

WEDNESDAY, APRIL 28, 2010

The Beauty of a Cash Balance Buy-Out Tool

By Stephen J. Butler

Today, many businesses — especially professional firms such as law practices — have a sobering problem when it comes to older partners. It can be difficult enough to negotiate a sale of an owner's interest, and finding a way to pay for it is an even greater challenge.

A unique retirement plan variation can grease the skids of an exit strategy and leave all parties in a win-win situation. This would involve the creative use of a special retirement hybrid known as a cash balance plan. In the context of a partnership buy-out, a cash balance plan can be incorporated as an overlay to an existing 401(k) plan and create the opportunity for massive retirement plan contributions for older people in their 60's. By massive, I mean something in the neighborhood of \$150,000 per year for many business owners approaching retirement.

The typical dilemma for younger owners of a professional practice stems from their need to come up with after-tax dollars to buy out a retiring partner. This means that a payment of \$500,000 will cost \$1,000,000 in pre-tax dollars. Then, the dollars are taxed at capital gains rates to the departing partner who, if an original founder of the business, probably has a cost basis of zero. Therefore, the entire amount of the sale proceeds will be taxed at capital gains rates. In simple terms, over half of all the money required at the start of the transaction will be paid in taxes by a combination of the buyer and seller.

The beauty of incorporating a cash balance plan into the mix is that the contributions are a tax-deductible expense for the firm and its remaining younger business owners. For the seller, the deposits are tax-free, or at least tax-deferred, until the retiring seller starts spending the money years later in retirement. Moreover, the money in the plan can be invested and compounding on a tax-deferred basis over the years.

In an actual example of a small firm with an owner and a handful of employees, we start by calculating a yearly "service credit" for each year the firm's owner has worked. In an actual recent case, this turned out to be \$25,000 a year for the 25 years this professional had been self-employed, a total of \$600,000 becomes the "opening balance." ("Opening balance" is another way of saying that this is what he should have had by now if he had started saving years ago.) Since he wants to retire in five years, we extend the \$25,000 annual service credit out for that length of time compounded at 6 percent per year. We also compound the \$600,000 opening balance out for five more years at 6 percent. The total of the two numbers

is just under \$1,000,000.

Now, we work backwards to determine how much money has to be contributed over the next five years to accumulate the \$1,000,000 lump sum funding level we have just calculated. An annual tax-deductible contribution of \$175,000 earning 6 percent for the next five years will do the trick. Fortunately, with the business (at least) in its prime of life, this owner could afford to make those tax-deductible contributions.

Meanwhile, what about other employees in this small firm? Well, typical turnover at small firms generally means that not many folks have worked long enough to have accumulated much in the way of an "opening balance." This reduces the lump sum to be funded for them. Also, their younger ages as a group allow us to use a much lower service credit. The service credit for the business owner was 12.5 percent of current salary. The other employees had a 2 percent of current salary service credit, because hypothetically, they had the advantage of about 30 years until retirement. This meant that the business owner contributed about \$15,000 for a handful of younger employees as a cost for the right to contribute \$175,000 into his own account. A further advantage is that each employee has his or her own specific account. They can actually see their money as opposed to just a vague promise of an "accrued benefit" that may or may not be adequately funded.

The cash balance plan, in this small company environment, offers a tremendous advantage for older business owners or professionals. This example was extreme, to illustrate the point, but this vehicle can be incorporated as an overlay to existing 401(k) plans to "supercharge" the contribution levels and accomplish more for senior owner/employees who find themselves "behind the retirement eight-ball." Employers view their contributions for employees (required of only the lowest-paid half of the non-owner employees) as a good bargain. The thought

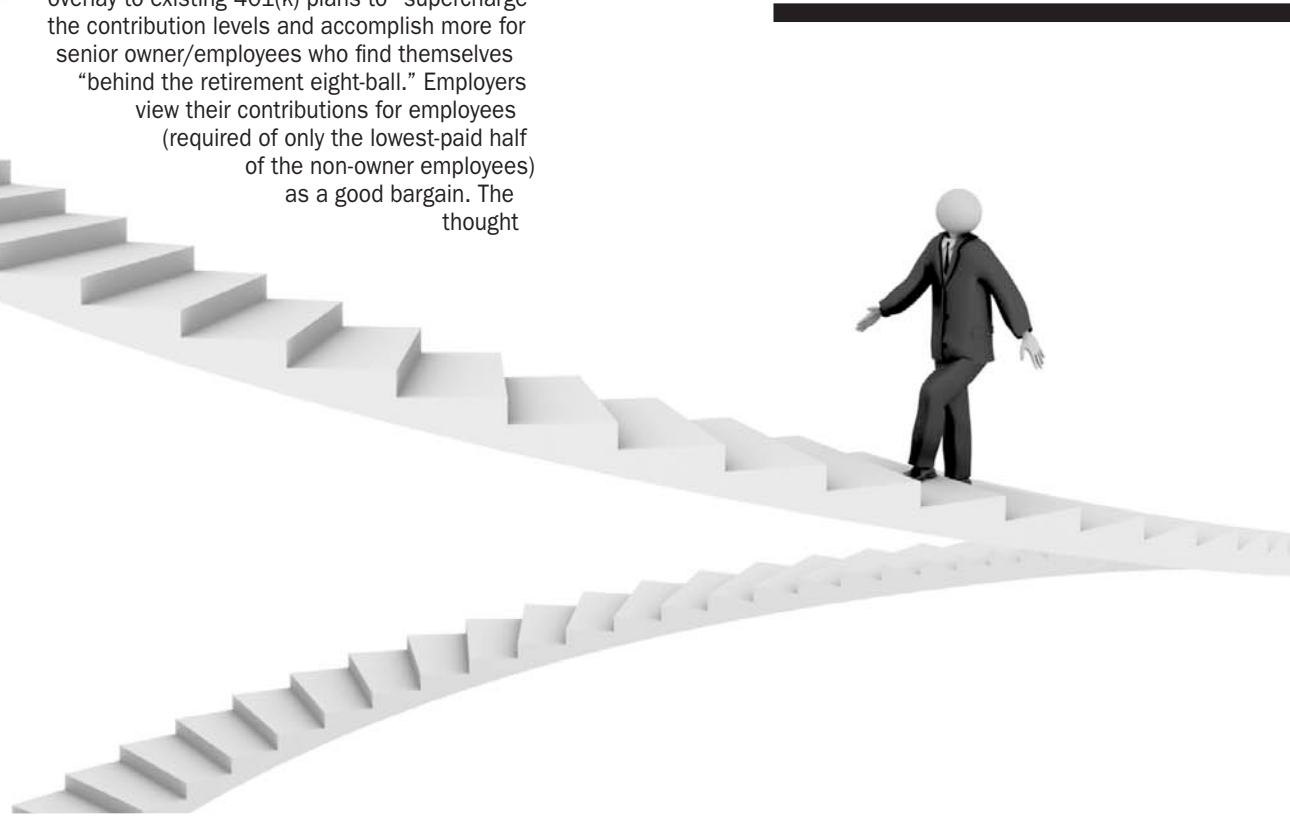
process says, "I'm just giving to my associates a portion of what I otherwise would have paid in taxes."

This example above is small and simple to illustrate the mechanism. In the case where the tool is used to fund the business interest buyout of a senior partner, younger partners are treating the substantial retirement plan contribution as installment payments for his or her ownership interest.

People selling business interests later in life too often assume the value of their stock amounts to what they have calculated as that final nut to fund their retirement lifestyle — and the sales price in their mind's eye has been "grossed up" to cover what the estimated capital gains tax on the sales proceeds. Either that or the sellers have some round number in their heads like "One million dollars." The nicest people in the world can rationalize what's in their self-interest. Buyers, of course, only care about what the business can support financially and still be a going concern. Emotional benchmarks mean little or nothing, and this disparity in priorities can bring negotiations to a stand still.

Judicious use of the cash balance plan, before it gets too late, begins the process of eating the elephant one bite at a time. Practiced over a number of years as part of the sales process, it relieves the pressure of having to come to terms with a single, final, large number.

A unique retirement plan variation can grease the skids of an exit strategy and leave all parties in a win-win situation.



Stephen J. Butler is the founder and president of Pension Dynamics Corp., a retirement plan consulting and administration company, in business since 1980. He can be contacted at sbutler@pensiondynamics.com or <http://www.pensiondynamics.com>.

The Peculiarities of Pleading in Patent Cases

By Craig E. Countryman

Two recent Supreme Court cases have ratcheted up the level of specificity most federal plaintiffs must include in their complaints to survive a defendant's motion to dismiss the case prior to discovery, but some peculiarities of patent cases may limit the effect of those decisions to them. Federal Rule of Civil Procedure 8 requires the complaint contain "a short and plain statement of the claim showing that the pleader is entitled to relief." Until recently, the Courts of Appeals, following language in *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957), had generally held that the defendant could not prevail on a motion to dismiss unless it was "beyond doubt" that there were "no set of facts" consistent with the complaint's allegations that would entitle the plaintiff to relief.

Bell Atlantic v. Twombly, 550 U.S. 544 (2007) began a shift in this regime. The complaint alleged the defendants, regional Bell telephone companies, violated Section 1 of the Sherman Act, which prohibits an unreasonable "contract, combination...or conspiracy, in restraint of trade or commerce." It alleged the defendants each took similar action to stifle the ability of new providers to enter their local markets while taking care not to enter one another's markets. The Court deemed the complaint insufficient because it did not allege facts suggesting an agreement between the defendants, as opposed to identical, indepen-

Two recent Supreme Court cases have ratcheted up the level of specificity most federal plaintiffs must include in their complaints to survive a defendant's motion to dismiss the case prior to discovery, but some peculiarities of patent cases may limit the effect of those decisions to them.

dent action by each of them. The opinion distinguished between the possible, plausible, and probable. According to the Court, although the defendants' conduct was "consistent with" an agreement to exclude others, that did not make it "plausible" to believe such an agreement was formed. As the Court stated, there was no "reasonable expectation that discovery will reveal evidence of illegal agreement." The plaintiff's ultimate allegation that an agreement existed was not enough to satisfy Rule 8's requirement that the plaintiff show the "grounds" of his "entitlement to relief" because doing so "requires more than labels and conclusions, and a formulaic recitation of a cause of action's elements will not do."

Ashcroft v. Iqbal, 127 S. Ct. 1937 (2009) continued the shift, confirming that *Twombly*'s requirements apply to any case subject to Rule 8. It dismissed a complaint alleging constitutional violations by federal officials related to terrorism policies adopted after September 11. One element of the claim required showing the policies were intentionally adopted to classify individuals on account of race, religion or national origin. The Court found the complaint failed to state a claim because it did not allege facts demonstrating it was "plausible" the policies were adopted for that purpose, despite its bare allegation of intentional discrimination. The Court reiterated that "the tenet that a court must

accept as true all of the allegations contained in a complaint is inapplicable to legal conclusions." In addition, while acknowledging that Rule 9(b) allows intent to be alleged "generally," the Court held this does not excuse the plaintiff from satisfying the Rule 8's pleading standard.

One might think these decisions directly apply to patent cases. But unlike the causes of action in *Twombly* and *Iqbal*, the Federal Rules include a form complaint for patent cases (Form 18), and Rule 84 says the form "suffice[s] under these rules and illustrate[s] the simplicity and brevity that these rules contemplate." The form uses an exemplary patent on an electric motor and simply requires the plaintiff allege that it owns the patent and the "defendant has infringed and is still infringing the Letters Patent by making, selling, and using electric motors that embody the patented invention." This seems like a bare "legal conclusion," which the Supreme Court has deemed insufficient to survive a motion to dismiss, for the complaint does not recite any facts about the defendant's electric motors or compare them to the patent. It does not even specify a particular model of electric motor or particular patent claims that are allegedly infringed. And yet Rule 84 says it suffices, as the post-*Twombly* decision in *McZeal v. Sprint Nextel Corp.*, 501 F.3d 1354 (Fed. Cir. 2007) confirmed.

Two district courts, acting after *Iqbal*, have suggested that generic descriptions of the type of product accused of infringement, e.g. "cell phones" or "touchpads," are insufficient. *Bender v. LG Elecs.*, 2010 WL 889541 (N.D. Cal.); *Elan Microelectronics v. Apple*, 2009 WL 2972374 (N.D. Cal.) (Seeborg, M.J.). They avoid *McZeal* by suggesting it was superseded by *Iqbal*, but they would still seem to conflict with the form patent complaint. As a matter of policy, they are understandable because the form's drafters might not have imagined the now common situation where a defendant sells hundreds or thousands of different products, the patent is highly technical, and it is not immediately clear what products are accused of infringement. Nonetheless, plenty of other decisions have found such general pleading adequate after *Iqbal*.

What about the pleading requirements for issues in patent cases on which Form 18 is silent? Form 18 only addresses pleading "direct" infringement — that is, infringement where the defendant is itself making, using, selling, or importing the claimed invention. It does not speak to pleading induced or contributory infringement, where the plaintiff is accusing the defendant of abetting another's direct infringement and some showing of knowledge or intent is required, or joint infringement, where the defendant outsources the performance of one step of a claimed process to another it "directs or controls." Nor does it elaborate upon what is required to plead "willful infringement," which sometimes warrants treble damages.

It would seem the *Twombly/Iqbal* plausibility standard applies to these issues. The only reason it does not apply to direct infringement is because Form 18 explicitly says otherwise. Indeed, as the *Elan* court recently put it: "Both types of indirect infringement include additional elements, none of which Form 18 even purports to address. In the absence of any other form that addresses indirect infringement and is made



binding on the courts through Rule 84, the Court must apply the teachings of *Twombly* and *Iqbal*." Willfulness and indirect infringement, which require proof of ill intent, seem particularly vulnerable after *Iqbal*. And, sure enough, a number of district courts have begun dismissing claims for indirect and joint infringement as being insufficiently pled under these cases. *Elan* is one example, as are *Koninklijke Philips Electronics v. ADS Group*, 2010 WL 938216 (S.D.N.Y.), *Bender v. Motorola*, 2010 WL 726739 (N.D. Cal.) and *Friday Group v. Ticketmaster*, 2008 WL 5233078 (E.D. Mo.). But other opinions have been forgiving, such as *Bender v. National Semiconductor*, 2009 WL 4730896 (N.D. Cal.) and *Mallinckrodt v. E-Z-EM*, 671 F. Supp. 2d 563 (D. Del. 2009).

Defendants should consider filing more Rule 12(b)(6) motions under the new pleading standards. Although obtaining dismissal with prejudice, rather than simply a more specific amended complaint, may be difficult, such motions can help defendants narrow the products at issue, close off theories on indirect or joint infringement, and potentially limit discovery. Meanwhile, plaintiff should consider adding more detail to their complaints to avoid costly motion practice, although without giving away too much detail. Some districts have patent local rules that require early, detailed infringement contentions, which may render motion practice superfluous. Indeed, one judge expressed frustration in that circumstance, and "strongly encourage[d] the parties to try the case on the merits and not unnecessarily burden the Court with technical issues that lack practical substance." *Bedrock Computer v. Softlayer*, Case No. 09-cv-269-LED (E.D. Tex.) (Mar. 29, 2010). So defendants should assess whether a motion will yield a real benefit.

The apparent conflict between Form 18 and *Twombly* and *Iqbal* suggests the Supreme Court's new pleading requirements exceed those contemplated by the Rules. Those decisions are unlikely to be revisited anytime soon, however, so the drafters of the Federal Rules may want to consider revising Form 18 to eliminate the conflict. Such a revision could also provide examples of sufficient pleading for other patent issues not currently addressed.



Craig E. Countryman is an associate in the Southern California office of Fish & Richardson. His practice emphasizes patent litigation in the area of chemistry.