

Start Ups and Emerging Companies – 101: Restricted Stock

Restricted stock simply means that the stock is issued subject to a "substantial risk of forfeiture". In essence, if there are written restrictions on the stock that prevent the founder from selling it, and require the founder to sell it back to the company if he or she quits, the stock is subject to a "substantial risk of forfeiture" and hence, is "restricted".

Why would someone receive Restricted Stock?

Founders are typically issued restricted stock to prevent the founder from taking his or her shares and walking away from the day-to-day business, leaving the remaining founders with the burden to run and grow the company for his/her benefit. In such case, the founder that walked away would, if not restricted financially from doing so, continue to be an owner of the company and would benefit financially from the company if it were a success, at the time and expense of the other founders. Therefore, it is common for a founder to take his stock subject to a "4 year vesting with a one year cliff" restriction.

Under the following example, the stock "vests" (becomes unrestricted) over a period of 4 years. Until it vests, the stock cannot be sold and may be repurchased by the company if the founder quits. After one year, 25% of the stock becomes unrestricted (vests). Thereafter, the remaining stock vests at 1/48 of the stock per month, until the last of the stock becomes unrestricted in year 5.

As mentioned above, typically, written restrictions that give rise to a "substantial risk of forfeiture" are put into place to prevent the founder from leaving the company prematurely. However, IRS Treasury Regulation 31783 gives guidance on this topic, providing in a nutshell that a "substantial risk of forfeiture" can mean virtually any substantive potential for a future forfeiture, as long as it is a real risk. For example, a company could require the forfeiture of stock if the company does not reach a particular sales goal or other metric.

Consider the implications of [IRC 83\(b\)](#).



by Derek A. Ridgway

For more information, please contact:

Derek A. Ridgway, Partner

925-746-8484

dridgway@hansonbridgett.com