a trivial aspect of this case, that  
25 is the foremost issue before the Court. The question posed by

1 Justice Scalia about a tax on bond proceeds according to this  
2 Court in Rockford, that's a tax on the United States and in the  
3 reverse situation, it's a tax on the State here.

4 And in response to Justice Blackmun's question about  
5 Pollock, you cannot apply the rule of New York v. United States  
6 or Massachusetts v. United States, and sustain the action here.  
7 In each of those cases, the Court was mindful of the  
8 proposition that you cannot tax the power to borrow. That's  
9 what this Court also said in 1962 in Free v. Bland when the  
10 State had what might seem a trivial interest to assert on the  
11 form of a savings bond. And this Court said unanimously in a  
12 seven to zero opinion that that interferes with the ability of  
13 the Federal Treasury officials to determine the form of the  
14 instrument. They're charged with the responsibility for  
15 raising debt, and it would interfere with the power of the  
16 United States to borrow.

17 That's the exact principles involved in this case.

18 Thank you.

19 CHIEF JUSTICE REHNQUIST: Thank you, Mr. Linton.

20 The case is submitted.

21 (Whereupon, at 11:55 a.m., the case in the above-  
22 entitled matter was submitted.)  
23  
24  
25

1 REPORTERS' CERTIFICATE

2  
3 DOCKET NUMBER: 94, Original

4 CASE TITLE: State of South Carolina v. James A. Baker, III

5 HEARING DATE: December 7, 1987

6 LOCATION: Washington, D.C.

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8 I hereby certify that the proceedings and evidence  
9 are contained fully and accurately on the tapes and notes  
10 reported by me at the hearing in the above case before the  
11 United States Supreme Court  
12 and that this is a true and accurate transcript of the case.

13 Date: December 11, 1987

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