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Supreme Court decision reshapes corporate bankruptcy strategies

The U.S. Supreme Court has altered the landscape of corporate bankruptcy strategies, particularly those involving mass tort liabilities. The June ruling in *Harrington v. Purdue Pharma L.P.* has effectively closed a controversial loophole that allowed companies to shield owners and executives from lawsuits through bankruptcy proceedings.

The Purdue Pharma case

At the heart of this decision is the bankruptcy case of Purdue Pharma, the manufacturer of OxyContin, which has been at the center of the opioid crisis. The Sackler family, owners of Purdue Pharma, sought to resolve thousands of lawsuits by offering a settlement of up to \$6 billion in exchange for immunity from future litigation.

This strategy, known as a non-consensual third-party release, would have shielded the Sacklers from liability without them personally filing for bankruptcy. In practice, a non-consensual third-party release prevents creditors or claimants from pursuing legal action against certain non-debtor parties (e.g., company owners or executives) related to the debtor's liabilities, even if all the affected parties don't agree to the arrangement.

The court's decision

In a 5-4 ruling (which didn't fall along ideological lines), the Supreme Court held that the Bankruptcy Code does not allow for such non-consensual third-party releases. Justice Neil Gorsuch



underscored a fundamental principle of bankruptcy law: Its protections are generally reserved for the entity in financial distress — the debtor — and do not extend to other parties, regardless of their connection to the debtor.

The court's interpretation of Section 1123(b) of the Bankruptcy Code concluded that it does not grant bankruptcy courts the power to discharge debts of non-debtors without the consent of affected claimants.

Implications for corporate bankruptcy strategies

Here are some implications of the decision for corporate bankruptcy strategies:

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**WALTERS
LEVINE
DeGRAVE**
ATTORNEYS AT LAW
SARASOTA • TAMPA • CHICAGO

Sarasota office: (941) 364-8787
Tampa office: (813) 254-7474
Chicago office: (312) 782-8807
www.walterslevine.com

Supreme Court overturns 'Chevron' doctrine: Implications for businesses



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At the end of the 2023-2024 term, the U.S. Supreme Court issued a landmark ruling in *Loper Bright Enterprises v. Raimondo*, overturning the longstanding *Chevron* doctrine that has been a cornerstone of administrative law for nearly 40 years.

The decision has far-reaching implications for federal agencies, businesses and the regulatory landscape.

Understanding *Chevron* deference

The *Chevron* doctrine, established in 1984, required courts to defer to a federal agency's reasonable interpretation of an ambiguous statute it administers. *Chevron* was based on the premise that federal agencies, given their specialized knowledge and experience in their particular domains, were in a better position to clarify and apply ambiguous statutory language.

The new ruling

In overruling *Chevron*, the Supreme Court declared that judges must exercise their own judgment in interpreting statutes.

Previously, if a statute was silent or ambiguous, the courts deferred to the agency interpretation if it was based on a "permissible construction" of the statute. Essentially, if a law was unclear, the courts would side with the agency, as long as the agency's interpretation was reasonable.

The *Loper* ruling alters the balance of interpretative power, placing the onus on judges to discern statutory meaning. Though the courts may still consider an agency's specialized knowledge in its interpretations, they are no longer obligated to defer to these agency views. As Chief Justice John Roberts stated plainly, "*Chevron* is overruled."

Ideological split

The court's decision was split 6-3 along ideological lines, with the conservative majority overturning the longstanding doctrine.

The court's three liberal justices strongly advocated for maintaining the *Chevron* doctrine. Justice Elena Kagan contended that federal agencies possess special-

ized scientific and technical knowledge that makes them more capable than the courts in clarifying vague or complex statutory language.

Justice Ketanji Brown Jackson emphasized the doctrine's important purpose, suggesting that under *Chevron*, Congress empowers federal agencies to make necessary policy choices, such as filling gaps or defining terms in statutes. She warned that overturning *Chevron* could force courts to make these kinds of policy decisions instead.

On the other hand, conservative justices like Brett Kavanaugh viewed *Chevron*'s deference to agencies as problematic. Kavanaugh argued that *Chevron* "ushers in shocks to the system every four or eight years when a new administration comes in," leading to "massive change" in areas such as securities law, communications law and environmental law.

Implications for business and regulatory landscape

The ruling could have significant implications across various sectors:

- **Workplace law:** Agencies such as the Department of Labor, Equal Employment Opportunity Commission, and National Labor Relations Board may face stricter scrutiny of their regulations. That could affect minimum salary thresholds for Fair Labor Standards Act exemptions, rules defining independent contractors, and the Federal Trade Commission's proposed ban on non-compete clauses.

- **Consumer protection:** Agencies like the Consumer Financial Protection Bureau and Federal Trade Commission may face increased challenges to their regulations, potentially affecting credit rules and bank fees.

- **Health care:** The Food and Drug Administration and Department of Health and Human Services may see challenges to their regulatory authority, impacting Medicaid and Medicare regulations, Affordable Care Act implementation, HIPAA interpretations, and the FDA's approval process.

- **Technology and telecommunications:** The Federal Communications Commission's ability to regulate internet service providers, including net neutrality rules, may be affected. Regulations on data brokers, social media platforms, and AI could face increased scrutiny.

Extended statute of limitations for challenges

In a related decision issued on July 1, *Corner Post v. Board of Governors of the Federal Reserve System*, the Supreme Court extended the timeframe for challenging agency actions.

In essence, the six-year statute of limitations for challenging federal agency action under the Administrative Procedure Act now commences when the plaintiff is injured by the challenged action, not when the regulation is published.

That opens the door to challenges of longstanding regulations, potentially creating a "tsunami of lawsuits against agencies," as warned by Justice Jackson in her dissent.

IRS unveils plan to close \$50B loophole used by large partnerships

The Internal Revenue Service and the U.S. Department of the Treasury have announced an initiative aimed at closing what they describe as a “major tax loophole” exploited by large, complex partnerships. The move could potentially increase tax revenue by more than \$50 billion over the next decade.

Targeting ‘related party basis shifting’

The plan focuses on a practice known as “related party basis shifting,” in which businesses operating through multiple legal entities manipulate asset values to maximize tax deductions or minimize future gains.

A key aspect of this strategy often revolves around depreciation. An entity within the partnership structure might purchase an asset and depreciate it over time, reducing its basis to zero or near-zero. Instead of selling the fully depreciated asset, which would result in a taxable gain, the entity transfers it to a related entity within the partnership structure. The receiving entity may then be able to reset the asset's basis to a higher value, allowing for new depreciation deductions.

This cycle can potentially be repeated multiple times, allowing the partnership to claim more depreciation deductions than would be possible with a single entity. By repeatedly depreciating the same asset, the partnership can reduce its taxable income without any real economic change or new investment.

Proposed regs and revenue ruling

After a year-long study, the agencies have declared

their intention to issue proposed regulations. Additionally, they've released a revenue ruling addressing related-party partnership transactions involving basis shifting without “economic substance” or “substantial business purpose.”

The IRS plans to ramp up its efforts by:

- Publishing guidance for accountants and lawyers to clarify that basis shifting purely for tax avoidance is illegal.

- Proposing regulations requiring large partnerships to provide more detailed information about certain transactions.

- Creating specialized teams within the IRS's legal and large-business auditing units to focus on these partnerships.

Addressing the growing tax gap

Treasury data shows that pass-through business filings with over \$10 million in assets increased by 70 percent between 2010 and 2019. However, the audit rate for these partnerships plummeted from 3.8 percent to just 0.1 percent during the same period. This trend has contributed to an estimated \$160 billion annual tax gap attributed to the top 1 percent of tax filers, the Treasury said.

Meanwhile, some tax experts argue that the current tax code allows for changes in basis and that businesses are operating within legal boundaries. Legal challenges can be expected.

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- *Reconsideration of bankruptcy as a shield:* The ruling makes it more challenging for owners and executives to shield their personal wealth through corporate bankruptcy proceedings.

- *Impact on “Texas Two-Step” strategy:* The decision adds complexity to the so-called “Texas Two-Step” maneuver, in which companies split into separate entities to isolate liabilities before filing for bankruptcy.

- *Emphasis on consensual releases:* The court made clear that consensual third-party releases are still permissible. That distinction will likely lead to increased efforts by companies to obtain consent from claimants for any releases.

- *Potential for increased litigation:* Without the option of non-consensual releases, companies may face more protracted and costly litigation as individual claimants pursue their cases separately.

- *Legislative scrutiny:* The ruling aligns with

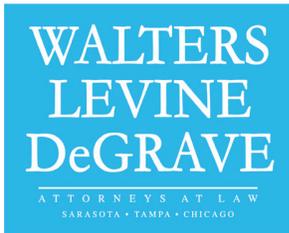
efforts by some lawmakers to prohibit broad legal releases to non-debtors. That may spur further legislative action to codify or expand upon the court's decision.

Looking ahead

The *Purdue Pharma* decision marks a significant shift in bankruptcy law and practice, forcing companies to adapt their risk management strategies.

For example, companies will likely intensify due diligence in M&A deals involving potential liabilities. Additionally, there might be increased demand for directors and officers (D&O) insurance as executives seek personal liability protection.





Sarasota office: (941) 364-8787 • Tampa office: (813) 254-7474
Chicago office: (312) 782-8807
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High Court ruling prompts reevaluation of buy-sell agreements

In a decision at the end of the 2023-2024 term, the U.S. Supreme Court altered the tax landscape for closely held companies, triggering a necessary shift in business succession planning.

The case, *Connelly v. United States*, has implications for business owners utilizing life insurance-funded buy-sell agreements and similar contingency plans.

Case overview

The dispute centered around Crown C Supply, a St. Louis-based building supply company owned by brothers Michael and Thomas Connelly. Their estate planning strategy included a buy-sell agreement funded by \$3.5 million life insurance policies on each brother.

Following Michael's death in 2013, the company received the insurance payout and used \$3 million to redeem Michael's shares as per their agreement. The remaining \$500,000 was allocated to company operations.

The crux of the legal battle: Should the \$3 million in insurance proceeds be factored into Crown's valuation for estate tax purposes, despite its use in share redemption?

The court's decision

Overturing previous circuit court decisions, the Supreme Court held that a company's contractual obligation to redeem shares does not offset the increased

value from life insurance proceeds. Life insurance payouts to a company must be included in its valuation for estate tax purposes, regardless of their intended use for share redemption.

Implications for business owners

The *Connelly* decision impacts life insurance-funded planning strategies for closely held businesses. Companies holding such policies may need to reassess their arrangements in order to avoid unexpected taxes. The court, for example, suggested that different structures, such as cross-purchase agreements, might yield more favorable tax outcomes.

Business owners with buy-sell agreements, especially those funded by life insurance, should seek legal counsel to:

- Evaluate the potential impact of the *Connelly* decision on their specific situation.
- Explore options for protecting business continuity and ownership transition plans.
- Develop strategies to minimize potential tax burdens.
- Proactive planning will be key for closely held business owners seeking to protect their business and their heirs.