

Pacific Ethanol, Inc.
Form DEF 14A
November 17, 2009

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant
Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
 Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))
 Definitive Proxy Statement
 Definitive Additional Materials
 Soliciting Material Pursuant to Section 240.14a-12

PACIFIC ETHANOL, INC.
(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- No fee required
 Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1. Title of each class of securities to which transaction applies:
2. Aggregate number of securities to which transaction applies:
3. Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):
4. Proposed maximum aggregate value of transaction:
5. Total fee paid:

Fees paid previously with preliminary materials.

Edgar Filing: Pacific Ethanol, Inc. - Form DEF 14A

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1. Amount
Previously Paid:
2. Form, Schedule or Registration
Statement No.:
3. Filing Party:
4. Date Filed:

PACIFIC ETHANOL, INC.

400 Capitol Mall, Suite 2060
Sacramento, California 95814

November 19, 2009

Dear Fellow Stockholders:

We cordially invite you to attend the 2009 Annual Meeting of stockholders of Pacific Ethanol, Inc., which will be held at 9:00 a.m., local time, on December 29, 2009 at 400 Capitol Mall, Suite 2060, Sacramento, California 95814. All stockholders of record at the close of business on November 12, 2009 are entitled to vote at the Annual Meeting. The formal meeting notice and Proxy Statement are attached.

At this year's Annual Meeting, stockholders will be asked to elect seven directors and ratify the appointment of Hein & Associates LLP to serve as our independent registered public accounting firm for the year ending December 31, 2009. In addition, stockholders will transact any other business that may properly come before the meeting. A report on the business operations of Pacific Ethanol will also be presented at the meeting and stockholders will have an opportunity to ask questions.

This year, in accordance with rules adopted by the United States Securities and Exchange Commission, we are using the Internet as our primary means of furnishing proxy materials to our stockholders. Accordingly, most stockholders will not receive paper copies of our proxy materials. We will instead send our stockholders a notice with instructions for accessing the proxy materials and voting electronically over the Internet or by telephone. The notice also provides information on how stockholders may request paper copies of our proxy materials. We believe this new rule will help us reduce the environmental impact and costs of printing and distributing paper copies and improve the speed and efficiency by which our stockholders can access these materials.

Whether or not you plan to attend the Annual Meeting, it is important that your shares be represented and voted at the meeting and we urge you to vote as soon as possible. As an alternative to voting in person at the Annual Meeting, you may vote electronically over the Internet or by telephone, or if you receive a proxy card or voting instruction form in the mail, by mailing the completed proxy card or voting instruction form. Timely voting by any of these methods will ensure your representation at the Annual Meeting.

We look forward to seeing you December 29th.

Sincerely,
William L. Jones,
Chairman of the Board

PACIFIC ETHANOL, INC.
NOTICE OF THE 2009 ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD DECEMBER 29, 2009

NOTICE IS HEREBY GIVEN that the 2009 Annual Meeting of stockholders of Pacific Ethanol, Inc., a Delaware corporation, will be held at 9:00 a.m., local time, on December 29, 2009 at our corporate headquarters at 400 Capitol Mall, Suite 2060, Sacramento, California 95814, for the following purposes, as more fully described in the Proxy Statement accompanying this notice:

1. To elect seven directors to serve on our Board of Directors until the next annual meeting of stockholders and/or until their successors are duly elected and qualified. The nominees for election are William L. Jones, Neil M. Koehler, Terry L. Stone, John L. Prince, Douglas L. Kieta, Larry D. Layne and Michael D. Kandris.
2. To ratify the appointment of Hein & Associates LLP as our independent registered public accounting firm for the year ending December 31, 2009.
3. To transact such other business as may properly come before the Annual Meeting or any adjournment(s) or postponement(s) thereof.

All stockholders of record at the close of business on November 12, 2009 are entitled to notice of and to vote at the Annual Meeting and any adjournment(s) or postponement(s) thereof.

We cordially invite all stockholders to attend the Annual Meeting in person. Whether or not you plan to attend, it is important that your shares be represented and voted at the meeting. As an alternative to voting in person at the Annual Meeting, you can vote your shares electronically over the Internet, or if you receive a proxy card or voting instruction form in the mail, by mailing the completed proxy card or voting instruction form.

For admission to the Annual Meeting, each stockholder may be asked to present valid picture identification, such as a driver's license or passport, and proof of ownership of our capital stock as of the record date, such as the enclosed proxy card or a brokerage statement reflecting stock ownership.

By Order of the Board of Directors,
William L. Jones,
Chairman of the Board

Sacramento, California
November 19, 2009

YOUR VOTE IS VERY IMPORTANT REGARDLESS OF THE NUMBER OF SHARES YOU OWN. PLEASE READ THE ATTACHED PROXY STATEMENT CAREFULLY. TO ENSURE YOUR REPRESENTATION AT THE ANNUAL MEETING PLEASE PROMPTLY SUBMIT YOUR PROXY OR VOTING INSTRUCTION ELECTRONICALLY OVER THE INTERNET OR BY TELEPHONE, OR IF YOU RECEIVE A PAPER PROXY CARD OR VOTING INSTRUCTION FORM, YOU MAY MAIL THE COMPLETED PROXY CARD OR VOTING INSTRUCTION FORM IN THE ENCLOSED POSTAGE-PAID ENVELOPE.

INTERNET AVAILABILITY OF PROXY MATERIALS

THIS YEAR, IN ACCORDANCE WITH RULES ADOPTED BY THE U.S. SECURITIES AND EXCHANGE COMMISSION, WE ARE USING THE INTERNET AS OUR PRIMARY MEANS OF FURNISHING PROXY MATERIALS TO OUR STOCKHOLDERS. CONSEQUENTLY, MOST STOCKHOLDERS WILL NOT RECEIVE PAPER COPIES OF OUR PROXY MATERIALS. WE WILL INSTEAD SEND EACH STOCKHOLDER A NOTICE OF INTERNET AVAILABILITY OF PROXY MATERIALS WITH INSTRUCTIONS FOR ACCESSING OVER THE INTERNET THE PROXY MATERIALS, INCLUDING OUR PROXY STATEMENT AND ANNUAL REPORT, AND VOTING ELECTRONICALLY OVER THE INTERNET. THE NOTICE OF INTERNET AVAILABILITY OF PROXY MATERIALS ALSO PROVIDES INFORMATION ON HOW STOCKHOLDERS MAY OBTAIN PAPER COPIES OF OUR PROXY MATERIALS IF THEY SO CHOOSE. WE BELIEVE THIS NEW RULE WILL HELP PACIFIC ETHANOL REDUCE THE ENVIRONMENTAL IMPACT AND COSTS OF PRINTING AND DISTRIBUTING PAPER COPIES AND IMPROVE THE SPEED AND EFFICIENCY BY WHICH YOU CAN ACCESS THESE MATERIALS. IF YOU PREVIOUSLY ELECTED TO RECEIVE OUR PROXY MATERIALS ELECTRONICALLY, THESE MATERIALS WILL CONTINUE TO BE SENT VIA EMAIL UNLESS YOU CHANGE YOUR ELECTION.

PACIFIC ETHANOL, INC.

PROXY STATEMENT
FOR THE 2009 ANNUAL MEETING OF STOCKHOLDERS
DECEMBER 29, 2009

TABLE OF CONTENTS

| | Page |
|--|------|
| <u>Voting and Proxy</u> | 2 |
| <u>Proposal One — Election Of Directors</u> | 4 |
| <u>Information About Our Board of Directors, Board Committees and Related Matters</u> | 5 |
| <u>Proposal Two — Ratification of Appointment of Independent Registered Public Accounting Firm</u> | 14 |
| <u>Other Matters</u> | 14 |
| <u>Audit Matters</u> | 14 |
| <u>Security Ownership of Certain Beneficial Owners and Management</u> | 17 |
| <u>Section 16(a) Beneficial Ownership Reporting Compliance</u> | 18 |
| <u>Equity Compensation Plan Information</u> | 18 |
| <u>Executive Compensation and Related Information</u> | 19 |
| <u>Executive Officers</u> | 19 |
| <u>Compensation Discussion and Analysis</u> | 20 |
| <u>Compensation Committee Report</u> | 26 |
| <u>Summary Compensation Table</u> | 26 |
| <u>Grants of Plan-Based Awards</u> | 29 |
| <u>Outstanding Equity Awards at Fiscal Year-End</u> | 30 |
| <u>Option Exercises and Stock Vested</u> | 30 |
| <u>Potential Payments upon Termination or Change in Control</u> | 31 |
| <u>Calculation of Potential Payments upon Termination or Change in Control</u> | 32 |
| <u>Compensation Committee Interlocks and Insider Participation</u> | 32 |
| <u>Certain Relationships and Related Transactions</u> | 33 |
| <u>Other Information</u> | 37 |

PACIFIC ETHANOL, INC.

PROXY STATEMENT
FOR THE 2009 ANNUAL MEETING OF STOCKHOLDERS
DECEMBER 29, 2009

VOTING AND PROXY

This Proxy Statement is being furnished in connection with the solicitation of proxies by our board of directors (“Board”) for use at the 2009 Annual Meeting of stockholders to be held at 9:00 a.m., local time, on December 29, 2009 at 400 Capitol Mall, Suite 2060, Sacramento, California 95814, and at any adjournment(s) or postponement(s) of the Annual Meeting. This Proxy Statement is first being mailed to stockholders on or about November 19, 2009.

A copy of our Annual Report on Form 10-K for the year ended December 31, 2008, as amended, has been provided concurrently with this proxy statement (or made available electronically, for stockholders who elected to access these materials over the Internet) to all stockholders entitled to notice of and to vote at the Annual Meeting. The Annual Report is not to be regarded as proxy soliciting material or as a communication through which any solicitation of proxies is made.

If you are a “registered holder,” that is your shares are registered in your own name through our transfer agent, and you are viewing this proxy over the Internet you may vote electronically over the Internet. For those stockholders who receive a paper proxy in the mail, you may also vote electronically over the Internet or by telephone or by completing and mailing the proxy card provided. The website identified in our Notice of Internet Availability of Proxy Materials provides specific instructions on how to vote electronically over the Internet. Those stockholders who receive a paper proxy by mail, and who elect to vote by mail, should complete and return the mailed proxy card in the prepaid and addressed envelope that was enclosed with the proxy materials.

If your shares are held in “street name,” that is, your shares are held in the name of a brokerage firm, bank or other nominee, you will receive instructions from your record holder that must be followed for your record holder to vote your shares per your instructions. Your broker will be sending you a Notice of Internet Availability which contains instructions on how to access the website to vote your shares. If, however, you have elected to receive paper copies of our proxy materials from your brokerage firm, bank or other nominee, you will receive a voting instruction form. Please complete and return the enclosed voting instruction form in the addressed, postage paid envelope provided.

Stockholders who have previously elected to access our proxy materials and annual report electronically over the Internet will continue to receive an email, referred to in this proxy statement as an email notice, with information on how to access the proxy information and voting instructions.

Only proxy cards and voting instruction forms that have been signed, dated and timely returned and only proxies that have been timely voted electronically will be counted in the quorum and voted. The Internet and telephone voting facilities will close at 11:59 p.m. Eastern Time, Monday, December 28, 2009.

Stockholders who vote over the Internet or by telephone need not return a proxy card or voting instruction form by mail, but may incur costs, such as usage charges, from telephone companies or Internet service providers.

You may also vote your shares in person at the Annual Meeting. If you are a registered holder, you may request a ballot at the Annual Meeting. If your shares are held in street name and you wish to vote in person at the meeting, you must obtain a proxy issued in your name from the record holder (e.g., your broker) and bring it with you to the Annual Meeting. We recommend that you vote your shares in advance as described above so that your vote will be counted if you later decide not to attend the Annual Meeting.

If you receive more than one Notice of Internet Availability of Proxy Materials, email notice, proxy card or voting instruction form because your shares are held in multiple accounts or registered in different names or addresses, please vote your shares held in each account to ensure that all of your shares will be voted.

All votes will be tabulated by the inspector of election appointed for the Annual Meeting, who will separately tabulate affirmative and negative votes, abstentions and broker non-votes.

If your proxy is properly submitted, the shares represented thereby will be voted at the Annual Meeting in accordance with your instructions. If you are a registered holder and you do not specify how the shares represented thereby are to be voted, your shares will be voted (i) "FOR" the election of each of the seven nominees to our Board listed in the proxy, (ii) "FOR" the approval of Proposal Two, and (iii) in the discretion of the proxy holders as to any other matters that may properly come before the Annual Meeting or any adjournment(s) or postponement(s) of the Annual Meeting, as well as any procedural matters. If your shares are held in street name and you do not specify how the shares represented thereby are to be voted, your broker may exercise its discretionary authority to vote on Proposals One and Two.

If your shares are registered in your name, you may revoke or change your vote at any time before the Annual Meeting by voting again electronically over the Internet or telephone, or by filing a notice of revocation or another proxy card with a later date with our Secretary at Pacific Ethanol, Inc., 400 Capitol Mall, Suite 2060, Sacramento, California 95814. If you are a registered stockholder and attend the Annual Meeting and vote by ballot, any proxy that you submitted previously to vote the same shares will be revoked automatically and only your vote at the Annual Meeting will be counted. If your shares are held in street name, you should contact the record holder to obtain instructions if you wish to revoke or change your vote before the Annual Meeting; please note that if your shares are held in street name, your vote in person at the Annual Meeting will not be effective unless you have obtained and present a proxy issued in your name from the record holder.

At the close of business on November 12, 2009, the record date for determining stockholders entitled to notice of and to vote at the Annual Meeting, we had issued and outstanding 57,636,828 shares of common stock held by 509 holders of record and 2,346,152 shares of Series B Cumulative Convertible Preferred Stock ("Series B Preferred Stock") held by five holders of record. Only stockholders of record at the close of business on the record date are entitled to notice of and to vote at the Annual Meeting or at any adjournment(s) or postponement(s) of the meeting.

Each share of our common stock issued and outstanding on the record date entitles the holder of that share to one vote at the Annual Meeting for all matters to be voted on at the meeting. Each share of our Series B Preferred Stock issued and outstanding on the record date entitles the holder of that share to three votes at the Annual Meeting for all matters to be voted on at the meeting.

The holders of a majority of the voting power of our issued and outstanding capital stock and entitled to vote on a proposal at the Annual Meeting, present in person or represented by proxy, shall constitute a quorum for purposes of voting on such proposal. Votes cast at the Annual Meeting will be tabulated by the person or persons appointed by us to act as inspectors of election for the meeting. Shares of our common stock and our Series B Preferred Stock represented in person or by proxy (regardless of whether the proxy has authority to vote on all matters), as well as abstentions and broker non-votes, will be counted for purposes of determining whether a quorum is present at the Annual Meeting.

An “abstention” is the voluntary act of not voting by a stockholder who is present at a meeting and entitled to vote. “Broker non-votes” are shares of voting stock held in record name by brokers and nominees concerning which (i) instructions have not been received from the beneficial owners or persons entitled to vote, (ii) the broker or nominee does not have discretionary voting power under applicable rules or the instrument under which it serves in such capacity, or (iii) the record holder has indicated on the proxy or has executed a proxy and otherwise notified us that it does not have authority to vote such shares on that matter.

Abstentions and broker non-votes are not be included in the vote totals for the election of directors and therefore will have no effect on the vote for that proposal. For Proposal Two, which requires for approval the affirmative vote of the majority of shares present in person or represented by proxy at the meeting and entitled to vote on the proposal, abstentions but not broker non-votes will be treated as shares present and entitled to vote on the proposals. Applying that standard, an abstention will have the effect of a vote “against” Proposal Two, and a broker non-vote will reduce the absolute number (although not the percentage) of the affirmative votes needed for approval of Proposal Two.

We will pay the expenses of soliciting proxies for the Annual Meeting, including the cost of preparing, assembling and mailing the proxy solicitation materials. Proxies may be solicited personally, by mail or by telephone, or by our directors, officers and regular employees who will not be additionally compensated. We have no present plans to hire special employees or paid solicitors to assist in obtaining proxies, but we reserve the option to do so if it appears that a quorum otherwise might not be obtained. The matters to be considered and acted upon at the Annual Meeting are referred to in the preceding notice and are discussed below more fully.

PROPOSAL ONE — ELECTION OF DIRECTORS

Our bylaws provide for seven directors unless otherwise changed by resolution of our Board. Directors are elected annually and hold office until the next annual meeting of stockholders and/or until their respective successors are duly elected and qualified. Stockholders who desire to nominate any person for election to our Board must comply with our bylaws, including our advance notice bylaw provisions relating to the nomination of persons for election to our Board. See “Information about our Board of Directors, Board Committees and Related Matters—Board Committees and Meetings, Nominating and Governance Committee” below. It is intended that the proxies solicited by our Board will be voted “FOR” election of the following seven nominees unless a contrary instruction is made on the proxy: William L. Jones, Neil M. Koehler, Terry L. Stone, John L. Prince, Douglas L. Kieta, Larry D. Layne and Michael D. Kandris. If, for any reason, one or more of the nominees is unavailable as a candidate for director, an event that is not anticipated, the person named in the proxy will vote for another candidate or candidates nominated by our Nominating and Governance Committee. However, under no circumstances may a proxy be voted in favor of a greater number of persons than the number of nominees named above. All of the nominees for director are, at present, directors of Pacific Ethanol and have been nominated by our Nominating and Governance Committee and ratified by our full Board.

Required Vote of Stockholders

The seven nominees receiving the highest number of affirmative votes of the outstanding shares of our common stock and Series B Preferred Stock, voting together as a single class, present at the Annual Meeting in person or by proxy and entitled to vote, will be elected as directors to serve until the next annual meeting of stockholders and/or until their successors are duly elected and qualified. Votes against a candidate, abstentions and broker non-votes will be counted for purposes of determining whether a quorum is present for this proposal, but will not be included in the vote totals for this proposal and, therefore, will have no effect on the vote.

Recommendation of the Board of Directors

OUR BOARD UNANIMOUSLY RECOMMENDS A VOTE “FOR” THE ELECTION OF THE SEVEN DIRECTOR NOMINEES LISTED ABOVE.

INFORMATION ABOUT OUR BOARD OF DIRECTORS,
BOARD COMMITTEES AND RELATED MATTERS

Directors and Director Nominees

The following table sets forth certain information regarding our current directors and director nominees as of November 16, 2009:

| Name | Age | Positions Held |
|----------------------|-----|---|
| William L. Jones | 59 | Chairman of the Board, Director and Director Nominee |
| Neil M. Koehler | 51 | Chief Executive Officer, President, Director and Director Nominee |
| Terry L. Stone (1) | 60 | Director and Director Nominee |
| John L. Prince (1) | 66 | Director and Director Nominee |
| Douglas L. Kieta (2) | 66 | Director and Director Nominee |
| Larry D. Layne (3) | 68 | Director and Director Nominee |
| Michael D. Kandris | 61 | Director and Director Nominee |

- (1) Member of the Audit, Compensation and Nominating and Governance Committees.
- (2) Member of the Compensation and Nominating and Governance Committees.
- (3) Member of the Audit and Compensation Committees.

Following is a brief description of the business experience and educational background of each of the nominees for director, including the capacities in which he has served during the past five years:

William L. Jones has served as Chairman of the Board and as a director since March 2005. Mr. Jones is a co-founder of Pacific Ethanol California, Inc. (“PEI California”), which is now one of our wholly-owned subsidiaries, and served as Chairman of the Board of PEI California since its formation in January 2003 through March 2004, when he stepped off the board of PEI California to focus on his candidacy for one of California’s United States Senate seats. Mr. Jones was California’s Secretary of State from 1995 to 2003. Since May 2002, Mr. Jones has also been the owner of Tri-J Land & Cattle, a diversified farming and cattle company in Fresno County, California. Mr. Jones has a B.A. degree in Agribusiness and Plant Sciences from California State University, Fresno.

Neil M. Koehler has served as Chief Executive Officer, President and as a director since March 2005. Mr. Koehler served as Chief Executive Officer of PEI California since its formation in January 2003 and as a member of its board of directors since March 2004. Prior to his association with PEI California, Mr. Koehler was the co-founder and General Manager of Parallel Products, one of the first ethanol production facilities in California, which was sold to a public company in 1997. Mr. Koehler was also the sole manager and sole limited liability company member of Kinergy Marketing, LLC, which he founded in September 2000, and which is now one of our wholly-owned subsidiaries. Mr. Koehler has over 20 years of experience in the ethanol production, sales and marketing industry in the Western United States. Mr. Koehler is a Director of the California Renewable Fuels Partnership, a Director of the Renewable Fuels Association and is a nationally-recognized speaker on the production and marketing of renewable fuels. Mr. Koehler has a B.A. degree in Government from Pomona College.

Terry L. Stone has served as a director since March 2005. Mr. Stone is a Certified Public Accountant with over thirty years of experience in accounting and taxation. He has been the owner of his own accountancy firm since 1990 and has provided accounting and taxation services to a wide range of industries, including agriculture, manufacturing, retail, equipment leasing, professionals and not-for-profit organizations. Mr. Stone has served as a part-time instructor at California State University, Fresno, teaching classes in taxation, auditing and financial and management accounting. Mr. Stone is also a financial advisor and franchisee of Ameriprise Financial Services, Inc. Mr. Stone has a B.S. degree in Accounting from California State University, Fresno.

John L. Prince has served as a director since July 2005. Mr. Prince is retired but also works as a consultant to Ruan Transport Corp. and other companies. Mr. Prince was an Executive Vice President with Land O' Lakes, Inc. from July 1998 until his retirement in 2004. Prior to that time, Mr. Prince was President and Chief Executive Officer of Dairyman's Cooperative Creamery Association, or the DCCA, located in Tulare, California, until its merger with Land O' Lakes, Inc. in July 1998. Land O' Lakes, Inc. is a farmer-owned, national branded organization based in Minnesota with annual sales in excess of \$6 billion and membership and operations in over 30 states. Prior to joining the DCCA, Mr. Prince was President and Chief Executive Officer for nine years until 1994, and was Operations Manager for the preceding ten years commencing in 1975, of the Alto Dairy Cooperative in Waupun, Wisconsin. Mr. Prince has a B.A. degree in Business Administration from the University of Northern Iowa.

Douglas L. Kieta has served as a director since April 2006. Mr. Kieta is currently retired. Prior to retirement in January 2009, Mr. Kieta was employed by BE&K, Inc., a large engineering and construction company headquartered in Birmingham, Alabama, where he served as the Vice President of Power since May 2006. From April 1999 to April 2006, Mr. Kieta was employed at Calpine Corporation where he was the Senior Vice President of Construction and Engineering. Calpine Corporation is a major North American power company which leases and operates integrated systems of fuel-efficient natural gas-fired and renewable geothermal power plants and delivers clean, reliable and fuel-efficient electricity to customers and communities in 21 U.S. states and three Canadian provinces. Mr. Kieta has a B.S. degree in Civil Engineering from Clarkson University and a Master's degree in Civil Engineering from Cornell University.

Larry D. Layne has served as a director since December 2007. Mr. Layne joined First Western Bank in 1963 and served in various capacities with First Western Bank and its acquiror, Lloyds Bank of California, and Lloyd's acquiror, Sanwa Bank, until his retirement in 2000. Sanwa Bank was subsequently acquired by Bank of the West. From 1999 to 2000, Mr. Layne was Vice Chairman of Sanwa Bank in charge of its Commercial Banking Group which encompassed all of Sanwa Bank's 38 commercial and business banking centers and 12 Pacific Rim branches as well as numerous internal departments. From 1997 to 2000, Mr. Layne was also Chairman of the Board of The Eureka Funds, a mutual fund family of five separate investment funds with total assets of \$900 million. From 1996 to 2000, Mr. Layne was Group Executive Vice President of the Relationship Banking Group of Sanwa Bank in charge of its 107 branches and 13 commercial banking centers as well as numerous internal departments. Mr. Layne has also served in various capacities with many industry and community organizations, including as Director and Chairman of the Board of the Agricultural Foundation at California State University, Fresno ("CSUF"); Chairman of the Audit

Committee of the Ag. Foundation at CSUF; board member of the Fresno Metropolitan Flood Control District; and Chairman of the Ag Lending Committee of the California Bankers Association. Mr. Layne has a B.S. degree in Dairy Husbandry from CSUF and is a graduate of the California Agriculture Leadership Program.

Michael D. Kandris has served as a director since June 2008. Mr. Kandris has been the President, Western Division of Ruan Transportation Management Systems (“RTMS”) for the past year and a half. For the previous six years, Mr. Kandris served as President and Chief Operating Officer of RTMS. Mr. Kandris has 30 years of experience in all modes of transportation and logistics. As President for RTMS, Mr. Kandris held responsibilities in numerous operations and administrative functions. Mr. Kandris serves as a board member for the National Tank Truck Organization. Mr. Kandris has a B.S. degree in Business from California State University, Hayward.

Corporate Governance

Our Board believes that good corporate governance is paramount to ensure that Pacific Ethanol is managed for the long-term benefit of our stockholders. Our Board has adopted corporate governance guidelines that guide its actions with respect to, among other things, the composition of the Board and its decision making processes, Board meetings and involvement of management, the Board’s standing committees and procedures for appointing members of the committees, and its performance evaluation of our Chief Executive Officer.

Our Board has adopted a Code of Business Conduct and Ethics that applies to all of our directors, officers and employees and an additional Code of Business Ethics that applies to our Chief Executive Officer and senior financial officers. The Codes of Ethics, as applied to our principal executive officer, principal financial officer and principal accounting officer constitutes our “code of ethics” within the meaning of Section 406 of the Sarbanes-Oxley Act of 2002 and is our “code of conduct” within the meaning of the listing standards of NASDAQ. Our Codes of Ethics are available at our website at <http://www.pacificethanol.net>. Information on our Internet website is not, and shall not be deemed to be, a part of this Proxy Statement or incorporated into any other filings we make with the Securities and Exchange Commission.

Director Independence

Our corporate governance guidelines provide that a majority of the Board and all members of the Audit, Compensation and Nominating and Governance Committees of the Board will be independent. On an annual basis, each director and executive officer is obligated to complete a Director and Officer Questionnaire that requires disclosure of any transactions with Pacific Ethanol in which a director or executive officer, or any member of his or her immediate family, have a direct or indirect material interest. Following completion of these questionnaires, the Board, with the assistance of the Nominating and Governance Committee, makes an annual determination as to the independence of each director using the current standards for “independence” established by the Securities and Exchange Commission and NASDAQ, additional criteria set forth in our corporate governance guidelines and consideration of any other material relationship a director may have with Pacific Ethanol.

The Board has determined that all of its directors are independent under these standards, except for (i) Mr. Jones, who is the father-in-law of Ryan W. Turner, one of our former executive officers who resigned in April 2006, and who is currently a consultant to Pacific Ethanol, and (ii) Mr. Koehler, who serves full-time as our Chief Executive Officer and President.

Stockholder Communications with our Board of Directors

Our Board has implemented a process by which stockholders may send written communications directly to the attention of our Board or any individual member of our Board. Mr. Stone, the Chairman of our Audit Committee, is responsible for monitoring communications from stockholders and providing copies of such communications to the other directors as he considers appropriate. Communications will be forwarded to all directors if they relate to substantive matters and include suggestions or comments that Mr. Stone considers to be important for the directors to consider. Stockholders who wish to communicate with our Board can write to Terry L. Stone, The Board of Directors, Pacific Ethanol, Inc., 400 Capitol Mall, Suite 2060, Sacramento, California 95814.

Board Committees and Meetings

Our business, property and affairs are managed under the direction of our Board. Our directors are kept informed of our business through discussions with our executive officers, by reviewing materials provided to them and by participating in meetings of our Board and its committees. During 2008, our Board held 21 meetings. All directors attended at least 75% of the aggregate of the meetings of our Board and of the committees on which they served or that were held during the period they were directors or committee members.

Members of our Board and its committees also consulted informally with management from time to time and acted at various times by written consent without a meeting during 2008. Additionally, the independent members of the Board met in executive session regularly without the presence of management.

It is our policy to invite and encourage our directors to attend our annual meetings. At the date of our 2008 annual meeting, we had seven members on our Board, six of whom were in attendance at our 2008 annual meeting.

Our Board has established standing Audit, Compensation and Nominating and Governance Committees. Each committee operates pursuant to a written charter that has been approved by our Board and the corresponding committee and that is reviewed annually and revised as appropriate. Each charter is available at our website at <http://www.pacificethanol.net>.

Audit Committee

Our Audit Committee selects our independent auditors, reviews the results and scope of the audit and other services provided by our independent auditors, and reviews our financial statements for each interim period and for our year end. Messrs. Stone, Prince and Layne served on our Audit Committee for all of 2008. Our Board has determined that each member of the Audit Committee is “independent” under the current NASDAQ listing standards and satisfies the other requirements under NASDAQ listing standards and Securities and Exchange Commission rules regarding audit committee membership. Our Board has determined that Mr. Stone (i) qualifies as an “audit committee financial expert” under applicable Securities and Exchange Commission rules and regulations governing the composition of the Audit Committee, and (ii) satisfies the “financial sophistication” requirements of the NASDAQ listing standards. During 2008, our Audit Committee held 10 meetings. The Audit Committee Report for 2008 can be found on page 15 of this Proxy Statement.

Compensation Committee

Our Compensation Committee is responsible for establishing and administering our overall policies on compensation and the compensation to be provided to our executive officers, including, among other things, annual salaries and bonuses, stock options, stock grants, other stock-based awards, and other incentive compensation arrangements. In addition, the Compensation Committee reviews the philosophy and policies behind the salary, bonus and stock compensation arrangements for all other employees. Although our Compensation Committee makes all compensation decisions as to our executive officers, our Chief Executive Officer makes recommendations to our Compensation Committee regarding compensation for the other named executive officers. Our Compensation Committee has the authority to administer our 2006 Stock Incentive Plan with respect to grants to executive officers and directors, and also has authority to make equity awards under our 2006 Stock Incentive Plan to all other eligible individuals. However, our Board may retain, reassume or exercise from time to time the power to administer our 2006 Stock Incentive Plan. Equity awards made to members of the Compensation Committee must be authorized and approved by a disinterested majority of our Board.

The Compensation Committee evaluates both performance and compensation to ensure that the total compensation paid to our executive officers is fair, reasonable and competitive so that we can attract and retain superior employees in key positions. The Compensation Committee believes that compensation packages offered to our executives, including the named executive officers, should include both cash and equity-based compensation that reward performance as measured against established goals. The Compensation Committee has the authority to retain consultants, and other advisors and in furtherance of the foregoing objectives, our Compensation Committee in 2008 engaged Hewitt Associates LLC, a global human resources consulting firm, to conduct an annual review of our total compensation program for the named executive officers and other executives. From that review, Hewitt Associates provided our Compensation Committee with relevant market data and alternatives to consider when making compensation decisions as to the named executive officers and when making decisions as to the recommendations being made by our management for other executives. In making compensation decisions, our Compensation Committee compared each element of total compensation against market data obtained by Hewitt Associates. To the extent considered necessary, the Compensation Committee may reengage Hewitt Associates, or in the expected absence of significant changes in market data, the Compensation Committee may reuse the data obtained in 2008 as a reference point for future compensation decisions. The Compensation Committee generally expects to set total compensation for the named executive officers at the median of compensation paid to similarly situated executives of the companies comprising the market data provided to us by Hewitt Associates.

Additional information concerning the compensation policies and objectives established by the Compensation Committee is included under the heading “Executive Compensation and Related Information — Compensation Discussion and Analysis” below. The Compensation Committee Report for 2008 can be found on page 26 of this Proxy Statement.

Messrs. Stone, Prince, Kieta and Layne served on our Compensation Committee for all of 2008. Our Board has determined that each member of the Compensation Committee is “independent” under the current NASDAQ listing standards. During 2008, our Compensation Committee held five meetings.

Nominating and Governance Committee

Our Nominating and Governance Committee selects nominees for our Board. During 2008, our Nominating and Governance Committee consisted of Messrs. Stone, Prince and Kieta. Our Board has determined that each member of the Nominating and Governance Committee is “independent” under the current NASDAQ listing standards. During 2008, our Nominating and Governance Committee held one meeting.

The Nominating and Governance Committee will consider candidates for director recommended by any stockholder that is the beneficial owner of shares representing more than 1.0% of the then-outstanding shares of our common stock and who has beneficially owned those shares for at least one year. The Nominating and Governance Committee will evaluate those recommendations by applying its regular nominee criteria and considering the additional information described in the Nominating and Governance Committee's below-referenced charter. Stockholders that desire to recommend candidates for the Board for evaluation may do so by contacting Pacific Ethanol in writing, identifying the potential candidate and providing background and other relevant information. Stockholders must also comply with our bylaws, including our advance notice bylaw provisions relating to the nomination of persons for election to our Board that, among other things, require that nominations of persons for election to our Board at annual meetings be submitted to our Secretary, unless otherwise notified, by the close of business on the 45th day before the first anniversary of the date on which we first mailed our proxy materials for the prior year's annual meeting. We first mailed our proxy materials for our 2008 annual meeting on or about May 9, 2008 and anticipate mailing our proxy materials for our 2009 annual meeting on or about November 19, 2009. We have received no stockholder nominations of persons for election to our Board for our Annual Meeting.

Our Nominating and Governance Committee utilizes a variety of methods for identifying and evaluating nominees for director. Candidates may also come to the attention of the Nominating and Governance Committee through current Board members, professional search firms and other persons. In evaluating potential candidates, our Nominating and Governance Committee will take into account a number of factors, including, among others, the following:

- the candidate's independence from management;
- whether the candidate has relevant business experience;
- judgment, skill, integrity and reputation;
- existing commitments to other businesses;
- corporate governance background;
- financial and accounting background, to enable the committee to determine whether the candidate would be suitable for Audit Committee membership; and
- the size and composition of our Board.

Compensation of Directors

We use a combination of cash and stock-based incentive compensation to attract and retain qualified candidates to serve on our Board. In setting the compensation of directors, we consider the significant amount of time that Board members spend in fulfilling their duties to Pacific Ethanol as well as the experience level we require to serve on our Board. The Board, through its Compensation Committee, annually reviews the compensation and compensation policies for Board members. In recommending director compensation, the Compensation Committee is guided by three goals (i) compensation should fairly pay directors for work required in a company of our size and scope, (ii) compensation should align directors' interests with the long-term interests of our stockholders, and (iii) the structure of the compensation should be clearly disclosed to our stockholders.

In addition, as with our executive compensation, in making compensation decisions as to our directors, our Compensation Committee compared our cash and equity compensation payable to directors against market data obtained by Hewitt Associates. The data included a general industry survey of 235 companies with less than \$1.0 billion in annual revenues and a general industry survey of 51 companies with between \$500 million and \$1.0 billion in annual revenues. The Compensation Committee set compensation for our directors at approximately the median of compensation paid to directors of the companies comprising the market data provided to us by Hewitt Associates.

Cash Compensation

Current Program. On April 8, 2008, and effective as of April 1, 2008, our Compensation Committee approved a new cash compensation plan for directors which provides the Chairman of our Board annual compensation of \$80,000, the Chairman of our Audit Committee annual compensation of \$42,000, the Chairman of our Compensation Committee annual compensation of \$36,000, the Chairman of our Nominating and Governance Committee annual compensation of \$36,000, the Chairman of our Transportation Committee annual compensation of \$36,000 and the Chairman of our Strategic Transactions Committee annual compensation of \$36,000. All other directors, except employee directors, receive annual compensation of \$24,000. These amounts are paid in advance in bi-weekly installments. In addition, directors are reimbursed for certain reasonable and documented expenses in connection with attendance at meetings of our Board and its committees. Employee directors do not receive director compensation in connection with their service as directors.

Prior Program. Our cash compensation plan for directors during 2007 and the first quarter of 2008 provided the Chairman of our Board annual compensation of \$80,000, the Chairman of our Audit Committee annual compensation of \$22,000 and the Chairman of our Compensation Committee annual compensation of \$20,000. All other directors, except employee directors, received annual compensation of \$12,000. These amounts were paid in monthly installments. In addition, directors were reimbursed for certain reasonable and documented expenses in connection with attendance at meetings of our Board and its committees. Employee directors did not receive director compensation in connection with their service as directors.

Equity Compensation

Following our annual meeting each year, our Compensation Committee or our full Board is to grant equity compensation to our newly elected or reelected directors which is to vest as to 100% of the grants in one year. Vesting is to be subject to continued service on our Board during the full year.

In determining the amount of equity compensation, the Compensation Committee determines the value of total compensation, approximately targeting the median of compensation paid to directors of the companies comprising the market data provided to us by Hewitt Associates. The Compensation Committee then determines the cash component based on this market data. The balance of the total compensation target is then allocated to equity awards, and the number of shares to be granted to our directors is based on the estimated value of the underlying shares on the expected grant date.

Compensation of Employee Director

Mr. Koehler was compensated as a full-time employee and officer but received no additional compensation for service as a Board member during 2008. Information regarding the compensation awarded to Mr. Koehler is included in the "Summary Compensation Table" below.

Director Compensation Table

The following table summarizes the compensation of our directors for the year ended December 31, 2008:

| Name | Fees Earned or Paid in Cash (\$)(1) | Stock Awards (\$)(2) | (3) | Total (\$) |
|--------------------|--|----------------------------|-----|---------------|
| William L. Jones | \$ 80,000 | \$ 136,150 | (3) | \$ 216,150 |
| Terry L. Stone | \$ 37,000 | \$ 126,530 | (4) | \$ 163,530 |
| John L. Prince | \$ 32,000 | \$ 126,530 | (5) | \$ 158,530 |
| Douglas L. Kieta | \$ 30,000 | \$ 126,530 | (6) | \$ 156,530 |
| Larry D. Layne | \$ 32,000 | \$ 130,045 | (7) | \$ 162,045 |
| Michael D. Kandris | \$ 21,000 | \$ 30,000 | (8) | \$ 51,000 |

- (1) For a description of annual director fees and fees for chair positions, see the disclosure above under “Compensation of Directors—Cash Compensation.” The value of perquisites and other personal benefits was less than \$10,000 in aggregate for each director.
- (2) The amounts shown are the compensation costs recognized in our financial statements for 2008 related to vesting of shares of restricted stock awarded to each director since 2006. The fair values of the shares of restricted stock awarded were calculated based on the fair market value of our common stock on the grant date. No grants of restricted stock were made in years prior to 2006.
- (3) At December 31, 2008, Mr. Jones held 75,500 shares from stock awards, including 39,340 unvested shares, and also held options to purchase an aggregate of 50,000 shares of common stock. Mr. Jones was granted 31,200 and 44,300 shares of our common stock on October 4, 2006 and June 12, 2008, having aggregate grant date fair values of \$407,472 and \$104,991, respectively, calculated based on the fair market value of our common stock on the applicable grant date.
- (4) At December 31, 2008, Mr. Stone held 59,900 shares from stock awards, including 25,300 unvested shares, and also held options to purchase an aggregate of 15,000 shares of common stock. Mr. Stone was granted 15,600 and 44,300 shares of our common stock on October 4, 2006 and June 12, 2008, having aggregate grant date fair values of \$203,736 and \$104,991, respectively, calculated based on the fair market value of our common stock on the applicable grant date.
- (5) At December 31, 2008, Mr. Prince held 59,900 shares from stock awards, including 25,300 unvested shares, and also held options to purchase an aggregate of 15,000 shares of common stock. Mr. Prince was granted 15,600 and 44,300 shares of our common stock on October 4, 2006 and June 12, 2008, having aggregate grant date fair values of \$203,736 and \$104,991, respectively, calculated based on the fair market value of our common stock on the applicable grant date.
- (6) At December 31, 2008, Mr. Kieta held 59,900 shares from stock awards, including 25,300 unvested shares. Mr. Kieta was granted 15,600 and 44,300 shares of our common stock on October 4, 2006 and June 12, 2008, having aggregate grant date fair values of \$203,736 and \$104,991, respectively, calculated based on the fair market value of our common stock on the applicable grant date.
- (7) At December 31, 2008, Mr. Layne held 59,900 shares from stock awards, including 35,700 unvested shares. Mr. Layne was granted 15,600 and 44,300 shares of our common stock on January 17, 2008 and June 12, 2008, having aggregate grant date fair values of \$86,112 and \$104,991, respectively, calculated based on the fair market value of our common stock on the applicable grant date.
- (8) At December 31, 2008, Mr. Kandris held 25,300 shares from stock awards, all of which were unvested shares. Mr. Kandris was granted 25,300 shares of our common stock on June 12, 2008, having an aggregate grant date fair value of \$59,961, calculated based on the fair market value of our common stock on the grant date. Mr. Kandris was appointed as a director on June 11, 2008.

Indemnification of Directors and Officers

Section 145 of the Delaware General Corporation Law permits a corporation to indemnify its directors and officers against expenses, judgments, fines and amounts paid in settlement actually and reasonably incurred in connection with a pending or completed action, suit or proceeding if the officer or director acted in good faith and in a manner the officer or director reasonably believed to be in the best interests of the corporation.

Our certificate of incorporation provides that, except in certain specified instances, our directors shall not be personally liable to us or our stockholders for monetary damages for breach of their fiduciary duty as directors, except liability for the following:

- any breach of their duty of loyalty to Pacific Ethanol or our stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Section 174 of the Delaware General Corporation Law; and
- any transaction from which the director derived an improper personal benefit.

In addition, our certificate of incorporation and bylaws obligate us to indemnify our directors and officers against expenses and other amounts reasonably incurred in connection with any proceeding arising from the fact that such person is or was an agent of ours. Our bylaws also authorize us to purchase and maintain insurance on behalf of any of our directors or officers against any liability asserted against that person in that capacity, whether or not we would have the power to indemnify that person under the provisions of the Delaware General Corporation Law. We have entered and expect to continue to enter into agreements to indemnify our directors and officers as determined by our Board. These agreements provide for indemnification of related expenses including attorneys' fees, judgments, fines and settlement amounts incurred by any of these individuals in any action or proceeding. We believe that these bylaw provisions and indemnification agreements are necessary to attract and retain qualified persons as directors and officers. We also maintain directors' and officers' liability insurance.

The limitation of liability and indemnification provisions in our certificate of incorporation and bylaws may discourage stockholders from bringing a lawsuit against our directors for breach of their fiduciary duty. They may also reduce the likelihood of derivative litigation against our directors and officers, even though an action, if successful, might benefit us and other stockholders. Furthermore, a stockholder's investment may be adversely affected to the extent that we pay the costs of settlement and damage awards against directors and officers as required by these indemnification provisions. At present, there is no pending litigation or proceeding involving any of our directors, officers or employees regarding which indemnification is sought, and we are not aware of any threatened litigation that may result in claims for indemnification.

Insofar as the provisions of our certificate of incorporation or bylaws provide for indemnification of directors or officers for liabilities arising under the Securities Act of 1933, as amended (the "Securities Act"), we have been informed that in the opinion of the Securities and Exchange Commission this indemnification is against public policy as expressed in the Securities Act and is therefore unenforceable.

PROPOSAL TWO —
RATIFICATION OF APPOINTMENT OF
INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Our Audit Committee has appointed the independent registered public accounting firm of Hein & Associates LLP to audit and comment on our financial statements for the year ending December 31, 2009, and to conduct whatever audit functions are deemed necessary. Hein & Associates LLP audited our financial statements for the year ended December 31, 2008 that were included in our most recent Annual Report on Form 10-K, as amended.

A representative of Hein & Associates LLP is expected to be present at the Annual Meeting, will have the opportunity to make a statement if he or she desires to do so and will be available to respond to appropriate questions from stockholders.

Required Vote of Stockholders

Although a vote of stockholders is not required on this proposal, our Board is asking our stockholders to ratify the appointment of our independent registered public accounting firm. The ratification of the appointment of our independent registered public accounting firm requires the affirmative votes of a majority of the votes of the shares of our common stock and Series B Preferred Stock, voting together as a single class, present at the Annual Meeting in person or by proxy and entitled to vote, which shares voting affirmatively must also constitute at least a majority of the voting power required to constitute a quorum.

In the event that our stockholders do not ratify the appointment of Hein & Associates LLP as our independent registered public accounting firm, the appointment will be reconsidered by our Audit Committee. Even if the appointment is ratified, our Audit Committee, in its discretion, may direct the appointment of a different independent registered public accounting firm at any time during the year if the Audit Committee believes that such a change would be in our and our stockholders' best interests.

Recommendation of the Board of Directors

OUR BOARD UNANIMOUSLY RECOMMENDS A VOTE "FOR" RATIFICATION OF THE APPOINTMENT OF HEIN & ASSOCIATES LLP TO SERVE AS OUR INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE YEAR ENDING DECEMBER 31, 2009.

OTHER MATTERS

Our Board knows of no other matters to be brought before the Annual Meeting. However, if other matters should come before the Annual Meeting, it is the intention of the person named in the proxy to vote such proxy in accordance with his or her judgment on such matters.

AUDIT MATTERS

Principal Accountant Fees and Services

The following table presents fees for professional audit services rendered by Hein & Associates LLP for the years ended December 31, 2008 and 2007.

| | 2008 | 2007 |
|--------------------|------------|--------------|
| Audit Fees | \$ 962,897 | \$ 1,201,300 |
| Audit-Related Fees | — | 38,800 |
| Tax Fees | — | 2,200 |
| All Other Fees | — | — |
| Total | \$ 962,897 | \$ 1,242,300 |

Audit Fees. Consist of amounts billed for professional services rendered for the audit of our annual consolidated financial statements included in our Annual Reports on Form 10-K, and reviews of our interim consolidated financial statements included in our Quarterly Reports on Form 10-Q and our Registration Statements on Form S-3, including amendments thereto, and the review of our internal accounting and reporting controls as required under Section 404 of the Sarbanes-Oxley Act of 2002.

Audit-Related Fees. Audit-Related Fees consist of fees billed for professional services that are reasonably related to the performance of the audit or review of our consolidated financial statements but are not reported under “Audit Fees.” Such fees include amounts billed for professional services performed in connection with mergers and acquisitions.

Tax Fees. Tax Fees consist of fees for professional services for tax compliance activities, including the preparation of federal and state tax returns and related compliance matters.

All Other Fees. Consists of amounts billed for services other than those noted above.

Our Audit Committee has determined that all non-audit services provided by Hein & Associates LLP are compatible with maintaining Hein & Associates LLP’s audit independence.

Our Audit Committee is responsible for approving all audit, audit-related, tax and other services. The Audit Committee pre-approves all auditing services and permitted non-audit services, including all fees and terms to be performed for us by our independent auditor at the beginning of the fiscal year. Non-audit services are reviewed and pre-approved by project at the beginning of the fiscal year. Any additional non-audit services contemplated by us after the beginning of the fiscal year are submitted to the Chairman of our Audit Committee for pre-approval prior to engaging our independent auditor for such services. These interim pre-approvals are reviewed with the full Audit Committee at its next meeting for ratification. During 2008 and 2007, all services performed by Hein & Associates LLP were pre-approved by our Audit Committee in accordance with these policies and applicable Securities and Exchange Commission regulations.

The following Audit Committee Report is not considered proxy solicitation material and is not deemed filed with the Securities and Exchange Commission. Notwithstanding anything to the contrary set forth in any of our previous filings made under the Securities Act or under the Securities Exchange Act of 1934, as amended (“Exchange Act”) that might incorporate future filings made by us under those statutes, the Audit Committee Report will not be incorporated by reference into any such prior filings or into any future filings made by us under those statutes.

Audit Committee Report

The Audit Committee oversees our financial reporting process on behalf of the Board and is directly responsible for the compensation, appointment and oversight of our independent registered public accounting firm. Management is responsible for the preparation, presentation and integrity of our financial statements and for the appropriateness of the accounting principles and reporting policies that are used. Management is also responsible for testing the system of internal control over financial reporting, and reports to the Audit Committee on any deficiencies found. Our independent registered public accounting firm, Hein & Associates LLP, is responsible for auditing our financial

statements and expressing an opinion as to their conformity with U.S. generally accepted accounting principles, as well as examining and reporting on management's assertion about the effectiveness of our internal controls over financial reporting. Under its written charter, our Audit Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, has direct access to our independent registered public accounting firm as well as any of our employees, and has the ability to retain, at our expense, special legal, accounting, or other consultants or experts it deems necessary in the performance of its duties.

The Audit Committee reviewed and discussed the audited financial statements in the Annual Report on Form 10-K for the fiscal year ended December 31, 2008 with management and Hein & Associates LLP. The Audit Committee has also discussed and reviewed with Hein & Associates LLP the matters required to be discussed by Statements on Auditing Standards No. 61, as amended, "Communications with Audit Committees", as adopted by the Public Company Accounting Oversight Board in Rule 3200T. In addition, the Audit Committee obtained from Hein & Associates LLP the written disclosures and the letter required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountants' communications with the audit committee concerning independence and discussed with Hein & Associates LLP its independence from management and Pacific Ethanol, Inc. The Audit Committee has also considered whether the provision of non-audit services by Hein & Associates LLP is compatible with maintaining its independence, and has satisfied itself with respect to Hein & Associates LLP's independence.

Based on the reviews and discussions referred to above, the Audit Committee recommended to our Board (and our Board has approved) that the audited financial statements be included in the Annual Report on Form 10-K for the fiscal year ended December 31, 2008 for filing with the Securities and Exchange Commission.

Respectfully submitted,
Audit Committee
Terry L. Stone
John L. Prince
Larry D. Layne

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information with respect to the beneficial ownership of our common stock as of November 16, 2009, the date of the table, by:

- each person known by us to beneficially own more than 5% of the outstanding shares of our common stock;
- each of our directors;
- each of our current executive officers; and
- all of our directors and executive officers as a group.

Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission, and includes voting or investment power with respect to the securities. To our knowledge, except as indicated by footnote, and subject to community property laws where applicable, the persons named in the table below have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them. Shares of common stock underlying derivative securities, if any, that currently are exercisable or convertible or are scheduled to become exercisable or convertible for or into shares of common stock within 60 days after the date of the table are deemed to be outstanding in calculating the percentage ownership of each listed person or group but are not deemed to be outstanding as to any other person or group. Percentage of beneficial ownership is based on 57,636,828 shares of common stock and 2,346,152 shares of Series B Preferred Stock outstanding as of the date of the table.

| | | | |
|-------------------------------------|----|-------|----------|
| 0.8 | | 0.5 | |
| Cash and equivalents, end of period | \$ | 525.2 | \$ 168.5 |

In the three months ended August 31, 2005 H-3C was accounted for under the equity method. The three months ended August 31, 2006 include \$196.4 million of H-3C cash and equivalents.

Net cash provided by operating activities was \$3.3 million in the three months ended August 31, 2006, primarily reflecting our net loss of \$14.1 million, gains on sales of assets of \$10.0 million, and increased deferred income taxes of \$3.7 million, more than offset by \$20.1 million of depreciation and amortization, the minority interest in H-3C of \$8.9 million and \$3.3 million of stock based compensation. Changes in assets and liabilities resulted in a net use of cash of \$1.1 million, with inventory increasing \$21.7 million primarily due to increased inventory positions in our H-3C segment, largely offset by \$18.5 million in increased other liabilities, primarily in our H-3C segment.

Net cash provided by investing activities was \$17.3 million for the three months ended August 31, 2006, consisting of \$33.1 million of proceeds from the sale of the Santa Clara facility and insurance proceeds for the previously disclosed damage to our Hemel Hemstead facility, partially offset by \$9.8 million of net outflows related to purchases, sales and maturities of investments and by \$6.0 million of outflows related to purchases of property and equipment. We made investments totaling \$190.3 million in the three months ended August 31, 2006 in municipal and corporate bonds and government agency instruments. In the three months ended August 31, 2006 proceeds from maturities and sales of investments includes sales of municipal and corporate bonds and government agency instruments of \$163.5 million. In August 2006 we sold certain limited partnership interests and generated cash of approximately \$17.0 million with a gain on sale of investments of \$2.4 million and eliminated our future capital call requirements.

Net cash provided by financing activities was \$2.7 million in the three months ended August 31, 2006. During the three months ended August 31, 2006, we repurchased \$.2 million of shares of restricted stock awards upon vesting from employees including those shares to satisfy the tax withholding obligations that arise in connection with such vesting. This was offset by proceeds of \$2.9 million from issuances of our common stock upon exercise of stock options. On March 23, 2005, our Board of Directors approved a stock repurchase program providing for expenditures of up to \$100.0 million through March 31, 2007. Under the stock repurchase program, we may repurchase shares of our common stock having an aggregate purchase price of up to \$100.0 million in the open market, in privately negotiated transactions with shareholders or using derivative transactions; provided, however, that all repurchases must be pre-approved by the Audit and Finance Committee of the Board of Directors. We have not made any

purchases to date under this program. There is no requirement that we repurchase shares under the program and the program may be discontinued at any time.

During the year ended May 31, 2005, we entered into an agreement facilitating the issuance of standby letters of credit and bank guarantees required in the normal course of business. As of August 31, 2006, such bank-issued standby letters of credit and guarantees totaled \$6.8 million, including \$6.1 million relating to potential foreign tax, custom, and duty assessments.

We currently have no material capital expenditure purchase commitments other than ordinary course purchases of computer hardware, software and leasehold improvements.

We currently believe that our existing cash, cash equivalents and short-term investments will be sufficient to satisfy our

Table of Contents

anticipated cash requirements for at least the next 12 months.

EFFECTS OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with Statement of Financial Accounting Standard (SFAS) No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute of tax positions taken or expected to be taken on a tax return. This Interpretation is effective for the first fiscal year beginning after December 15, 2006. We are currently evaluating the impact FIN 48 will have on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years, with early adoption permitted. We have not yet determined the impact, if any, that the implementation of SFAS No. 157 will have on our results of operations or financial condition.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We hold marketable equity traded securities that have a brief trading history and are highly subject to market price volatility. We do not believe the equity security price fluctuations of plus or minus 50 percent would have a material impact on the value of these securities as of August 31, 2006.

There have been no material changes in market risk exposures from those disclosed in our Annual Report on Form 10-K for the fiscal year ended May 31, 2006.

ITEM 4. CONTROLS AND PROCEDURES

Our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of our quarter ended September 1, 2006 pursuant to Exchange Act Rule 13a-15(b). The term disclosure controls and procedures, as defined under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that, as of the end of our quarter ended September 1, 2006, our disclosure controls and procedures were effective.

The annual evaluation of internal control over financial reporting will first include H-3C with respect to our fiscal year ending June 1, 2007 and the related annual report on Form 10-K. We anticipate that we will incur considerable costs and use significant management time and other resources in the effort to bring H-3C into compliance with Section 404 and other requirements of the Sarbanes-Oxley Act.

There have been no changes in our internal control over financial reporting that occurred during the three months ended August 31, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Table of Contents

The information set forth in Note 13 to the Notes to the Condensed Consolidated Financial Statements is incorporated by reference herein.

ITEM 1A. RISK FACTORS

Risk factors may affect our future business and results. The matters discussed below could cause our future results to materially differ from past results or those described in forward-looking statements and could have a material adverse effect on our business, financial condition, results of operations and stock price.

We have incurred significant net losses in recent fiscal periods, including \$14 million for the three months ended August 31, 2006, \$101 million for the year ended May 31, 2006, and \$196 million for year ended May 31, 2005, and we may not be able to return to profitability.

Although we are taking steps designed to improve our results of operations, such as the restructuring we announced in June 2006, we cannot provide assurance that we will return to profitability.

We have faced a number of challenges that have affected our operating results during the current and past several fiscal years. Specifically, we have experienced, and may continue to experience, the following, particularly in our SCN segment:

declining sales due to price competition and reduced incoming order rate;

risk of increased excess and obsolete inventories;

excess facilities;

operating expenses that, as a percentage of sales, have exceeded our desired financial model; and

disruptions resulting from our workforce reductions and employee attrition.

If we do not respond effectively to increased competition caused by industry volatility and consolidation our business could be harmed.

Our business could be seriously harmed if we do not compete effectively. We face competitive challenges that are likely to arise from a number of factors, including the following:

industry volatility resulting from rapid product development cycles;

increasing price competition due to maturation of basic networking technologies;

industry consolidation resulting in competitors with greater financial, marketing, and technical resources; and

the presence of existing competitors with greater financial resources together with the potential emergence of new competitors with lower cost structures and more competitive offerings.

We may not be able to compensate for lower sales or unexpected cash outlays with cost reductions sufficient to generate positive net income or cash flow.

Although we have implemented cost and expense reductions with the goal to achieve profitability, we may need to further reduce costs which may in turn reduce our sales. If we are not able to effectively reduce our costs and expenses, particularly in our SCN segment, we may not be able to generate positive net income or cash flow from operations. If we continue to experience negative cash flow from operations over a prolonged period of time or if we suffer unexpected cash outflows, our liquidity and ability to operate our business effectively could be adversely affected.

We are unable to predict the exact amount of cost reductions required for us to generate positive net income or cash flow from operations because it is difficult to predict the amount of our future sales and gross margins. The amount of our future sales depends, in part, on future economic and market conditions, which are difficult to forecast accurately.

Efforts to reduce operating expenses have involved, and could involve further, workforce reductions, closure of offices and sales or discontinuation of businesses, leading to reduced sales and other disruptions in our business.

Table of Contents

Our operating expenses as a percent of sales continue to be higher than our desired long-term financial model. We have taken, and will continue to take, actions to reduce these expenses. Such actions have and may in the future include reductions in our workforce, closure of facilities, relocation of functions and activities to lower cost locations, the sale or discontinuation of businesses, changes or modifications in IT systems or applications, or process reengineering. As a result of these actions, the employment of some employees with critical skills may be terminated and other employees have, and may in the future, leave our company voluntarily due to the uncertainties associated with our business environment and their job security. In addition, reductions in overall staffing levels could make it more difficult for us to sustain historic sales levels, to achieve our growth objectives, to adhere to our preferred business practices and to address all of our legal and regulatory obligations in an effective manner, which could, in turn, ultimately lead to missed business opportunities, higher operating costs or penalties.

We are significantly dependent on our H-3C joint venture in China and if H-3C is not successful, it could materially and adversely impact our business, business prospects and operating results.

H-3C, which is domiciled in Hong Kong and has its principal operations in Hangzhou, China, is subject to all of the operational risks that normally arise for a technology company with global operations including risks relating to research and development, manufacturing, sales, service, marketing, and corporate functions. Given the significance of H-3C to our financial results, if H-3C is not successful, our business will likely be adversely affected.

Our business, business prospects and operating results have significant dependencies upon product deliveries from H-3C and the results of our H-3C operating segment. In particular, our product development activities, product manufacturing and procurement of certain products, intellectual property and channel activities have become increasingly interdependent with those of H-3C.

Sales from our H-3C joint venture and therefore China constitute a material portion of our total sales, and our business, financial condition and results of operations will to a significant degree be subject to economic, political and social events in China.

Our sales are significantly dependent on China. We expect that a significant portion of our sales will be derived from China for the foreseeable future. As a result, our business, financial condition and results of operations are to a significant degree subject to economic, political, legal and social developments and other events in China and surrounding areas.

Our China joint venture, H-3C, is dependent on Huawei, our co-owner in this venture, in several material respects, including as an important customer; should Huawei reduce its business with or operational assistance to H-3C, our business could be materially affected.

H-3C derives a material portion of its sales from or through Huawei. In the three months ended August 31, 2006 for the H-3C segment Huawei accounted for 30% of the revenue for the segment. Should Huawei reduce its business with H-3C, H-3C's sales will suffer. Further, Huawei provides certain foreign office support platforms for H-3C. If Huawei ceases this support, international operations will be more burdensome and expensive for H-3C. Huawei also provides certain information technology, software licensing and rental of premises to H-3C.

If we fail to adequately evolve our financial and managerial control and reporting systems and processes, including the management of our H-3C segment, our ability to manage and grow our business will be negatively affected.

Our ability to successfully offer our products and implement our business plan in a rapidly evolving market depends upon an effective planning and management process. We will need to continue to improve our financial and managerial control and our reporting systems and procedures in order to manage our business effectively in the future. If we fail to implement improved systems and processes, our ability to manage our business and results of operations could be adversely affected. For example, now that we control and consolidate our joint venture in China, H-3C, we are spending additional time, resources and capital to manage its business, operations and financial results. We will need to adequately incentivize H-3C management and other key employees. We will also need to manage the multiple channels to our markets. If we are not able to successfully manage our H-3C venture, our business results could be adversely affected.

Table of Contents

We may not be able to complete or finance a transaction with Huawei to purchase additional interest in our joint venture, H-3C, on favorable terms or at all; if we cannot complete a transaction, our strategy to further invest in H-3C may not occur, we will be subject to the risks of the bid process described below and our business may suffer.

On August 8, 2006, we announced that we will begin negotiations with Huawei for the purchase by us of an additional equity interest in H-3C. We currently own 51% of H-3C and Huawei owns 49%. Under the terms of our existing shareholders' agreement, and as previously disclosed, we each have the right, commencing on and after November 15, 2006, to initiate a bid process to purchase the equity interest in H-3C held by the other. The negotiations are intended to result in an agreement outside of the bid process. We cannot provide assurance that we will be able to negotiate acceptable terms with Huawei or that the transaction will be consummated at all. In addition, any such transaction is subject to regulatory approval by the Chinese government and we cannot provide assurance that such approval will be granted. We may need to raise equity or debt capital in order to finance any such transaction, and such financing may not be available on terms acceptable to us. Any equity financing would be dilutive to our existing stockholders. Any debt financing would involve using cash generated from operations to service the interest and pay down the principal, diverting funds that might otherwise be invested in our businesses. We may also use existing cash to finance a portion of the consideration for any such transaction, which, if used, would reduce available cash on hand. If we cannot complete a transaction, the bid process risks described below would apply. If we cannot complete a transaction, our strategy to increase our investment in H-3C may not be available to us and our business may suffer as a result unless we employ successful alternative strategies.

We, and our joint venture partner, Huawei, each have the right, starting in November 2006, to initiate a bid process to buy the other out of our China joint venture, H-3C; if Huawei wins the bid process, we will no longer be able to consolidate H-3C's results and may, over time, lose the right to source and resell H-3C's products.

Starting in November 2006, Huawei and 3Com each can initiate a bid process to purchase the equity interest in H-3C owned by the other. Under the bid process, if one party makes a bid to buy out the other, the party receiving the bid offer must either accept that offer or make its own, higher, bid to buy out the other party. The bidding process would alternate until one party either accepts the other's bid or fails to make a higher bid. If Huawei wins the bid process to buy out our equity ownership in H-3C, upon consummation of the closing of that transaction we will no longer be able to consolidate H-3C's results with ours. Our OEM agreement with H-3C, pursuant to which we source products from H-3C and resell them, has an initial five-year term ending November 2008. This agreement automatically renews for successive two-year terms unless a party gives the other party at least 180-days prior written notice that it does not wish to renew the agreement. Should Huawei win the bid process, it may cause H-3C to terminate its OEM agreement with us effective November 2008 or during one of the successive terms. Because we source networking products from H-3C for resale and such products are material to our success, if H-3C terminated its OEM agreement with us it would adversely impact our financial results.

We may not be successful at identifying and responding to new and emerging market and product opportunities, or at responding quickly enough to technologies or markets that are in decline.

The markets in which we compete are characterized by rapid technology transitions and short product life cycles.

Therefore, our success depends on our ability to do the following:

- identify new market and product opportunities;

- predict which technologies and markets will see declining demand;

- develop and introduce new products and solutions in a timely manner;

- gain market acceptance of new products and solutions, particularly in targeted emerging markets; and

- rapidly and efficiently transition our customers from older to newer enterprise networking technologies.

Our financial position or results of operations could suffer if we are not successful in achieving these goals. For example, our business would suffer if any of the following occurs:

- there is a delay in introducing new products;

we lose certain channels of distribution or key partners;

our products do not satisfy customers in terms of features, functionality or quality; or

our products cost more to produce than we expect.

Because we will continue to source products from OEMs and from H-3C and rely on original design manufacturers to assist in product design, we may not be able to independently identify current product and technology trends or to respond to such

Table of Contents

trends through the design and production of new products as well as if we were working independently.

Our success is dependent on continuing to hire and retain qualified managers and other personnel; if we are not successful in attracting and retaining these personnel, our business will suffer.

Competition for qualified employees is intense. If we fail to attract, hire, or retain qualified personnel, our business will be harmed. We have experienced significant turnover in our management team in the last several years and we may continue to experience change at this level. If we cannot retain qualified senior managers, our business may not succeed. In addition, in order to calculate our stock-based compensation charge, we make assumptions regarding several factors, including the forfeiture rate for our equity instruments. If we are successful in retaining management and other key employees with significant equity compensation, we will likely decrease our future forfeiture rate assumptions, which will in turn likely increase our stock-based compensation charge.

We expect to utilize strategic relationships and other alliances as key elements in our strategy. If we are not successful in forming desired ventures and alliances or if such ventures and alliances are not successful, our ability to achieve our growth and profitability goals could be adversely affected.

We have announced alliances with third parties, such as IBM, Trapeze Networks and Siemens Business Services. In the future, we expect to evaluate other possible strategic relationships, including joint ventures and other types of alliances, and we may increase our reliance on such strategic relationships to broaden our sales channels, complement internal development of new technologies and enhancement of existing products, and exploit perceived market opportunities.

If we fail to form the number and quality of strategic relationships that we desire, or if such strategic relationships are not successful, we could suffer missed market opportunities, channel conflicts, delays in product development or delivery, or other operational difficulties. Further, if third parties acquire our strategic partners or if our competitors enter into successful strategic relationships, we may face increased competition. Any of these difficulties could have an adverse effect on our future sales and results of operations.

Our strategy of outsourcing functions and operations may fail to reduce cost and may disrupt our operations.

We continue to look for ways to decrease cost and improve efficiency by contracting with other companies to perform functions or operations that, in the past, we have performed ourselves. We have outsourced the majority of our manufacturing and logistics for our SCN products. We now rely on outside vendors to meet the majority of our manufacturing needs as well as a significant portion of our IT needs for the SCN segment. Additionally, we outsource certain functions to Siemens Business Services for technical support and product return services. To achieve future cost savings or operational benefits, we may expand our outsourcing activities to cover additional services which we believe a third party may be able to provide in a more efficient or effective manner than we could do internally ourselves.

Although we believe that outsourcing will result in lower costs and increased efficiencies, this may not be the case. Because these third parties may not be as responsive to our needs as we would be ourselves, outsourcing increases the risk of disruption to our operations. In addition, our agreements with these third parties sometimes include substantial penalties for terminating such agreements early or failing to maintain minimum service levels. Because we cannot always predict how long we will need the services or how much of the services we will use, we may have to pay these penalties or incur costs if our business conditions change.

Our reliance on industry standards, technological change in the marketplace, and new product initiatives may cause our sales to fluctuate or decline.

The enterprise networking industry in which we compete is characterized by rapid changes in technology and customer requirements and evolving industry standards. As a result, our success depends on:

the convergence of technologies, such as voice, data and video on single, secure networks;

the timely adoption and market acceptance of industry standards, and timely resolution of conflicting U.S. and international industry standards; and

Table of Contents

our ability to influence the development of emerging industry standards and to introduce new and enhanced products that are compatible with such standards.

Slow market acceptance of new technologies, products, or industry standards could adversely affect our sales or overall results of operations. In addition, if our technology is not included in an industry standard on a timely basis or if we fail to achieve timely certification of compliance to industry standards for our products, our sales of such products or our overall results of operations could be adversely affected.

We focus on enterprise networking, and our results of operations may fluctuate based on factors related entirely to conditions in this market.

Our focus on enterprise networking may cause increased sensitivity to the business risks associated specifically with the enterprise networking market and our ability to execute successfully on our strategies to provide superior solutions for larger and multi-site enterprise environments. To be successful in the enterprise networking market, we will need to be perceived by decision making officers of large enterprises as committed for the long-term to the high-end networking business. Also, expansion of sales to large enterprises may be disruptive in a variety of ways, such as adding larger systems integrators that may raise channel conflict issues with existing distributors, or a perception of diminished focus on the small and medium enterprise market.

A significant portion of our SCN sales is derived from a small number of resellers. If any of these partners reduces its business with us, our business could be seriously harmed.

We distribute many of our products through two-tier distribution channels that include distributors, systems integrators and Value Added Resellers (VARs). A significant portion of our sales is concentrated among a few distributors; our two largest distributors accounted for a combined 35 percent of SCN sales for the three months ended August 31, 2006, a combined 34 percent of SCN sales for the year ended May 31, 2006 and a combined 34 percent of SCN sales for year ended May 31, 2005. If either of these distributors reduces its business with us, our sales and overall results of operations could be adversely affected.

We depend on distributors who maintain inventories of our products. If the distributors reduce their inventories of our products, our sales could be adversely affected.

We work closely with our distributors to monitor channel inventory levels and ensure that appropriate levels of products are available to resellers and end users. Our target range for channel inventory levels is between three and five weeks of supply on hand at our distributors. Partners with a below-average inventory level may incur stock outs that would adversely impact our sales. Our distribution agreements typically provide that our distributors may cancel their orders on short notice with little or no penalty. If our channel partners reduce their levels of inventory of our products, our sales would be negatively impacted during the period of change.

If we are unable to successfully develop relationships with system integrators, service providers, and enterprise VARs, our sales may be negatively affected.

As part of our sales strategy, we are targeting system integrators (SIs), service providers (SPs), and enterprise VARs (eVARs). In addition to specialized technical expertise, SIs, SPs and eVARs typically offer sophisticated services capabilities that are frequently desired by larger enterprise customers. In order to expand our distribution channel to include resellers with such capabilities, we must be able to provide effective support to these resellers. If our sales, marketing or services capabilities are not sufficiently robust to provide effective support to such SIs, SPs, and eVARs, we may not be successful in expanding our distribution model and current SI, SP, and eVAR partners may terminate their relationships with us, which would adversely impact our sales and overall results of operations.

The members of the board of our China joint venture designated by our co-owner, Huawei, have protective rights over the approval of certain matters; accordingly if Huawei does not agree with us on these matters, these rights could harm 3Com's business by preventing us from taking desired actions.

The governance documents applicable to our joint venture in China, H-3C, include the requirement that certain actions be approved by an affirmative vote of two-thirds of H-3C's board of directors, including at least one director appointed by

Table of Contents

3Com Corporation and one director appointed by Huawei. This right gives Huawei's board members the right to approve certain matters at the H-3C level, including the following:

any amendment to the Articles or charter documents;

any voluntary bankruptcy, liquidation, dissolution or winding up;

changes in authorized capital stock or the issuance of capital stock (or rights to acquire capital stock);

any significant merger, acquisition, disposition or other corporate reorganization;

determining the amount of dividends to pay and whether to pay special dividends not required by the dividend policy;

related party transactions, including loans and capital contributions;

incurrence of debt over a specified amount that falls outside of the approved budget; and

any sale, exclusive license or other transfer or disposition of any significant technology or intellectual property.

If there are disagreements between us and Huawei with respect to these matters, we may not be able to implement certain actions and the success of this joint venture may be adversely affected.

Our competition with Huawei in the enterprise networking market could have a material adverse effect on our sales and our results of operations.

As Huawei expands its international operations, there could be increasing instances where we compete directly with Huawei in the enterprise networking market. As a co-owner and OEM customer of H-3C, Huawei has access to many of H-3C's products thereby enhancing Huawei's current ability to compete directly with us. We could lose a competitive advantage in markets where we compete with Huawei, which could have a material adverse effect on our sales and overall results of operations.

We may pursue acquisitions of other companies that, if not successful, could adversely affect our business, financial position and results of operations.

In the future, we may pursue acquisitions of companies to enhance our existing capabilities. There can be no assurances that acquisitions that we might pursue will be successful. If we pursue an acquisition but are not successful in completing it, or if we complete an acquisition but are not successful in integrating the acquired company's technology, employees, products or operations successfully, our business, financial position or results of operations could be adversely affected.

We may be unable to manage our supply chain successfully, which would adversely impact our sales, gross margin and profitability.

Current business conditions and operational challenges in managing our supply chain affect our business in a number of ways:

in the past, some key components have had limited availability;

as integration of networking features on a reduced number of computer chips continues, we are increasingly facing competition from parties who are our suppliers;

our ability to accurately forecast demand is diminished;

our reliance on, and long-term arrangements with, third-party manufacturers places much of the supply chain process out of our direct control and heightens the need for accurate forecasting and reduces our ability to transition quickly to alternative supply chain strategies; and

we may experience disruptions to our logistics.

Some of our suppliers are also our competitors. We cannot be certain that in the future our suppliers, particularly those who are also in active competition with us, will be able or willing to meet our demand for components in a timely and cost-effective manner.

Table of Contents

There has been a trend toward consolidation of vendors of electronic components. Our reliance on a smaller number of vendors and the inability to quickly switch vendors increase the risk of logistics disruptions, unfavorable price fluctuations, or disruptions in supply, particularly in a supply-constrained environment.

Supplies of certain key components can become tighter as industry demand for such components has increased. If the resulting increase in component costs and time necessary to obtain these components persists, we may experience an adverse impact to gross margin.

If overall demand for our products or the mix of demand for our products is significantly different from our expectations, we may face inadequate or excess component supply or inadequate or excess manufacturing capacity. This would result in orders for products that could not be manufactured in a timely manner, or a buildup of inventory that could not easily be sold. Either of these situations could adversely affect our market share, sales, and results of operations or financial position.

Our strategies to outsource the majority of our manufacturing requirements to contract manufacturers may not result in meeting our cost, quality or performance standards. The inability of any contract manufacturer to meet our cost, quality or performance standards could adversely affect our sales and overall results from operations.

The cost, quality, performance, and availability of contract manufacturing operations are and will be essential to the successful production and sale of many of our products. We may not be able to provide contract manufacturers with product volumes that are high enough to achieve sufficient cost savings. If shipments fall below forecasted levels, we may incur increased costs or be required to take ownership of inventory. In addition, a significant component of maintaining cost competitiveness is the ability of our contract manufacturers to adjust their own costs and manufacturing infrastructure to compensate for possible adverse exchange rate movements. To the extent that the contract manufacturers are unable to do so, and we are unable to procure alternative product supplies, then our own competitiveness and results of operations could be adversely impacted.

We have implemented a program with our manufacturing partners to ship products directly from regional shipping centers to customers. Through this program, we are relying on these partners to fill customer orders in a timely manner. This program may not yield the efficiencies that we expect, which would negatively impact our results of operations. Any disruptions to on-time delivery to customers would adversely impact our sales and overall results of operations.

China's governmental and regulatory reforms and changing economic environment may impact our ability to do business in China.

As a result of the historic reforms of the past several decades, multiple government bodies are involved in regulating and administering affairs in the enterprise networking industry in China. These government agencies have broad discretion and authority over all aspects of the networking, telecommunications and information technology industry in China; accordingly their decision may impact our ability to do business in China. While we anticipate that the basic principles underlying the reforms China has made will remain unchanged, any of the following changes in China's political and economic conditions and governmental policies could have a substantial impact on our business:

the promulgation of new laws and regulations and the interpretation of those laws and regulations;

enforcement and application of rules and regulations by the Chinese government;

the introduction of measures to control inflation or stimulate growth; or

any actions that limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

Furthermore, China's economic environment has been changing as a result of China's entry, in December of 2001, into the World Trade Organization, or the WTO. If China's entry into the WTO results in increased competition or has a negative impact on China's economy, our business could suffer. Since early 2004, the Chinese government has implemented certain measures to control the pace of economic growth. Such measures may cause a decrease in the level of economic activity in China, which in turn could adversely affect our results of operations and financial condition.

Uncertainties with respect to the Chinese legal system may adversely affect us.

Table of Contents

We conduct our business in China primarily through our joint venture, H-3C, a Hong Kong entity which in turn owns a Chinese entity. These entities are generally subject to laws and regulations applicable to foreign investment in China. In addition, there are uncertainties regarding the interpretation and enforcement of laws, rules and policies in China. Because many laws and regulations are relatively new and the Chinese legal system is still evolving, the interpretations of many laws, regulations and rules are not always uniform. Moreover, the interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Finally, enforcement of existing laws or contracts based on existing law may be uncertain, and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management's attention.

If tax benefits available to our China joint venture, H-3C, are reduced or repealed, our business could suffer.

The Chinese government is considering the imposition of a unified corporate income tax that would phase out, over time, the preferential tax treatment to which H-3C is currently entitled. While it is not certain whether the government will implement a unified tax structure or whether H-3C will receive grandfathered status from any new tax, if a new tax structure is implemented, such new tax structure may adversely affect our financial condition.

H-3C is subject to restrictions on paying dividends and making other payments to us.

Chinese regulations currently permit payment of dividends only out of accumulated profits, as determined in accordance with Chinese accounting standards and regulations. Our joint venture, a Hong Kong entity, does business through a Chinese entity that is required to set aside a portion of its after-tax profits according to Chinese accounting standards and regulations to fund certain reserves. The Chinese government also imposes controls on the conversion of Renminbi into foreign currencies and the remittance of currencies out of China. We may experience difficulties in completing the administrative procedures necessary to obtain and remit foreign currency. These restrictions may in the future limit our ability to receive dividends or repatriate funds from H-3C.

If we fail to maintain an effective system of internal control over financial reporting that includes our China joint venture, H-3C, we may not be able to accurately report our financial results or prevent fraud.

The annual evaluation of internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002 will first include H-3C with respect to our fiscal year ending June 1, 2007 and the related annual report on Form 10-K. If we cannot enhance H-3C's existing controls by the evaluation date, our management may conclude that our internal control over financial reporting at the end of that period is not effective. Moreover, even if our management concludes that our internal control over financial reporting is effective, our independent registered public accounting firm may not be able to attest to our management's conclusions or may reach an opposite conclusion. Furthermore, having effective internal control over financial reporting is necessary for us to produce reliable financial reports and is important to help prevent fraud. If we fail to achieve and maintain effective internal control over financial reporting on a consolidated basis, it could result in the loss of investor confidence in the reliability of our financial statements, which in turn could harm our business and negatively impact the trading price of our common stock. Furthermore, we anticipate that we will incur considerable costs and use significant management time and other resources in an effort to bring H-3C into compliance with Section 404 and the other requirements of the Sarbanes-Oxley Act.

We are subject to risks relating to currency rate fluctuations and exchange controls and we do not hedge this risk in China.

Due to our consolidation of our joint venture in China, a significant portion of our sales and a portion of our costs will be made in China and denominated in Renminbi. In July 2005, China uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move initially revalued the Renminbi by 2.1% against the U.S. dollar; however, it is uncertain what further adjustments may be made in the future. The Renminbi-U.S. dollar exchange rate could float, and the Renminbi could appreciate or depreciate relative to the U.S. dollar. Any movement of the Renminbi may materially and adversely affect our cash flows, revenues, operating results and financial position.

We do not currently hedge the currency risk in H-3C through foreign exchange forward contracts or otherwise and China employs currency controls restricting Renminbi conversion, limiting our ability to engage in currency hedging activities in

Table of Contents

China. Various foreign exchange controls are applicable to us in China, and such restrictions may in the future make it difficult for H-3C or us to repatriate earnings, which could have an adverse effect on our cash flows and financial position.

We may need to engage in complex and costly litigation in order to protect, maintain or enforce our intellectual property rights; in some jurisdictions, such as China, our rights may not be as strong as the rights we enjoy in the U.S.

Whether we are defending the assertion of intellectual property rights against us, or asserting our intellectual property rights against others, intellectual property litigation can be complex, costly, protracted, and highly disruptive to business operations because it may divert the attention and energies of management and key technical personnel. Further, plaintiffs in intellectual property cases often seek injunctive relief and the measures of damages in intellectual property litigation are complex and often subjective or uncertain. Thus, the existence of this type of litigation, or any adverse determinations related to such litigation, could subject us to significant liabilities and costs. If any of our OEM, Original Design Manufacturer, or ODM, or joint venture partners become involved in intellectual property disputes and are unable to hold us harmless, then we may incur liabilities or suffer disruption of our business. Any one of these factors could adversely affect our sales, gross margin, overall results of operations, cash flow or financial position.

In addition, the legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. For example, in China, the legal system in general, and the intellectual property regime in particular, are still in the development stage. It may be very difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights, and those of H-3C, in these jurisdictions.

We may not be able to defend ourselves successfully against claims that we are infringing the intellectual property rights of others.

Many of our competitors, such as telecommunications, networking, and computer equipment manufacturers, have large intellectual property portfolios, including patents that may cover technologies that are relevant to our business. In addition, many smaller companies, universities, and individual inventors have obtained or applied for patents in areas of technology that may relate to our business. The industry continues to be aggressive in assertion, licensing, and litigation of patents and other intellectual property rights.

In the course of our business, we receive claims of infringement or otherwise become aware of potentially relevant patents or other intellectual property rights held by other parties. We evaluate the validity and applicability of these intellectual property rights, and determine in each case whether we must negotiate licenses or cross-licenses to incorporate or use the proprietary technologies, protocols, or specifications in our products. If we are unable to obtain and maintain licenses on favorable terms for intellectual property rights required for the manufacture, sale, and use of our products, particularly those that must comply with industry standard protocols and specifications to be commercially viable, our financial position or results of operations could be adversely affected. In addition, if we are alleged to infringe the intellectual property rights of others, we could be required to seek licenses from others or be prevented from manufacturing or selling our products, which could cause disruptions to our operations or the markets in which we compete. Finally, even if we have indemnification rights in respect of such allegations of infringement, from our suppliers or licensors, we may not be able to recover our losses under those indemnity rights.

Fluctuations in our operating results and other factors may contribute to volatility in the market price of our stock.

Historically, our stock price has experienced volatility. We expect that our stock price may continue to experience volatility in the future due to a variety of potential factors such as:

fluctuations in our quarterly results of operations and cash flow;

changes in our cash and equivalents and short term investment balances;

variations between our actual financial results and published analysts' expectations; and

announcements by our competitors.

In addition, over the past several years, the stock market has experienced significant price and volume fluctuations that have affected the stock prices of many technology companies. These factors, as well as general economic and political conditions or investors' concerns regarding the credibility of corporate financial statements and the accounting profession, may have a material adverse affect on the market price of our stock in the future.

Table of Contents**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table summarizes repurchases of our stock, including shares returned to satisfy employee tax withholding obligations, in the three months ended August 31, 2006:

| Period | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1) | Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|--|---|
| June 3, 2006 through June 30, 2006 | 1,223(2) | \$ 4.56 | | \$ 100,000,000 |
| July 1, 2006 through July 28, 2006 | 34,127(2) | 5.04 | | \$ 100,000,000 |
| July 29, 2006 through September 1, 2006 | 2,093(2) | 4.41 | | \$ 100,000,000 |
| Total | 37,443 | \$ 4.99 | | \$ 100,000,000 |

(1) On March 23, 2005, our Board of Directors approved a new stock repurchase program providing for expenditures of up to \$100.0 million through March 31, 2007, provided that all repurchases are pre-approved by the Audit and Finance Committee of the Board of Directors. We did not repurchase shares of our common stock pursuant to this authorization in

the three months ended August 31, 2006. However, we may use cash to repurchase shares in future periods. Our last open market purchase was made in August, 2004 for 10,700,041 shares.

- (2) Represents shares returned to us to satisfy tax withholding obligations that arose upon the vesting of restricted stock awards.

Table of Contents**ITEM 6. EXHIBITS**

| Exhibit Number | Exhibit Description | Form | Incorporated by Reference | | | Filed Herewith |
|----------------|--|-------|---------------------------|-------------------|-------------|----------------|
| | | | File No. | Exhibit | Filing Date | |
| 2.1 | Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999 | 10-Q | 002-92053 | 2.1 | 4/4/00 | |
| 2.2 | Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc. | 10-Q | 002-92053 | 2.11 | 4/4/00 | |
| 2.3 | Asset Purchase Agreement by and between the Registrant and UTStarcom, Inc. dated March 4, 2003 | 8-K | 000-12867 | 10.1 | 6/9/03 | |
| 2.4 | Agreement and Plan of Merger, dated December 13, 2004, by and among the Registrant, Topaz Acquisition Corporation and TippingPoint Technologies, Inc. | 8-K | 000-12867 | 2.1 | 12/16/04 | |
| 2.5 | Securities Purchase Agreement by and among 3Com Corporation, 3Com Technologies, Huawei Technologies Co., Ltd. and Shenzhen Huawei Investment & Holding Co., Ltd., dated as of October 28, 2005 | 8-K/A | 000-12867 | 2.1 | 3/30/06 | |
| 3.1 | Corrected Certificate of Merger filed to correct an error in the Certificate of Merger | 10-Q | 002-92053 | 3.4 | 10/8/99 | |
| 3.2 | Registrant's Bylaws, as amended on March 23, 2005 | 8-K | 000-12867 | 3.1 | 3/28/05 | |
| 3.3 | Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock | 10-Q | 000-12867 | 3.6 | 10/11/01 | |
| 4.1 | Third Amended and Restated Preferred Shares Rights Agreement, dated as of November 4, 2002 | 8-A/A | 000-12867 | 4.1 | 11/27/02 | |
| 10.1 | 3Com Corporation Employment Agreement, dated as of August 8, 2006 between the registrant and Edgar Masri * | 8-K | 000-12867 | 10.1 | 8/9/06 | |
| 10.2 | 3Com Corporation Stand Alone Stock Option Agreement dated September 5, 2006 by and between Edgar Masri and 3Com Corporation * | | | | | X |
| 10.3 | Form of 3Com Corporation 2003 Stock Plan Restricted Stock Unit Grant Award Agreement* | | | | | X |
| 10.4 | Executive Officer Fiscal 2007 Compensation* | 8-K | 000-12867 | Text of Item 1.01 | 6/26/06 | |
| 10.5 | 3Com Corporation Consultant Services Agreement made as of August 8, 2006 by | 8-K | 000-12867 | 10.1 | 8/11/06 | |

| | | | | | | |
|------|---|-----|-----------|------|---------|---|
| | and between 3Com Corporation and Anik Bose | | | | | |
| 10.6 | Purchase and Sale Agreement made as of July 24, 2006 by and between 3Com Corporation and SSC II, L.P. | 8-K | 000-12867 | 10.1 | 7/26/06 | |
| 10.7 | Agreement for the Lease of Hangzhou Real Property between Huawei Technologies Co. Ltd. and Hangzhou Huawei-3Com | | | | | X |

34

Table of Contents

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | | Filed Herewith |
|---------------------------|---|----------------------------------|-----------------|----------------|--------------------|---------------------------|
| | | Form | File No. | Exhibit | Filing Date | |
| 31.1 | Technology Co., Ltd. dated January 1, 2004 Certification of Principal Executive Officer | | | | | X |
| 31.2 | Certification of Principal Financial Officer | | | | | X |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | | X |

* Indicates a management contract or compensatory plan

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

3Com Corporation
(Registrant)

Dated: October 10, 2006

By: /s/ DONALD M. HALSTED, III
Donald M. Halsted, III
Executive Vice President, Finance and
Chief Financial Officer (Principal
Financial and Accounting Officer and a
duly authorized officer of the registrant)

Table of Contents**EXHIBIT INDEX**

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | | Filed Herewith |
|----------------|---|---------------------------|-----------|---------|-------------|----------------|
| | | Form | File No. | Exhibit | Filing Date | |
| 2.1 | Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999 | 10-Q | 002-92053 | 2.1 | 4/4/00 | |
| 2.2 | Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc. | 10-Q | 002-92053 | 2.11 | 4/4/00 | |
| 2.3 | Asset Purchase Agreement by and between the Registrant and UTStarcom, Inc. dated March 4, 2003 | 8-K | 000-12867 | 10.1 | 6/9/03 | |
| 2.4 | Agreement and Plan of Merger, dated December 13, 2004, by and among the Registrant, Topaz Acquisition Corporation and TippingPoint Technologies, Inc. | 8-K | 000-12867 | 2.1 | 12/16/04 | |
| 2.5 | Securities Purchase Agreement by and among 3Com Corporation, 3Com Technologies, Huawei Technologies Co., Ltd. and Shenzen Huawei Investment & Holding Co., Ltd., dated as of October 28, 2005 | 8-K/A | 000-12867 | 2.1 | 3/30/06 | |
| 3.1 | Corrected Certificate of Merger filed to correct an error in the Certificate of Merger | 10-Q | 002-92053 | 3.4 | 10/8/99 | |
| 3.2 | Registrant's Bylaws, as amended on March 23, 2005 | 8-K | 000-12867 | 3.1 | 3/28/05 | |
| 3.3 | Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock | 10-Q | 000-12867 | 3.6 | 10/11/01 | |
| 4.1 | Third Amended and Restated Preferred Shares Rights Agreement, dated as of November 4, 2002 | 8-A/A | 000-12867 | 4.1 | 11/27/02 | |
| 10.1 | 3Com Corporation Employment Agreement, dated as of August 8, 2006 between the registrant and Edgar Masri * | 8-K | 000-12867 | 10.1 | 8/9/06 | |
| 10.2 | | | | | | X |

| | | | | | | |
|------|---|-----|-----------|----------------------|---------|---|
| | 3Com Corporation Stand Alone Stock Option Agreement dated September 5, 2006 by and between Edgar Masri and 3Com Corporation * | | | | | |
| 10.3 | Form of 3Com Corporation 2003 Stock Plan Restricted Stock Unit Grant Award Agreement* | | | | | X |
| 10.4 | Executive Officer Fiscal 2007 Compensation* | 8-K | 000-12867 | Text of Item 1.01 | 6/26/06 | |
| 10.5 | 3Com Corporation Consultant Services Agreement made as of August 8, 2006 by and between 3Com Corporation and Anik Bose | 8-K | 000-12867 | 10.1 | 8/11/06 | |
| 10.6 | Purchase and Sale Agreement made as of July 24, 2006 by and between 3Com Corporation and SSC II, L.P. | 8-K | 000-12867 | 10.1 | 7/26/06 | |
| 10.7 | Agreement for the Lease of Hangzhou Real Property between Huawei Technologies Co. Ltd. and Hangzhou Huawei-3Com | | | | | X |

Table of Contents

| Exhibit Number | Exhibit Description | Incorporated by Reference | | | | Filed Herewith |
|-----------------------|---|----------------------------------|-----------------|----------------|--------------------|-----------------------|
| | | Form | File No. | Exhibit | Filing Date | |
| 31.1 | Technology Co., Ltd. dated January 1, 2004 Certification of Principal Executive Officer | | | | | X |
| 31.2 | Certification of Principal Financial Officer | | | | | X |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | | | | | X |

* Indicates a management contract or compensatory plan