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TECHNOLOGY MAY-RATHON

BENEFITS AND COMPENSATION: MISSION CRITICAL FOR TECH COMPANY SUCCESS

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SECTION 01

REPEAL AND REPLACE: ACA FOR AHCA

Repeal and Replace

- American Health Care Act of 2017 (AHCA)
  - ➢ Passed by full House May 4 (with one vote to spare)
    - ❖ Expect consolidated bill language and Committee Report
      - – Has become difficult to track changes on top of changes on top of changes
  - ➢ Goes to Senate
    - ❖ Inevitable revisions, if not total replacement
      - – Politics harder, margins narrower in Senate
      - – Could die in Senate

Repeal and Replace

- What ACA provisions stay?
  - Federal and state based Exchanges (ACA reporting)
  - Preventive care services with no cost sharing
  - Dependent coverage to age 26
  - Appeals and external review standards
  - Provider nondiscrimination rules
  - Prohibition of lifetime and annual dollar limits
  - Essential health benefits standards (subject to state waivers)
  - Prohibition on pre-existing condition exclusions

Repeal and Replace

- What ACA provisions stay?
  - Requirement for all plans to apply in-network level of cost sharing for out-of network emergency services is not changed
  - SBCs
  - Wellness incentives permitted under ACA

Repeal and Replace

- AHCA based on budget reconciliation process
  - ➢ Done in House May 4 without any Democratic votes
  - ➢ Could only address Affordable Care Act (ACA) provisions that have a federal budget impact
    - ❖ Repeal of individual mandate (January 1, 2016)
    - ❖ Tax penalty for employer shared responsibility is reduced to zero (January 1, 2016)
    - ❖ Annual limit on Contributions to FSAs repealed (January 1, 2017)
    - ❖ Reinstates Medicare Part D RDS tax deduction for employers (January 1, 2017)

Repeal and Replace

- AHCA based on budget reconciliation process (cont.)
  - ➢ Could only address Affordable Care Act (ACA) provisions that have a federal budget impact (cont.)
    - ❖ Changes for HSAs (January 1, 2018)
      - – Increase annual tax free contribution limit to equal the limit on out-of-pocket cost sharing under qualified HDHP
      - – Additional catch up contribution of up to $1,000 (age 55+, both spouses)
      - – Qualified medical expense definition expanded to include over-the-counter medications and expenses incurred up to 60 days prior to date HSA was established
      - – Tax penalty for HSA withdrawals used for non-qualified expenses is reduced from 20% to 10%
    - ❖ ACA cost sharing subsidies are repealed (January 1, 2020)

Repeal and Replace

- AHCA based on budget reconciliation process (cont.)
  - Could only address Affordable Care Act (ACA) provisions that have a federal budget impact (cont.)
    - Repeal of Medicare Tax Increase (January 1, 2023)
    - Cadillac tax on high-cost employer-sponsored group health plans is suspended for tax years 2020 through 2025

HIPAA Update

- General Privacy and Security Compliance
- Guidance on Cloud Computing
  - Privacy Considerations
  - Security Considerations
- Recent OCR settlements / actions

SECTION 02

BENEFITS AND COMPENSATION CHALLENGES AND LIABILITIES THAT ARISE IN MERGERS AND ACQUISITIONS

Transaction Structure Matters

- Asset Purchase or Joint Venture vs. Stock Purchase or Merger
- Public vs. Private
- Seller vs. Buyer

Seller’s Planning

- Identify plans and agreements
  - Any change-in-control benefits?
  - Any compliance issues?
- Best time to address issues is before a transaction
- Planning opportunities will vary depending on timing

Buyer's Diligence

- Any plan or agreement could raise issues, but focus especially on big-ticket items
  - Equity rights
  - Employment and change-in-control agreements
  - Severance benefits
  - Bonus and retention arrangements
  - Pension and retirement plans (qualified and nonqualified)
    - Multiemployer plans
  - Retiree medical and other post-termination welfare benefits

Section 280G

- Internal Revenue Code (Code) provision that applies to payments in the nature of “compensation” that are “contingent” on a “change in control” paid to a “disqualified individual”
  - 20% excise tax on the “excess parachute payment”
  - Loss of tax deduction to the employer

Section 280G – Private Company Exemption

- Payments made by *privately held companies* when shareholder approval requirements are met
  - Payments must be approved by more than 75% of the disinterested shareholders entitled to vote immediately before the change-in-control
  - "Adequate disclosure" of all material facts regarding all material payments that otherwise would be parachute payments is provided to *all* persons entitled to vote
  - Payments must be contingent on the vote

SECTION 03

EQUITY COMPENSATION FOR EMERGING GROWTH COMPANIES

Types of Equity Awards

Appreciation in Value

- Stock Options
- Stock Appreciation Rights

Full Value

- Restricted Stock
- Restricted Stock Units/Phantom Shares

What is a Stock Option?

- What is a Stock Option?
  - Right to purchase a fixed number of shares at a fixed price
- Types of Stock Options
  - Nonqualified Stock Options (NQSOs)
  - Incentive Stock Options (ISOs)

Nonqualified Stock Options

- Nonqualified Stock Options
  - Must have exercise price not less than fair market value to avoid tax issues under section 409A of the Code
  - Must be granted on service recipient stock (no preferences as to dividends, liquidation rights, etc.) to avoid tax issues under section 409A of the Code
  - May be granted to any type of service provider (employee, director, consultant)
  - No tax at grant
  - Taxable at exercise on the spread (fair market value of the purchased shares at the time of exercise, less the exercise price of the purchased shares) at ordinary income rates
  - Deduction for company at time of exercise

Incentive Stock Options

- Incentive Stock Options
  - May only be granted to employees
  - Must have exercise price not less than fair market value
  - Granted by corporations only
  - Other Code requirements (e.g., hold shares for two years from grant and one year from exercise, term cannot exceed 10 years, $100,000 limitation, shareholder approval of equity plan within 12 months is required)
  - No tax at grant
  - No income tax at exercise (alternative minimum tax applies on the spread at date of exercise)
  - Taxable at sale of stock at capital gain rates if holding period requirements are met
  - Not subject to section 409A of the Code, but be careful

Advantages/Disadvantages of ISOs/NQSOs

- Potential advantages of ISOs compared to NQSOs:
  - Lower tax rate (capital gain)
  - Delayed tax (tax at sale of shares)
- Disadvantages of ISOs compared to NQSOs:
  - Company has no tax deduction if employee recognizes capital gain
  - Alternative minimum tax
  - Have to meet various requirements under the Code.

Stock Appreciation Rights

- Stock Appreciation Rights (SARs)
  - Employee receives the spread between the value of the stock at exercise and the exercise price
  - The spread can be paid in stock or cash
  - Must have exercise price not less than fair market value and be granted on service recipient stock to avoid tax issues under section 409A of the Code
  - No tax at grant
  - Taxable at ordinary income rates on the fair market value of net shares or cash issued on exercise
  - Deduction for company at time of exercise

Restricted Stock

- Restricted Stock
  - Grant of stock subject to a vesting schedule
  - Voting and dividend rights
  - Best for founders shares if private company
  - Generally taxed at time of vesting at ordinary income rates
  - 83(b) Election
    - Freezes ordinary income at date of grant
    - Must be made within 30 days of grant/irrevocable
    - Especially important where employee has paid purchase price for unvested shares
    - No further taxation until shares are sold
  - Deduction for company at time of vesting or, if 83(b) election is made, at time of grant
  - Not subject to section 409A of the Code

Restricted Stock Units/Phantom Shares

- Restricted Stock Units (RSUs)/Phantom Shares
  - Phantom rights convertible to stock or cash on distribution date
  - May grant dividend equivalent rights
  - Generally not taxed until distribution
  - Ordinary income; no 83(b) election available because no property transferred until distribution
  - Deduction for company at distribution
  - Can be paid in cash or stock
  - Performance-based RSUs have vesting based on achievement of performance goals
  - Distribution can be deferred beyond vesting must comply with section 409A

Advantages/Disadvantages of Appreciation Awards

- Advantages
  - Gives employee appreciation in value without employee's having to make an investment or pay tax currently
  - No tax at grant or vesting
  - Employee can choose when to exercise the option/SAR
    - Employee can control date of taxation
    - Most employees wait until a liquidity event to exercise options/SARs
  - ISO can result in capital gain if shares are held for holding period
  - Often used for private companies when stock starts to appreciate
- Disadvantages
  - Options/SARs can go underwater (if fair market value is less than exercise price)
  - Financial accounting charges are based on Black-Scholes value

Advantages/Disadvantages of Full Value Awards

- Advantages
  - Employee receives existing value of the shares, not just the appreciation
  - Full value shares do not go underwater
  - Financial accounting charge correlates to value delivered
  - Restricted stock
    - Can lock in tax event at grant or vesting, so future appreciation is capital gain
    - Often used for founders shares
  - RSUs
    - Postpone tax until distribution date
    - Often vest based on performance goals
- Disadvantages
  - Employee receives existing value of the shares; reward for breathing
  - Employee has little control over when the shares are taxed
  - Employee may have to pay tax before a liquidity event

Terms of Equity Grants

- Vesting
  - What are you trying to incentivize? Length of service, performance goals?
- Fair market value of shares
- Repurchase rights by the corporation/right of first refusal
- Non-competition covenants/clawbacks
- Change of control
  - Single trigger
  - Double trigger
  - Need flexibility to cash out equity grants upon change of control

Terms of Equity Grants

- Levels of equity grants
- Hiring a new executive
  - What form of equity?
  - How much equity?
  - Terms?
- No backdating!
  - IRS is auditing equity compensation, so it is important to keep accurate, contemporaneous board of directors minutes documenting equity grants

Securities Law Requirements

- Federal Securities Laws
  - Rule 701 for private company
  - Private placement
  - Form S-8 for public company
- State securities laws ("blue sky laws")

Public Company Equity Compensation Issues

- Stock exchange requirements
- Shareholder approval of equity compensation plans and Institutional Shareholder Services/Glass Lewis considerations
- Section 162(m) of the Code
- Section 409A of the Code and six month delay for payments to certain “specified employees” upon separation from service

Biography

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Saghi (Sage) Fattahian counsels clients on all aspects of health and welfare plans. She works with clients to comply with the complicated, shifting requirements under the US Internal Revenue Code, ERISA, ACA, COBRA, HIPAA, MHPAEA, GINA, and state and local laws. She assists health and welfare plans and their sponsors with daily operations and plan administration, including preparing and maintaining plan documents and related materials; reviewing and negotiating services agreements with third parties; consulting on operational issues; and assisting with claims and appeals.

Biography

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Carly E. Grey counsels employers on employee benefit and executive compensation matters. She advises on qualified and nonqualified retirement plans, health and welfare plans, and executive compensation arrangements. She also counsels clients on the legal issues arising under ERISA, the Internal Revenue Code, the Affordable Care Act, HIPAA, COBRA, and securities laws. In addition to helping employers resolve day-to-day compliance issues, Carly advises on complex employee benefits and executive compensation matters.

Biography

Erin Randolph-Williams
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Erin Randolph-Williams is part of a team that helps clients find solutions to their employee benefits–related problems. She counsels clients on employee benefits matters, including design, implementation, and administration of cash or deferred compensation arrangements, nonqualified deferred compensation plans, and executive and equity compensation arrangements. Erin negotiates employment agreements and severance arrangements for senior executives, and advises clients on all employee benefits and compensation-related aspects of mergers, acquisitions, sales and spin-offs.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

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Frankfurt
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Hong Kong*
Houston
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San Francisco
Santa Monica
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Washington, DC
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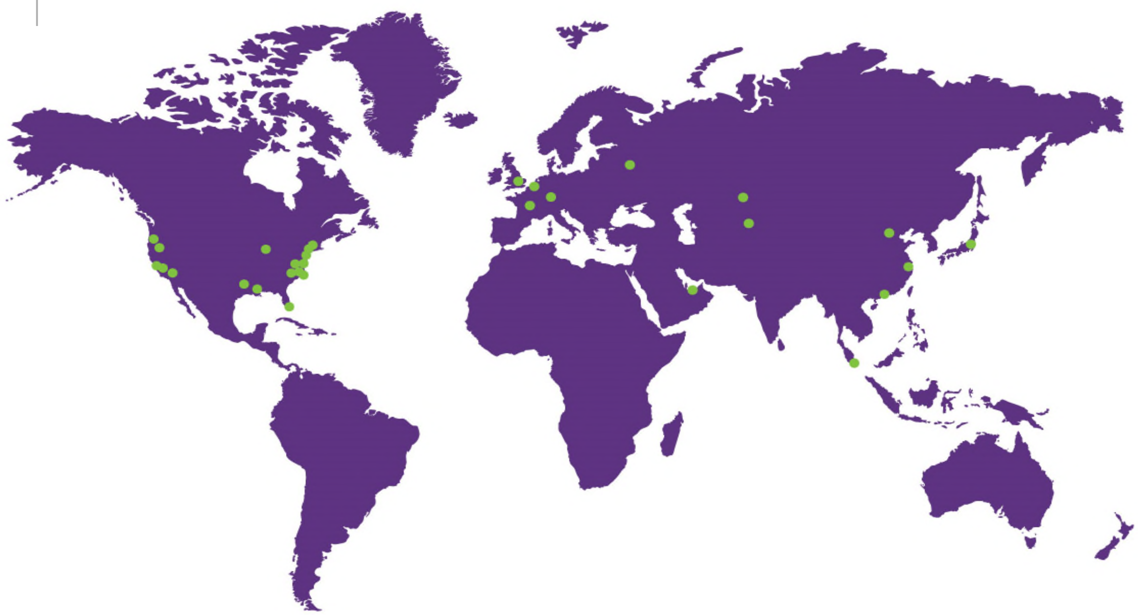

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*Our Beijing office operates as a representative office of Morgan, Lewis & Bockius LLP. In Shanghai, we operate as a branch of Morgan Lewis Consulting (Beijing) Company Limited, and an application to establish a representative office of the firm is pending before the Ministry of Justice. In Hong Kong, Morgan Lewis has filed an application to become a registered foreign law firm and is seeking approval with The Law Society of Hong Kong to associate with Luk & Partners.

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