Executive Compensation Alert

California Eases Rules for Stock Option Plans

JULY 11, 2007

Fenwick

FENWICK & WEST LLP

Effective July 9, 2007, California liberalized its regulations concerning the permissible provisions of stock option plans. Practically every stock option plan of a privately-held company that has employees in California that participate in the plan can take advantage of this liberalization.

For decades, California was unique among the 50 states in the stringency of its regulation of the scope of permissible provisions that a stock option plan or restricted stock plan could contain. For example, only California required that stock options granted to non-officer employees in California must "vest" (meaning that the shares could not be repurchased on termination of employment by refunding the purchase price) at an annual rate of at least 20% of the shares subject to the stock option.

Non-compliance with even one of the regulatory requirements meant that rather than the company being able to file a simple notice, and pay a small fee to, California, the company would have to submit a pages-long application to the California Dept. of Corporations, which could easily cost $10,000 or more to prepare. The liberalization of the regulations means this is far less likely to occur.

The table below lists the significant effects from the liberalization.

NOW	BEFORE
Performance-based vesting can be imposed on options granted to non-officer employees.	Options granted to non-officer employees had to vest at an annual rate of at least 20%, regardless of performance.
Shareholder approval of the plan need be obtained only within 12 months of the date of the first grant **in California** made under the plan.	Shareholder approval of the plan must be obtained within 12 months of the date of the adoption of the plan by the company's board of directors.
Non-voting common stock can be used.	Common stock of the class with the most favorable voting rights had to be used.
Any repurchase right on shares held by a non-officer employee can now extend more than 90 days beyond termination of employment.	Repurchase right on shares held by a non-officer employee essentially terminated 90 days after termination of employment.
Option granted to a 10% shareholder can have an exercise price equal to 100% of fair market value on the date of grant.	Option exercise price had to be at least 110% of fair market value on date of grant.
Financial information of the issuer can be kept private and confidential.	Financial information of the issuer had to be shared at least annually with both employee and non-employee optionees.

An area of uncertainty that now appears from this liberalization surrounds the employer's ability to set the repurchase price of any repurchase right. California Corporations Code Sec. 25401 prohibits non-disclosure, or falsification, of a material fact in connection with the purchase in California of a security. In amending these regulations, the California Dept. of Corporations called attention to this prohibition. It is not clear, for now, whether this prohibition requires in the option agreement any more than a statement of the price at which a repurchase of any shares issued will be made on termination of employment. There will likely be more developments in this area over time.

There has been technical liberalization in other ways, however, the practical effect is blunted as those requirements remain in place due to other laws (such as the federal tax laws when the plan is intended to provide for tax-favored "incentive stock options").

Private companies (corporations and LLCs) should amend their equity-based compensation plans to take advantage of this liberalization. This can be done at the same time as any amendments are made to bring a plan's terms in compliance with Section 409A of the federal tax code (and California's corollary to this federal law).

If you have any questions regarding this Notice, please contact Scott P. Spector (650.335.7251 – sspector@fenwick.com), Blake W. Martell (650.335.7606 – bmartell@fenwick.com) or Tahir J. Naim (650.335.7326 – tnaim@fenwick.com) in the Executive Compensation and Employee Benefits Group.