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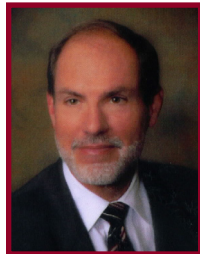
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## Welcome to the *Business Compass*



Welcome to the November issue of the Business Compass. This issue presents four feature articles. The first article, written by Marisa Zink (Akron) and David Hrina (Akron), discusses a significant new U.S. Supreme Court ruling which deals with the patentability of business methods. Jeffrey Weinstock (Boca Raton) authored the second article focusing on the benefits of the Florida homestead exemption and a new audit initiative related thereto. The third feature article, authored by myself, Chris Smith and Jon Stefanik focuses on the advantages and disadvantages of employee stock ownership plans ("ESOPs") in general and, more particularly, on their utility as a means of financing a sale of an owner's interest in a corporation. The last article was written by Patricia Pacenta and deals with the impact on business succession planning of the uncertainty over whether the estate and gift tax will be reinstated for 2010.

I hope you enjoy this edition of our newsletter. If you have any questions about any of the articles or about any other business law issue, please contact any of our practice group members. As always, we welcome your opinions and feedback. Thank you.

*Robert W. Malone*  
Business Practice Group Chair

## FEATURE ARTICLES

### Long-Awaited Bilski Decision Leaves Many Issues Unresolved

By: [David J. Hrina](#) and [Marisa J. Zink](#)

In a much-anticipated decision, the U.S. Supreme Court affirmed the rejection by the Court of Appeals for the Federal Circuit of Bernard Bilski's patent application for a method for handling energy hedge funds but failed to definitively address the larger issue of the patentability of various methods of doing business, and how to determine the same. The Court left the door open to business method patents in general but noted that the "machine-or-transformation" test adopted by the Court of Appeals should not be the sole test for determining patentability of business methods.

While acknowledging that the nation's patent laws should be given broad scope, the Supreme Court also noted three specific exceptions to patentability, namely "laws of nature, physical phenomena, and abstract ideas." The Bilski patent application claimed a procedure for instructing buyers and sellers on how to protect against the risk of price fluctuations in a discrete section of the economy. Claim 1 of the Bilski patent application described a series of steps instructing how to hedge risk, and claim 4 put the concept of claim 1 into a simple mathematical formula.

In determining that Bilski's claimed invention did not qualify for patent protection, the majority noted that Bilski's invention was merely an abstract idea and that the machine-or-transformation test is not the exclusive test for determining patentability.

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## Long-Awaited Bilski Decision Leaves Many Issues Unresolved

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The machine-or-transformation test considers whether a claimed process is tied to a particular machine, or if it transforms a particular article into a different state. The Court of Appeals for the Federal Circuit had ruled that the machine-or-transformation test was the sole test in determining patentability of a "process" under the Patent Act. However, the Supreme Court rejected that contention and ruled that the machine-or-transformation test was not the sole test to be used in considering whether a particular business method qualifies for patent protection.

More specifically, the Supreme Court held that adopting the machine-or-transformation test as the sole test for determining patentability would violate at least two statutory interpretation principles, namely (1) Courts "should not read into the patent laws limitations and conditions which the legislature has not expressed," and (2) "unless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning." While the Supreme Court acknowledged that the machine-or-transformation test is a useful investigative tool for determining patentability of processes under the Patent Act, it also acknowledged that patentable inventions could exist that would otherwise fail the machine-or-transformation test. Therefore, the Supreme Court reasoned that it did not make sense to confine the Patent Office to just the machine-or-transformation test in determining whether a particular invention was eligible for patent protection.

Furthermore, the Supreme Court upheld the idea that business processes and methods were patentable, stating that the Patent Act leaves open the possibility that at least some processes can be fairly described as business methods that are within patentable subject matter under the Patent Act. Notwithstanding, a concurring opinion written by Justice Breyer, with Justice Scalia joining, stated that "a general method of engaging in business transactions is not a patentable process within the meaning of" the Patent Act. The concurring Justices went on to state that this Court has "never before held that business methods are patentable, and ... the text, history, and purposes of the Patent Act make clear that they are not." Further, in discussing the machine-or-transformation test, the concurring Justices stated that "the Court intends neither to deemphasize the test's usefulness nor to suggest that many patentable processes lie beyond its reach."

In summary, the Court's decision in Bilski confirms the patentability of some business methods but, unfortunately, does not provide the inventor and the patent practitioner with a clear understanding of how to make the determination.

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## Florida Property Appraisers Get Tough on Dual Homestead Filers

By: Jeffrey D. Weinstock

Florida homestead has received much press in recent years. In Florida, homestead can mean several things. There is a "constitutional" homestead protection that exempts the entire value of one's personal residence from the claims of most creditors as long as the residence is limited to one-half acre within a municipality or, if outside a municipality, up to 160 contiguous acres.

In addition, there are other financial benefits to filing for and receiving a homestead exemption on your permanent residence. The homestead exemption would entitle most homeowners to a reduction of \$25,000 from their property's tax-assessed value. In addition, the homeowner is entitled to an additional exemption of up to \$25,000 on an assessed valuation greater than \$50,000 for all levies other than school district levies.

Of greater benefit (especially when property values are increasing) is the cap on increases in future real property taxes. Florida's Constitution limits the annual increase in the tax-assessed value of homestead property by the lower of three percent per year or the increase in the consumer price index. When the residential real estate market in Florida is appreciating rapidly, this limitation can also substantially reduce your property tax liability.

## Florida Property Appraisers Get Tough on Dual Homestead Filers

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Florida law, however, prohibits a person who is receiving a tax exemption similar to the homestead exemption in another state from also receiving a Florida homestead exemption.

The actual language of the Florida Constitution provides that “not more than one exemption shall be allowed any individual or family unit or with respect to any residential unit.” There are conflicting opinions as to what constitutes a “family unit” with respect to homestead.

If a husband and wife own jointly titled property in Florida as well as in another state and they were receiving a homestead exemption in that state, they would not also be entitled to a homestead exemption in Florida. Florida property appraisers have been more assertive recently in determining whether applicants for the homestead exemption are also obtaining exemptions in another state, enabling the property appraiser to deny the application for the Florida homestead exemption.

In addition, it appears that there have been increased efforts to identify ineligible exemptions and levy fines as a result. Although it may not be surprising to learn that there are criminal penalties for providing false information for the purpose of claiming a homestead exemption, there are also significant penalties associated with benefiting from an ineligible homestead exemption, which permits a county property appraiser to file a notice of tax lien against any property owned by that person in the county. In addition, the property owner must pay the property taxes plus a penalty of 50 percent of the unpaid taxes for each year and 15 percent interest per year.

Since there may be different situations and many variations in the manner in which one can have property titled, if you have any questions about whether or not you may be eligible for a homestead exemption in Florida, please contact one of our Florida attorneys.

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## Is an ESOP Right for You?

By: Jon R. Stefanik, Robert W. Malone and Christopher M. Smith

Employer Stock Ownership Plans (“ESOPs”) can be an attractive planning option for owners of small to medium-sized businesses seeking an exit strategy. ESOPs are especially useful in economic environments such as the present, where buyers are difficult to find and traditional financing methods are unavailable. Benefits provided by an ESOP include the following:

1. **Tax-Favored Financing.** Under a typical ESOP transaction, a sponsoring company borrows money from an outside lender (the “outside” loan) and loans the same amount to the ESOP (the “inside” loan), which the ESOP uses to fund its buyout of the retiring owner’s stock. Over time, the sponsoring company makes contributions to the ESOP to allow the ESOP to repay principal and interest on the inside loan, which the company then uses to repay the outside loan. The company’s contributions to the ESOP are fully deductible. Thus, the company has, in effect, obtained a deduction for principal as well as interest payments, which would not be possible using traditional financing.
2. **Owner Deferral.** If the sponsoring company is a C corporation, the retiring owner may be able to indefinitely defer tax on the sale of his company stock if the shareholder uses the sale proceeds to purchase domestic stocks or bonds and make an election under Internal Revenue Code Section 1042.
3. **S Corporation Tax Exemption.** The use of an ESOP in connection with an S corporation is particularly tax-advantaged since the income of the S corporation allocated to the ESOP is not subject to income tax. If the ESOP owns 100% of the company, the company will pay no federal income tax. For an S corporation that is only partially owned by an ESOP, the exemption from tax applies only to income attributable to the shares held by the ESOP.
4. **Dividends Are Tax-Deductible.** If the sponsoring company does not make an S election, reasonable dividends used to repay an ESOP loan are tax-deductible. Companies can also “pass through” dividends directly to employees. These payments do not count towards the contribution limits.
5. **Employee Morale.** Statistical evidence suggests that an ESOP can boost employee morale and reduce turnover, resulting in enhanced productivity for the sponsoring company.

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## Is an ESOP Right for You?

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6. Tax Deferral on Contributions. Employees do not pay tax on the stock allocated to their accounts until they receive a distribution thereof. They can delay the payment of taxes by rolling over their account into an IRA after separation of service.

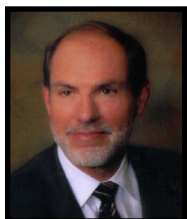
Before implementing an ESOP, a business owner should consider the following potential drawbacks:

1. Seller Financing. If the Selling Shareholder wants all or most of the consideration for his shares to be in the form of cash, the company must secure adequate financing, which may be difficult given the current restrictive lending environment. If the company cannot obtain adequate financing, the owner may have to finance some portion of the purchase consideration in the form of a subordinated promissory note. This adds an element of risk to the owner's exit, which risk is increased to the extent that the ESOP transaction causes the company to become more leveraged than was the case prior to the transaction. To compensate for this added risk, the subordinated promissory note held by the owner may be coupled with warrants for the company's stock. Through the warrants, the owner will retain the benefit of a share of the company's potential upside.
2. Original Issue Discount. The subordinated note held by the owner will ordinarily bear interest at a below-market rate if the note is coupled with warrants. This could result in a phantom non-cash income known as original issue discount accruing over the term of the note.
3. Cash Flow. An ESOP could impose a continuing cash flow strain on a company in the form of debt service obligations related to the financing of the original transaction and the ongoing buyout of retiring employees who are participants in the ESOP. The company's obligation to buy out retiring shareholder-employees is particularly problematical if a large number of shareholders quit or retire at the same time. Cash flow concerns are especially pertinent where the retiring owner holds the company's subordinated promissory note.
4. Expense. The costs of establishing and maintaining an ESOP will ordinarily exceed the costs associated with a third-party sale. Those costs would include a valuation of the company, a feasibility study, a repurchase liability analysis, increased accounting fees, legal fees for drafting the ESOP, and legal fees for the attorneys providing advice to the ESOP trustee. In addition, the ESOP would require annual valuations, and an outside ESOP trustee would charge ongoing fees. For small companies these costs may be greater than the potential benefits.
5. Trustee Issues. Many companies appoint employees as the trustees to save money on the cost of hiring an institutional trustee. This practice can create a number of issues. In negotiating the purchase of shares of an ESOP, the trustees owe a fiduciary duty to the participants to act on their behalf. A trustee often finds it difficult to negotiate objectively on behalf of the participant, to the potential detriment of the owner, who is typically the chief executive officer of the company.

Under certain circumstances, an ESOP can provide a promising means of financing the buyout of a retiring owner. An ESOP is not, however, a one-size-fits-all solution, and careful consideration should be given to the potential drawbacks referenced above before implementation of an ESOP.

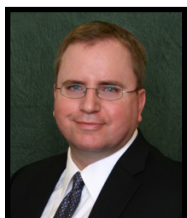
Please contact a member of our Tax and Employee Benefits Practice Group if you are considering or have questions regarding an ESOP.

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## Business Succession Planning: Time to Take Action Despite Congressional Inaction?

By: Patricia A. Pacenta

Hard to believe, 2010 is nearly over, yet the federal estate tax picture is no clearer than it was last New Year's Eve. Will Congress reenact the federal estate tax as it existed in 2009? Will Congress make it retroactive to apply to all those dying in 2010? Or, will Congress do nothing and allow the estate tax exemption to drop to \$1 million on January 1 and the maximum estate tax rate to rise to 55%? Will Congress will enact some other exemption amount or tax rates? Only the foolhardy dare to predict. Many observers believe Congress will not enact estate tax legislation until after the November elections.

In the face of such uncertainty, a "wait and see" approach to planning is understandable but not wise. If anything is certain it is that permanent repeal of the federal estate tax will not occur. Chances are good that an exemption amount of \$3.5 million is the maximum Congress will enact. In truth, estate and business succession planning must still be a business owner's priority.

It is critical that an estate and business succession plan provide as much flexibility as possible, consistent with the business owner's goals. Estate planning can add flexibility by providing contingent trust arrangements, gifts and other strategies to be implemented or not, depending upon the circumstances at death.

Now may be a perfect time, even perhaps the best time, to gift a business interest or other property to the younger generation. Gifts are most effective if made when the gifted property is temporarily depreciated or can be undervalued for other reasons. The current low-growth, low-interest-rate climate is excellent for gifts or sales of minority business interests and for grantor-retained annuity trusts (GRATs). A bill is pending in Congress to restrict the use of a GRAT with which one can gift the appreciation in stock or other property at little or no estate or gift tax cost, but to date it has not been enacted. For now, but perhaps not for long, GRATs are still available.

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## UPDATES & INSIGHTS

### Tax Law...

As you probably know, realized gains from the disposition of property can be deferred through a like-kind exchange. However, did you know that an investment or commercial property can be exchanged for a leasehold interest in real property with a 30 year or greater term? For purposes of determining the leasehold term, optional renewal periods are included. Therefore, when disposing of an interest in real property, keep in mind you need not acquire a fee interest in replacement property. A long-term leasehold interest will suffice.



Steven A.  
Dimengo

### Nonprofit Law...

By now, most clients have complied with the IRS' new Form 990 requirements by updating their Bylaws, preparing Codes of Ethics, Conflict of Interest policies, Whistleblower policies, Gift Acceptance policies, Joint Venture policies, appropriate auditing procedures and the like. It is now becoming apparent that the IRS is increasing its audit capacity. The word out of Washington is that the first organizations to be audited will be those that did not indicate that they have the suggested policies in place. The second wave of audits will be to make certain that organizations not only have the policies, but are adhering to them. Finally, the audits will be determining whether tax exempt organizations are appropriately maintaining their exempt status. The Nonprofit Practice Group has not only been assisting organizations in putting together policies such as those described above and tailoring such policies so that they match their actual practices, but it has also assisted tax exempt organizations with preparations for and defense of IRS audits.



Gerald B.  
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## RECENT NEWS

The following members of the Business practice group were recently selected by their peers for inclusion in *The Best Lawyers in America*® 2011\*:

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- *Steven A. Dimengo*
- *Nicholas T. George*
- *Cathy C. Godshall*
- *Stephen M. Hammersmith*
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