



## PRIVATE EQUITY AND VENTURE CAPITAL UPDATE

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### RESTRICTED STOCK – AN ALTERNATE FORM OF EQUITY COMPENSATION IN VOLATILE CAPITAL MARKETS.

Stock options are frequently an attractive method of compensating executives, management and other key personnel for early stage companies. At issuance, stock options require none of the company's free cash, are easily granted and align the interests of the recipient with the company's long-term success. However, recent volatility in the credit and equity markets and the ongoing recession have limited the effectiveness of many previously granted options. Currently, depressed equity prices have forced many options "underwater" – that is, these options are currently valueless because the exercise prices exceed the current market value of these options.

Instead of granting stock options, an early stage company may want to consider issuing shares of restricted stock as an alternative method of equity compensation. Restricted stock is actual stock (as opposed to an option or warrant, which represents a right to acquire shares of stock in the future), and it can be used to align the recipient's interests with those of the issuing company. Additionally, shares of restricted stock are never "underwater" because the shares are fully issued at the time of the grant.

Companies almost always grant shares of restricted stock subject to vesting provisions in some form. In the context of restricted stock, vesting provisions give the issuing company a way to manage the rate at which the recipient of restricted stock enjoys the economic benefits of ownership. These vesting provisions may be tied to the passage of time, the achievement of certain milestones, or both. Delayed vesting of restricted stock encourages the recipient to remain with the company in order to maximize the value of the restricted stock. A simple outline of a time-based vesting scheme (which actually functions through a reverse-vesting provision) follows:

- The company grants shares of restricted stock to the recipient and, simultaneously, the two parties enter into a separate agreement which contains the vesting provisions for the shares of restricted stock (for our purposes, the "Vesting Agreement").
- The Vesting Agreement gives the company the right to repurchase the shares of restricted stock from the recipient at par value (or another specified, usually nominal, price).
- As provided by the terms of the Vesting Agreement, the company's right to repurchase the shares of restricted stock diminishes over time (*e.g.*, the company may lose the repurchase right with respect to 25% of the shares, each year for four years).

Recipients of restricted stock are able to obtain capital gains treatment for appreciation in the value of the restricted stock if the recipient files an "83(b) Election" under Section 83 of the

Internal Revenue Code. Unfortunately, when the recipient files the 83(b) Election the recipient must include the fair market value of the restricted stock in the recipient's income for that taxable year, which is potentially problematic if the company has a high valuation and the recipient does not have the available cash to satisfy this additional tax burden. If the recipient does not file an 83(b) Election, the recipient must recognize ordinary income, determined by subtracting the amount (if any) the recipient was required to pay for the stock from the fair market value of the stock on the vesting date, in the year in which the stock vests.

In most situations, the issuing company's tax consequences mirror those of the restricted stock recipient and thus largely depend on whether the recipient decides to file an 83(b) Election. Generally, the issuing company must recognize a compensation expense (and a matching deduction from taxable income) at the same time the recipient includes the fair market value of the restricted stock grant in the recipient's ordinary income. However, numerous factors may change a company's tax consequences and thus, before granting restricted stock and before the employee files or elects not to file an 83(b) Election, the company should consult its legal and tax advisors.

Restricted stock grants present an attractive alternative method of providing equity compensation to the key personnel of early stage companies. Grants of restricted stock require no up-front cash, require no future action on the part of the recipient (as contrasted with exercising stock options), and are less vulnerable to being rendered worthless because of capital market volatility. As a result, restricted stock grants may create fewer complications for early stage companies in future liquidity events than stock option grants.

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The foregoing is only a summary of one of the many significant issues affecting private companies. If you have any questions about the foregoing or about other private company issues, please direct them to your regular contact at Troutman Sanders LLP or to any of the persons listed in the sidebar to this release.