IMMERSION CORP
Form 10-Q
November 07, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 000-27969

IMMERSION CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	**94-3180138**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

801 Fox Lane, San Jose, California 95131

(Address of principal executive offices)(Zip Code)

(408) 467-1900

(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Number of shares of common stock outstanding at November 2, 2006: 24,624,580

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PART I
FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
IMMERSION CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share amounts)
(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 29,037	$ 28,171
Accounts receivable (net of allowances for doubtful accounts of: September 30, 2006, $132 and December 31, 2005, $383)	5,458	4,650
Inventories, net	2,419	2,655
Prepaid expenses and other current assets	857	1,131
Total current assets	37,771	36,607
Property and equipment, net	1,724	1,366
Intangibles and other assets, net	7,243	6,787
Total assets	$ 46,738	$ 44,760
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 1,234	$ 2,179
Accrued compensation	1,272	1,193
Other current liabilities	1,988	1,604
Deferred revenue and customer advances	2,179	2,741
Current portion of long-term debt		5
Total current liabilities	6,673	7,722
Long-term debt, less current portion	17,964	17,490
Long-term deferred revenue, less current portion	29,355	21,294
Long-term customer advance from Microsoft (Note 8)	15,000	15,000
Other long-term liabilities	34	49
Total liabilities	69,026	61,555
Contingencies (Note 16)		
Stockholders deficit:		
Common stock and additional paid-in capital $0.001 par value; 100,000,000 shares authorized; shares issued and outstanding: September 30, 2006, 24,619,956 and December 31, 2005, 24,360,427	109,207	106,277

Warrants		3,686		3,686
Accumulated other comprehensive income		83		64
Accumulated deficit		(135,264)		(126,822)
Total stockholders deficit		(22,288)		(16,795)
Total liabilities and stockholders deficit	$	46,738	$	44,760

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenues:				
Royalty and license	$ 1,336	$ 1,473	$ 4,948	$ 6,273
Product sales	4,261	3,376	11,544	9,328
Development contracts and other	962	538	2,752	1,804
Total revenues	6,559	5,387	19,244	17,405
Costs and expenses:				
Cost of product sales (exclusive of amortization of intangibles shown separately below)	1,980	1,756	5,137	4,808
Sales and marketing	3,068	2,679	9,154	8,576
Research and development	1,894	1,446	5,425	4,483
General and administrative	2,463	3,073	7,570	7,557
Amortization of intangibles	227	314	656	1,050
Litigation settlement	(300)		(1,350)	
Restructuring costs				185
Total costs and expenses	9,332	9,268	26,592	26,659
Operating loss	(2,773)	(3,881)	(7,348)	(9,254)
Interest and other income	63	131	250	373
Interest and other expense	(403)	(396)	(1,213)	(1,129)
Loss before provision for income taxes	(3,113)	(4,146)	(8,311)	(10,010)
Provision for income taxes	(44)	(12)	(131)	(110)
Net loss	$ (3,157)	$ (4,158)	$ (8,442)	$ (10,120)
Basic and diluted net loss per share	$ (0.13)	$ (0.17)	$ (0.34)	$ (0.42)
Shares used in calculating basic and diluted net loss per share	24,590	24,132	24,519	23,950

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net loss	$ (8,442)	$ (10,120)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	549	575
Amortization of intangibles	656	1,050
Stock-based compensation	2,141	2
Excess tax benefits from stock-based compensation	(19)	
Interest expense accretion on 5% Convertible Debenture (Note 6)	474	476
Fair value adjustment of Put Option and Registration Rights	(15)	(97)
Loss on disposal of equipment	2	
Write off of intangibles	35	
Changes in operating assets and liabilities:		
Accounts receivable	(802)	(89)
Inventories	299	(1,214)
Prepaid expenses and other current assets	254	416
Accounts payable	(1,279)	(2,571)
Accrued compensation and other current liabilities	477	133
Deferred revenue and customer advances	7,500	14,176
Net cash provided by operating activities	1,830	2,737
Cash flows used in investing activities:		
Intangibles and other assets	(1,126)	(768)
Purchases of property and equipment	(964)	(542)
Proceeds from the sale of property and equipment		5
Net cash used in investing activities	(2,090)	(1,305)
Cash flows from financing activities:		
Issuance of common stock under employee stock purchase plan	242	234
Exercise of stock options	528	1,291
Excess tax benefits from stock-based compensation	19	
Increase in issuance cost of 5% Convertible Debenture (Note 6)		(55)
Payments on notes payable and capital leases	(5)	(9)
Net cash provided by financing activities	784	1,461
Effect of exchange rates on cash and cash equivalents	342	252
Net increase in cash and cash equivalents	866	3,145
Cash and cash equivalents:		

Beginning of the period	28,171	25,538
End of the period	$ 29,037	$ 28,683
Supplemental disclosure of cash flow information:		
Cash paid for taxes	$ 27	$ 47
Cash paid for interest	$ 753	$ 776

See accompanying Notes to Condensed Consolidated Financial Statements.

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IMMERSION CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006
(Unaudited)

1. SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Immersion Corporation (the Company) was incorporated in 1993 in California and reincorporated in Delaware in 1999 and develops, manufactures, licenses, and supports a wide range of hardware and software technologies and products that enhance touch interaction with digital devices.

Principles of Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of Immersion Corporation and its majority-owned subsidiaries. All intercompany accounts, transactions, and balances have been eliminated in consolidation.

The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X and, therefore, do not include all information and footnotes necessary for a complete presentation of the financial position, results of operations, and cash flows, in conformity with accounting principles generally accepted in the United States of America. These condensed consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005. In the opinion of management, all adjustments consisting of only normal recurring items necessary for the fair presentation of the financial position and results of operations for the interim periods have been included.

The results of operations for the interim periods ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year.

Reclassifications

Certain reclassifications have been made to prior year balances in order to conform to the current year presentation. These reclassifications had no effect on net loss or stockholders deficit.

Revenue Recognition

The Company recognizes revenues in accordance with applicable accounting standards, including Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, Emerging Issues Task Force (EITF) Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, and the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred or service has been rendered, the fee is fixed and determinable, and collectibility is probable. The Company derives its revenues from three principal sources: royalty and license fees, product sales, and development contracts.

Royalty and license revenue The Company recognizes royalty and license revenue based on royalty reports or related information received from the licensee as well as time-based licenses of its intellectual property portfolio. Up-front payments under license agreements are deferred and recognized as revenue based on either the royalty reports received or amortized over the license period depending on the nature of the agreement. Advance payments under license agreements that also require the Company to provide future services to the licensee are deferred and recognized over the service period when vendor-specific objective evidence (VSOE) related to the value of the services does not exist.

The Company generally recognizes revenue from its licensees under one or a combination of the following models:

License revenue model	Revenue recognition
Perpetual license of intellectual property portfolio based on per unit royalties, no services contracted.	Based on royalty reports received from licensees. No further obligations to licensee exist.
Time-based license of intellectual property portfolio with up-front payments and/or annual minimum royalty requirements, no services contracted.	Based on straight-line amortization of annual minimum/up-front payment recognized over contract period or annual minimum period. No further obligations to licensee exist.
Perpetual license of intellectual property portfolio or technology license along with contract for development work.	Based on cost-to-cost percentage-of-completion accounting method over the service period. Obligation to licensee exists until development work is complete.
License of software or technology, no modification necessary, no services contracted.	Up-front revenue recognition based on SOP 97-2 criteria or EITF No. 00-21, as applicable.

Individual contracts may have characteristics that do not fall within a specific license model or may have characteristics of a combination of license models. Under those circumstances, the Company recognizes revenue in accordance with SAB No. 104, EITF No. 00-21, and SOP 97-2, as amended, to guide the accounting treatment for each individual contract. See also the discussion regarding Multiple element arrangements below. If the information received from the Company s licensees regarding royalties is incorrect or inaccurate, the Company s revenues in future periods may be adversely affected. To date, none of the information the Company has received from its licensees has caused any material adjustment to period revenues.

Product sales The Company recognizes revenues from product sales when the product is shipped, provided that collection is determined to be probable and no significant obligation remains. The Company sells the majority of its products with warranties ranging from 3 to 24 months. The Company records the estimated warranty costs during the quarter the revenue is recognized. Historically, warranty-related costs and related accruals have not been significant. The Company offers a general right of return on the MicroScribe® product line for 14 days after purchase. The Company recognizes revenue at the time of shipment of a MicroScribe digitizer and provides an accrual for potential returns based on historical experience. The Company offers no other general right of return on its products.

Development contracts and other revenue Development contracts and other revenue is comprised of professional services (consulting services and/or development contracts), customer support, and extended warranty contracts. Development contract revenues are recognized under the cost-to-cost percentage-of-completion accounting method based on physical completion of the work to be performed. Losses on contracts are recognized when determined. Revisions in estimates are reflected in the period in which the conditions become known. Customer support and extended warranty contract revenue is recognized ratably over the contractual period.

Multiple element arrangements The Company enters into revenue arrangements in which the customer purchases a combination of patent, technology, and/or software licenses, products, professional services, support, and extended warranties (multiple element arrangements). When VSOE of fair value exists for all elements, the Company allocates revenue to each element based on the relative fair value of each of the elements. The price charged when the element is sold separately generally determines the fair value or VSOE. For arrangements where VSOE of fair value exists only for the undelivered elements, the Company defers the full fair value of the undelivered elements and recognizes the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue, assuming all other criteria for revenue recognition have been met.

The Company s revenue recognition policies are significant because the Company s revenues are a key component of its results of operations. In addition, the Company s revenue recognition policies determine the timing of certain expenses, such as commissions and royalties.

Stock-based Compensation

On January 1, 2006, the Company adopted the provisions of, and accounted for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 123 revised 2004 (SFAS No. 123R), Share-Based Payment which replaced Statement of Financial Accounting Standards No. 123 (SFAS No. 123), Accounting for Stock-Based Compensation and supersedes Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees. Under the fair

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value recognition provisions of SFAS No. 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The valuation provisions of SFAS No. 123R apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS No. 123 pro forma disclosures.

With respect to its adoption of SFAS No. 123R, the Company elected the modified-prospective method, under which prior periods are not revised for comparative purposes. The adoption of SFAS No. 123R had a material impact on the Company s consolidated financial position, results of operations, and cash flows for the three months and nine months ended September 30, 2006. See Note 9 for further information regarding the Company s stock-based compensation assumptions and expenses, including pro forma disclosures as if the Company had recorded stock-based compensation expense for prior periods.

Recent Accounting Pronouncements

In June 2006, FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this interpretation is encouraged if the enterprise has not yet issued financial statements, including interim statements, in the period this interpretation is adopted. The Company is in the process of determining the impact of FIN 48 on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission (SEC) issued SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements (SAB No. 108). SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB No. 108 is effective for the Company s year ended December 31, 2006 consolidated financial statements. The Company is currently in the process of assessing the potential impact that the adoption of SAB No. 108 will have on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning January 1, 2008. The Company is currently in the process of assessing the potential impact that the adoption of SFAS No. 157 will have on its consolidated financial statements.

2. INVENTORIES

	September 30, 2006	December 31, 2005
	(In thousands)	
Raw materials and subassemblies	$ 2,142	$ 2,369
Work in process	45	55
Finished goods	232	231
Inventories, net	$ 2,419	$ 2,655

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3. PROPERTY AND EQUIPMENT

	September 30, 2006	December 31, 2005
	(In thousands)	
Computer equipment and purchased software	$ 3,046	$ 2,974
Machinery and equipment	2,827	2,235
Furniture and fixtures	1,279	1,229
Leasehold improvements	823	798
Total	7,975	7,236
Less accumulated depreciation	(6,251)	(5,870)
Property and equipment, net	$ 1,724	$ 1,366

4. INTANGIBLES AND OTHER ASSETS

	September 30, 2006	December 31, 2005
	(In thousands)	
Patents and technology	$ 12,562	$ 11,478
Other assets	105	83
Gross intangibles and other assets	12,667	11,561
Accumulated amortization of patents and technology	(5,424)	(4,774)
Intangibles and other assets, net	$ 7,243	$ 6,787

The estimated annual amortization expense for intangible assets as of September 30, 2006 is $827,000 in 2006, $879,000 in 2007, $844,000 in 2008, $743,000 in 2009, $687,000 in 2010, and $3.9 million in total for all years thereafter.

5. COMPONENTS OF OTHER CURRENT LIABILITIES AND DEFERRED REVENUE AND CUSTOMER ADVANCES

	September 30, 2006	December 31, 2005
	(In thousands)	
Accrued legal	$ 326	$ 307
Other current liabilities	1,662	1,297

Total other current liabilities	$ 1,988	$ 1,604
Deferred revenue	$ 2,140	$ 2,702
Customer advances	39	39
Total current deferred revenue and customer advances	$ 2,179	$ 2,741

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6. LONG-TERM DEBT

The components of long-term debt are as follows:

	September 30, 2006	December 31, 2005
	(In thousands)	
5% Senior Subordinated Convertible Debenture	$ 17,964	$ 17,490
Other		5
Total	17,964	17,495
Current portion		(5)
Total long-term debt	$ 17,964	$ 17,490

5% Senior Subordinated Convertible Debenture (5% Convertible Debenture) On December 23, 2004, the Company issued an aggregate principal amount of $20.0 million of 5% Convertible Debentures. The 5% Convertible Debentures will mature on December 22, 2009. The amount payable at maturity of each 5% Convertible Debenture is the initial principal plus all accrued but unpaid interest thereon, to the extent such principal amount and interest have not been converted into common shares or previously paid in cash. The Company cannot prepay the 5% Convertible Debenture except as described below in Mandatory Conversion and Mandatory Redemption of 5% Convertible Debentures at the Company s Option. Interest accrues daily on the principal amount of the 5% Convertible Debenture at a rate of 5% per year and is payable on the last day of each calendar quarter. Interest will cease to accrue on that portion of the 5% Convertible Debenture that is converted or paid, including pursuant to conversion rights or rights of redemption. The holder of a 5% Convertible Debenture has the right to convert the outstanding principal amount and accrued and unpaid interest, in whole or in part, into the Company s common shares at a price of $7.0265 per common share, the Conversion Price. In the event of a change of control, a holder may require the Company to redeem all or a portion of its 5% Convertible Debenture. This is referred to as the Put Option. The redeemed portion shall be redeemed at a price equal to the redeemed amount multiplied by (a) 105% of the principal amount of the 5% Convertible Debenture if the change of control occurs on or prior to December 23, 2006 or (b) 100% of the principal amount of the 5% Convertible Debenture if the change of control occurs after December 23, 2006. The Conversion Price will be reduced in certain instances when the Company sells, or is deemed to have sold shares of common stock at a price less than the applicable Conversion Price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for options or convertible securities. The Conversion Price will be proportionately adjusted if the Company subdivides (by stock split, stock dividend, recapitalization, or otherwise) or combines (by combination, reverse stock split, or otherwise) one or more classes of its common stock. So long as any 5% Convertible Debentures are outstanding, the Company will not, nor will the Company permit any of its subsidiaries to directly or indirectly incur or guarantee, assume or suffer to exist, any indebtedness other than permitted indebtedness under the 5% Convertible Debenture agreement. If an event of default occurs, and is continuing with respect to any of the Company s 5% Convertible Debentures, the holder may, at its option, require the Company to redeem all or a portion of the 5% Convertible Debenture.

Mandatory Conversion and Mandatory Redemption of 5% Convertible Debentures at the Company s Option If the daily volume-weighted average price of the Company s common shares is at or above 200% of the Conversion Price for at least 20 consecutive trading days and certain other conditions are met, the Company has the right to (i) require the holder of a 5% Convertible Debenture to convert the 5% Convertible Debenture in whole, including interest, into shares of the Company s common stock at a price of $7.0265 per common share, as may be adjusted under the debenture, as set forth and subject to the conditions in the 5% Convertible Debenture, or (ii) redeem the 5% Convertible Debenture. If the Company makes either of the foregoing elections with respect to any 5% Convertible Debenture, the Company must make the same election with respect to all 5% Convertible Debentures.

Warrants On December 23, 2004, in connection with the issuance of the 5% Convertible Debentures, the Company issued warrants to purchase an aggregate of 426,951 shares of its common stock at an exercise price of $7.0265. The warrants may be exercised at any time prior to 5:00 p.m. Eastern time, on December 23, 2009. Any warrants not exercised prior to such time will expire. The exercise price will be reduced in certain instances where shares of common stock are sold or deemed to be sold at a price less than the applicable exercise price, including the issuance of certain options, the issuance of convertible securities, or the change in exercise price or rate of conversion for option or convertible securities. The exercise price will be proportionately adjusted if the Company subdivides (by stock split, stock dividend, recapitalization, or otherwise) or combines (by combination, reverse stock split, or otherwise) one or more classes of its common stock.

Registration Rights On April 18, 2005, the Company s registration statement relating to the 5% Convertible Debentures, and the shares of common stock issuable upon conversion of the debentures and exercise of the warrants, was declared effective by the SEC. The Company expects to keep this registration statement effective until the earlier of

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(i) such time as all of the shares covered by the prospectus have been disposed of pursuant to and in accordance with the registration statement, or (ii) the date on which the shares may be sold pursuant to Rule 144(k) of the Securities Act.

The Company incurred approximately $1.3 million in issuance costs and other expenses in connection with the offering. This amount has been deferred and is being amortized to interest expense over the term of the 5% Convertible Debenture. Additionally, the Company evaluated the various instruments included in the agreements entered into on December 22, 2004 and allocated the relative fair values to be as follows: warrants $1.7 million, Put Option $0.1 million, Registration Rights $0.1 million, issuance costs $1.3 million, 5% Convertible Debenture $16.8 million. The 5% Convertible Debentures will be accreted to $20.0 million over their five-year life, resulting in additional interest expense. The value of the warrants has been included in Stockholders Deficit; the value of the Put Option and Registration Rights have been recorded as a liability and are subject to future value adjustments; and the value of the 5% Convertible Debentures has been recorded as long-term debt.

Annual maturities of long-term debt as of September 30, 2006 are $20.0 million in fiscal year 2009.

7. LONG-TERM DEFERRED REVENUE

At September 30, 2006, long-term deferred revenue included payments of approximately $25.3 million of compulsory license fees and interest from Sony Computer Entertainment Inc. and Sony Computer Entertainment of America Inc. (collectively, Sony Computer Entertainment), pursuant to Court orders dated January 10 and February 9, 2005. Due to the contingent nature of the court-ordered payments made by Sony Computer Entertainment, the Company will not record any revenue or interest associated with these payments as revenue or income until such time as the contingency lapses.

8. LONG-TERM CUSTOMER ADVANCE FROM MICROSOFT

On July 25, 2003, the Company contemporaneously executed a series of agreements with Microsoft Corporation (Microsoft) that (1) settled the Company s lawsuit against Microsoft, (2) granted Microsoft a worldwide royalty-free, irrevocable license to the Company s portfolio of patents (the License Agreement) in exchange for a payment of $19.9 million, (3) provided Microsoft with sublicense rights to pursue certain license arrangements directly with third parties including Sony Computer Entertainment which, if consummated, would result in payments to the Company (the Sublicense Rights), and conveyed to Microsoft the right to a payment of cash in the event of a settlement within certain parameters of the Company s patent litigation against Sony Computer Entertainment of America Inc. and Sony Computer Entertainment Inc. (the Participation Rights) in exchange for a payment of $0.1 million, (4) issued Microsoft shares of the Company s Series A Redeemable Convertible Preferred Stock (Series A Preferred Stock) for a payment of $6.0 million, and (5) granted the Company the right to sell up to $9.0 million of debentures to Microsoft under the terms and conditions established in newly authorized 7% Senior Redeemable Convertible Debentures (7% Debentures) with annual draw down rights over a 48-month period. The sublicense rights provided to Microsoft to contract directly with Sony Computer Entertainment have now expired. The Company has, to date, not sold any 7% Debentures, of which $4.0 million were available for sale at September 30, 2006.

Under these agreements, in the event of a settlement of the Sony Computer Entertainment litigation under certain terms, the Company will be required to make a cash payment to Microsoft of (i) an amount to be determined based on the settlement proceeds, and (ii) any funds received from Microsoft under the 7% Debentures.

In the event of a settlement of the Sony Computer Entertainment litigation, the Company will realize and retain net cash proceeds received from Sony Computer Entertainment only to the extent that settlement proceeds exceed the amounts due Microsoft for its Participation Rights and any outstanding 7% Debentures and interest as specified above. Under certain circumstances related to a Company initiated settlement with Sony Computer Entertainment, the Company would be obligated to pay Microsoft a minimum of $15.0 million. In the event of an unfavorable judicial resolution or a dismissal or withdrawal by the Company of the lawsuit meeting certain conditions, the Company would not be required to make any payments to Microsoft except pursuant to the payment provisions relating to any outstanding 7% Debentures.

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9. STOCK-BASED COMPENSATION

Stock Options

The Company s stock option program is a long-term retention program that is intended to attract, retain, and provide incentives for talented employees, officers and directors, and to align stockholder and employee interests. The Company considers its option programs critical to its operation and productivity; essentially all of its employees participate. Under the Company s stock option plans, the Company may grant options to purchase up to 16,338,095 shares of its common stock to employees, directors, and consultants at prices not less than the fair market value on the date of grant for incentive stock options and not less than 85% of fair market value on the date of grant for nonstatutory stock options. These options generally vest over 4 years and expire 10 years from the date of grant. At September 30, 2006, options to purchase 2,509,952 shares of common stock were available for grant and options to purchase 7,727,764 shares of common stock were outstanding.

Employee Stock Purchase Plan

The Company has an employee stock purchase plan (ESPP). Under the ESPP, eligible employees may purchase common stock through payroll deductions at a purchase price of 85% of the lower of the fair market value of the Company s stock at the beginning of the offering period or the purchase date. Participants may not purchase more than 2,000 shares in a six-month offering period or stock having a value greater than $25,000 in any calendar year as measured at the beginning of the offering period. A total of 500,000 shares of common stock are reserved for the issuance under the ESPP plus an automatic annual incr