Stock repurchases

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Stock repurchase agreements for private companies

In the context of a publicly traded company, a stock repurchase (also commonly known as a stock buyback) means a company's decision to purchase outstanding shares of its own stock. A company might do this for a number of reasons, such as a belief that its shares are undervalued, or as a strategy to provide a one-time payout to stockholders. But this rarely happens in early-stage, venture-backed private companies, where investors are focused on an exit event and where the company typically operates on limited cash meant to be used to grow the business. Instead, the term "stock repurchase" more commonly refers to a stock repurchase right.

What is a stock repurchase right?

A stock repurchase agreement—or a company repurchase right found in a founder's stock purchase agreement—is a contract with a stockholder that allows a company to buy back its shares at the original purchase price if certain conditions are met. Generally, a founder's shares in the company purchased at the early stage will contain a repurchase right so that a certain number of shares may be repurchased by the company if the stockholder's service to the company ends. This repurchase option will be released over time on a fixed schedule (most typically, over four years with a one-year cliff) until the stockholder owns all the shares outright.

Why enter into a stock repurchase agreement?

The goal of a company repurchase right is to motivate the founder/stockholder to continue working to build value at the company and to align their incentives with the company and its other stockholders.

When a company has multiple founders, it is in all of their interests to avoid a situation where an absentee or malicious founder could retain an undeserved portion of the company's equity. Imagine a startup with three founders, all initially committed and ready to build a business. But within a year, one of them has badly fallen out with the others, and becomes unhappy or engages in behavior that may be counterproductive. The second founder is more reliable, but after two years decides to leave the struggling company and pursue other interests. If the third founder sticks around and eventually makes the company a major success, it would be a bitter pill to have the other two as large stockholders on the cap table (see this article for other early stage breakup considerations). A company repurchase right with time-based vesting addresses this problem by allowing the company to buy back a portion of the shares from departed founders and service providers, usually for a nominal price. Even if there is only one founder, investors commonly require founders to enter into stock repurchase agreements in order to ensure that they remain fully committed to the company.

Why not simply grant stock options instead?

First, there are some tax advantages to stock granted pursuant to a restricted stock agreement: the long-term capital gains period begins at the time the stock is acquired, and is not subject to the additional holding periods that incentive stock options are. Second, stock that is subject to a repurchase option has all the same rights as the other shares of its same class, including voting power, whereas stock options are only rights to acquire stock and have no other rights until exercised.

Finally, stock options are subject to Section 409A of the Internal Revenue Code of 1986, while restricted stock is not. Section 409A is discussed in more detail here, but for these purposes, it's sufficient to know that compliance involves costs and administrative burdens that may be too heavy for very early-stage companies.

Important considerations

The first and most time-sensitive issue facing a stockholder who signs a stock repurchase agreement is whether to file an 83(b) election. This issue is discussed in detail in this article, but in brief, stock that is at a substantial risk of forfeiture (for example, by being subject to a repurchase option) will be taxable as it vests. If the stock appreciates in value, the taxes owed will also increase. An 83(b) election allows the stockholder to pay all taxes in a lump sum upfront when the stock price is low. This election must be made within 30 days of acquiring the stock, and there are no extensions. Because of the potential tax complications involved, many investors will require companies to represent that all 83(b) elections have been filed, which will increase the company's administrative and recordkeeping burden.
