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California Eases Restrictions on Stock Plans For Privately-Held Companies

Recognizing that compensatory benefit plans are important in creating jobs, increasing shareholder value and motivating employees, the California Corporations Commissioner recently eased limitations unique to California that hindered businesses in adopting equity incentive plans or extending such plans to California residents. The amendments provide privately-held corporations and limited liability companies with more flexibility in structuring equity incentives and administering plans. The amendments became effective on July 9, 2007, and represent a welcome and long anticipated reform that first began in 1999.

The new regulations require that, to be exempt under Section 25102(o) of the California Corporations Code, a stock option plan or stock purchase plan must comply with Rule 701 under the Securities Act of 1933 and satisfy certain additional California regulations, including a notice filing and fee. The new regulations repealed many of the prior restrictions on equity plans and softened others. A summary of the principal changes follows:

Elimination of Restrictions

Minimum Vesting Periods.

The prior regulations required minimum vesting (or lapse of repurchase restrictions) for non-executive employees at the rate of at least 20% per year over five years. Issuers are now free to customize vesting arrangements for all plan participants using targeted incentives, performance-based vesting or other criteria.

Minimum Exercise or Purchase Price.

Under the prior regulations, the exercise price of a stock option, or the purchase price under a purchase plan, could not be less than 85% of the security's fair value. If a participant owned more than 10% of the voting power of the company, the exercise price of a stock option could not be less than 110% of fair value and the purchase price under a purchase plan could not be less than 100% of the fair value. The new regulations eliminate these restrictions. However, the practical effect of the change is likely to be blunted by the adverse tax and accounting implications of issuing below-market grants.

Equal Voting Rights.

Shares issued under a plan are no longer required to carry equal voting rights, meaning issuers have new flexibility to use non-voting shares or shares with lesser voting rights.

Annual Financial Statements.

Issuers are no longer required to provide plan participants with annual financial statements, which will allow private companies to maintain the confidentiality of financial information.

Maximum Number of Shares.

Issuers are no longer required to limit the maximum number of shares under a plan to 30% or less of the total number of outstanding securities. However, since the California exemption is predicated on compliance with Rule 701, issuers may not make grants in any 12-month period that in the aggregate exceed the greater of $1 million, 15% of the total assets of the issuer or 15% of the outstanding amount of the class of securities being offered.

Restrictions on Repurchase Rights.

Under the prior regulations, an issuer's plan was at risk if it provided for a repurchase right, exercisable upon an employee's termination, that was not made at fair market value on the date of termination of employment for cash paid within 90 days of termination (or cancellation of purchase money indebtedness). Those limitations were repealed, and subject to the following caveats, issuers now have greater flexibility to determine the appropriate repurchase price, repurchase period and purchase consideration for equity awards. In order to ensure compliance with Section 409A of the Internal Revenue Code an issuer should not repurchase securities at greater than fair market value on the date of repurchase. In addition, the Commissioner's adopting release noted that superior access to information may give issuers an unfair advantage over plan participants and reiterated that Corporations Code Section 25401 requires disclosure of all material information to a grantee during the course of negotiating the repurchase price.

Liberalization of Other Requirements

Eligible Persons.

The list of persons who may participate in an option plan or purchase plan has been expanded to be consistent with the scope of eligible persons under Rule 701 and now includes officers, general partners, trustees and advisors. Registered domestic partners are deemed to qualify as "Family Members" for the purposes of Rule 701.

Shareholder Approval Requirements.

The prior regulations required that plans be approved by shareholders within the 12-month period before or after a plan's adoption. The new rules add an alternative shareholder approval requirement that permits approval prior to or within 12 months after the grant of the first award in California. The revision will assist those issuers who failed to obtain shareholder approval within 12 months of adopting a plan but receive the approval within 12 months of granting options in California.

Non-Reporting Foreign Private Issuers.

The new regulations permit privately-held "foreign private issuers," as defined under the Securities Exchange Act of 1934, to grant awards to up to 35 persons in California without having to obtain shareholder approval. Within this limit, non-reporting foreign private issuers can now avoid the cost and burden of obtaining shareholder approval under their local jurisdictions.

The new regulations ease the burden imposed on domestic and foreign private companies that wish to provide plan-based equity incentives to California employees and provide more freedom to structure incentive awards. Companies with California employees will now want to revisit their existing plans to consider whether changes are warranted to take advantage of the new flexibility permitted by the reform, particularly if plans are being re-evaluated in light of the final regulations recently issued by the Department of Treasury and the Internal Revenue Service under Internal Revenue Code Section 409A.

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