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THE CORPORATE EXECUTIVE

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THE NEWSLETTER FOR THOSE THAT ADVISE PUBLIC COMPANIES

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Microsoft
The New ISO Proposed Regs—NQSO Alert

A Word From The Publisher

Many elements of Microsoft's recently announced stock compensation changes are not yet fully developed, and our analysis here (and thoughts and implications for others who may follow in Microsoft's footsteps) is necessarily preliminary. But, we are getting out our September-October issue a few weeks early because we think readers will appreciate having the benefit of our current thinking. We will, of course, have more to say in future issues.

We also discuss a zinger in the IRS's new Proposed ISO Regs (pgs 6-8), which were issued on June 9 and are in the public comment/hearing process. We delve into the accounting aspects of transitioning to FAS 123 before or after a repricing (pgs 8-11). Lastly, we cover some confusion relating to the taxation of stock-for-stock exercises (pg 8) and briefly highlight the results of a recent timely survey on corporate governance practices (pg 11).

It's that time of year when we remind our readers of the upcoming NASPP Annual Conference (in Orlando, October 15-18), which this year will feature not only the latest thinking on what's behind what Microsoft is doing, but will also cover trends in plan design, implementation and administration in light of current and evolving legislative and regulatory developments. A full brochure is enclosed; for more information and to register online, go to NASPP.com. There are 54 workshop and panel sessions in all (presented in nine breakouts), covering the equity compensation waterfront: accounting, tax, securities (and other related) laws, communications/education, plan design and administration. Come, learn, and enjoy the networking opportunities this renowned and well-attended Annual Conference provides.

—J.M.B.

Our Preliminary Take on Microsoft

Much has been reported (and discussed) in the press and elsewhere about Microsoft's decision to (i) begin granting restricted stock "units" (see below) in lieu of stock options, (ii) provide liquidity for outstanding underwater options, and (iii) adopt FAS 123 (retroactively). Even though the trend toward restricted stock has been covered extensively by us and others, and several companies have already taken some of these steps (*e.g.*, Amazon—see pg 10), the magnitude at Microsoft (approximately 50,000 optionees; we don't know whether directors are participating) has created the sense that a sea change may be in process.

What is Microsoft Actually Doing?

Microsoft announced the new program to its employees in early July, even though many of the details hadn't yet been determined (and still haven't), because its annual option grant cycle was nigh. In fact, Microsoft remains in discussions with the IRS (regarding taxation of the deferred portion of payment for the underwater options—see below) and the SEC.

We do know that this year, instead of stock options, Microsoft will be granting restricted stock units vesting over five years in lieu of NQSOs to all persons who normally receive options. Not so well known is that, as we understand it, Microsoft will also be offering to buy via a tender offer all outstanding stock options with a strike price of $33 or higher (the current market price has ranged around $25). The optionees will not be selling (or transferring) their underwater options to J.P. Morgan Chase, but Microsoft will be issuing new options/warrants to J.P. Morgan.

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The purchase price payable by Microsoft to employees for their underwater options will be the Black-Scholes value (as determined in accordance with Microsoft's assumptions). The purchase price for all the options (should all holders of $33-plus options elect to tender) would be approximately $750 million.

To avoid depleting its stash, Microsoft is mimicking the cashless collar scenario (*i.e.*, purchase a call option using the proceeds from selling a put) that Microsoft, Intel and other companies used extensively in the '90s to buy back their stock (see the January–February 1995 issue of *The Corporate Counsel*): Microsoft will sell *new* stock options to Morgan, and use the sale proceeds to buy the underwater options tendered by employees.

The terms of the Morgan options will be structured to produce the same aggregate Black-Scholes value as the tendered employee options. While this could be accomplished with at-market options for fewer shares, we understand that the Morgan options will mirror the number of shares and the (above market) strike prices of the tendered options, but without any vesting and with an arbitrary termination date (or dates) that will be earlier overall than the tendered options (presumably, the shorter term offsets the increase in value resulting from the Morgan options not being subject to vesting). Thus, Microsoft not only fully funds its buyout of the employee options, but also can take the position with the marketplace that it has not increased dilution (no lower-priced options) or expended cash; and that, going forward, it is decreasing dilution by switching to restricted stock. [We haven't yet heard ISS, *et al*'s views on what Microsoft is doing. They may be waiting to see the details.]

Deferred Payment to Employees. Even though Morgan will pay Microsoft in full for its options when issued, Microsoft will pay to the tendering optionees only one-third of the tender price up front, with the balance payable over two years subject to continued employment (not on the vesting schedule of the employee's tendered options). We assume that Microsoft will simply pay interest, and will not use a growth factor such as phantom stock. [We would think Microsoft will provide that an employee who is terminated without cause prior to receiving the deferred payment may nonetheless be entitled to payment.]

Microsoft's Schedule TO

As we go to press, Microsoft has not yet filed a Schedule TO with the SEC, to commence its tender offer. We assume that one of the issues Microsoft is discussing with the Staff is whether the deferred payment obligation is a "security" that must be registered under the 1933 Act on Form S-8 unless an exemption is available (*e.g.*, the Section 3(a)(9) exemption for exchange of securities—see our September-October 2000 issue at pg 5). [If registration were required, would that entail 1933 Act filing fees of $40,000 (on two-thirds of up to $750 million) on top of the Schedule TO filing fee? We would hope not, in that Microsoft will have paid a TO filing fee for the full purchase price.]

Another issue that Microsoft may be discussing with the Staff is whether Morgan is a co-tenderor, as Morgan clearly would be a tenderor if it were buying the underwater options from the employees. Microsoft apparently has not yet filed with the SEC any of its preliminary announcements made to Microsoft employees (see Rule 13e-4(c)(1)). Microsoft's accountants must also be covering with the SEC's accounting Staff the issues discussed at pg 3.

Shareholder Approval Issues

No Repricing. It appears that Microsoft won't need shareholder approval, even under revised NASD Rule 4350(i) that became effective on June 30 (see the July-August 2003 issue of *The Corporate Counsel*). We had originally surmised that Microsoft might have timed things to beat the June 30 changes. But, there is no "repricing" in this structure, in that employees are not being offered the opportunity to exchange their options for lower-priced options or for restricted stock or another security (unless the deferred payment obligation is a "security", and that exchange were deemed by the NASD to constitute a repricing). [While the NASD's final version doesn't go quite as far as the NYSE's in requiring shareholder approval for a repricing, most Nasdaq repricings will likely now require approval (unless the plan expressly permits repricing without shareholder approval). Note that the Staff may take the position that even a cash buyout of (underwater) options would trigger the S-K Item 402(i) repricing disclosures in the proxy statement, *i.e.*, where NEOs participate (as far as we

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know, Microsoft's NEOs will be eligible to sell their options—except for Messrs. Gates and Ballmer, who don't get options).]

No Transfer of Options. We understand that Microsoft's plan allows the board to expand transferability beyond family members; query, isn't there a point beyond which broad (shareholder-approved) board amendment authority would still require specific shareholder approval of a plan amendment under the new SRO rules? (See the July-August 2003 issue of *The Corporate Counsel*.)

In any event, the underwater options are not being transferred to Morgan and amended to change the term and eliminate vesting but, instead, bought back and cancelled (with Microsoft retaining the position that those shares can be returned to the stock plan reserve). The deferred payment format is one reason for Microsoft to eschew the transfer approach, in that it would be awkward to say the least if it were Morgan that owed deferred money to Microsoft's employees, especially based on continued employment.

With (partially mirrored) options/warrants being issued to Morgan, no material plan amendment (*i.e.*, requiring shareholder approval under the new rules) is necessary because there is no transfer of plan options to an investment banker. Also, there needn't be a plan amendment authorizing the *grants* to Morgan, which Microsoft likely will treat as non-plan, non-compensatory options/warrants.

We assume also that there are no other quirks in Microsoft's stock plan(s) that would require a plan amendment (such as a provision prohibiting buybacks of options). We understand that Microsoft's plan already authorizes restricted stock or units (an amendment adding restricted stock to a plan would be material, requiring shareholder approval under the new rules; just tweaking the plan to authorize restricted stock units instead of restricted stock shouldn't), but subject to a sublimit that may need to be increased by the board (and approved by the shareholders) prior to the time that the plan shares would otherwise need to have been increased. We wouldn't be surprised to see an increase in the sublimit on the agenda at Microsoft's annual meeting this fall.

Why is Microsoft Adopting FAS 123? Voila—No Charge for Buyout?

When Amazon last year announced that it would start granting restricted stock rather than options, it didn't switch to FAS 123 (see pg 10). Why is Microsoft? Our first impression was that Microsoft's decision is based on public relations and on the inevitability that FAS 123 (or something like it) is around the corner for all. We consulted our usual gurus.

Consequences Under APB No. 25. The consequences of Microsoft's program under APB 25 would not be particularly harsh. There obviously would be a charge for the new restricted stock unit program (*i.e.*, the value at grant amortized over the vesting period), but not variable and essentially the same charge as under 123; except that 123 is more favorable for performance-vesting stock, which under APB 25 would be subject to variable accounting (we understand that several hundred top managers will also be receiving performance-vesting stock). (Keep in mind that, even if Microsoft were to exchange restricted stock for options, that wouldn't trigger variable accounting under APB 25/FIN 44—see our September-October 2001 issue at pg 5.)

There would also be a charge under APB 25 for the buyout of the options (*i.e.*, up to $750 million). The proceeds from the sale of options to Morgan, while cash flow offsetting, wouldn't offset the compensation expense, because the Morgan transaction is an investment in Microsoft and, therefore, the sale proceeds are not revenue.

Enter FAS 123. As discussed beginning at pg 8, for a company under FAS 123 that has elected the retroactive transition method, the accounting charge for the exchange of new options for vested underwater options (granted after December 15, 1995) could be zero, *i.e.*, the excess (if any) of the value of the new options over the Black-Scholes value of the underwater options. Here, the "exchange" of cash for options may well invoke the same accounting treatment.

One basis for this approach is that Microsoft may be engaging in an "indirect repricing". If Microsoft were deemed to be allowing transfer of the underwater options indirectly to Morgan, that would be an amendment of the options tantamount to an exchange of new options. Looking at substance over form, Microsoft ends

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up granting new options to Morgan [illegible]. Hence, there is no (current or future) accounting charge, except for unvested options (see pg 9).

In effect, switching to FAS 123 combined with the retroactive transition method moves the buyout [illegible]

The retroactive method also would readily provide comparisons over the next few years, showing that Microsoft's switch to restricted stock/units is less costly than granting options prior to 2003. Given the materiality of the numbers for stock compensation at many companies, we think most will prefer the retroactive approach to separately explaining in the years after adopting FAS 123 (*e.g.*, in press releases and MD&A) the effect of the differences in accounting methods (*e.g.*, that charges for post-123 grants are recognized over the vesting period, while even future vesting of pre-123 grants does not involve a charge). It will be interesting to see whether the FASB ends up requiring the retroactive method when it mandates expensing stock options.

Some Income Tax Considerations

Another reason that Microsoft may have chosen not to amend the employee options to make them transferable (to Morgan) is that a freely transferable option arguably has a "readily ascertainable" fair market value under Code Section 83, resulting for tax purposes in a deemed (taxable) grant of a new option (see our September-October 2002 issue at pg 3). [illegible] the employees will trigger a deduction for Microsoft.

Had Microsoft chosen to allow the underwater options to be transferred to Morgan (or if another company structures it that way), that would result in ordinary income tax to the employees on the sale to Morgan (hopefully, with any deferred proceeds also deferred for tax purposes), with no further deduction for Microsoft on Morgan's ultimate exercise and sale of the option stock (even though, because of Morgan's "dealer" status, Morgan's gain would likely be ordinary income not capital gain).

<u>Payroll Tax Burdens.</u> With the proposed structure, Microsoft employees will be deemed to receive wages in an amount equal to the sale price of their options, subject to withholding and payroll taxes (FICA, etc. will be [illegible]). But, Microsoft is seeking confirmation that the deferred payments to employees [illegible] "deferred compensation" which is payroll-taxed when earned (see the May-June 1983 issue of *The Corporate Counsel* at pg 7). (If Microsoft's deferred payments were characterized as deferred compensation under ERISA—see the May-June 1992 issue of *The Corporate Counsel* at pg 5—that would trigger a whole set of unwanted burdens, *i.e.*, involving up to 50,000 employees.)

Morgan's Hedging Activity

As we understand it, Morgan will hedge its "long" position, *i.e.*, the purchase from Microsoft of options to buy Microsoft stock, by selling call options (or stock?) or buying put options in an equivalent amount (or engaging in more exotic derivative transactions to the same effect). While we don't purport to understand these complexities (especially here, with various above-market options), Morgan essentially will put itself in a low-risk position to profit from increases in the price of Microsoft stock.

<u>Rule 144.</u> We have long championed the idea that a broker-intermediary that sells company securities in the public market as a result of a private transaction with the company or an affiliate would be deemed an "underwriter" (requiring 1933 Act registration) absent compliance with the Rule 144 safe harbor. (See, *e.g.*, the March-April 1997 issue of *The Corporate Counsel* at pg 2.)

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While the Staff says that further Rule 144 amendments are still on its agenda (see the March-April 2003 issue of *The Corporate Counsel* at pg 8), one has to go back a few Staff generations to find much sympathy for our position. Indeed, current Corp Fin Director Beller co-authored in his former life the prepaid forward contracts no-action letter request (for Goldman Sachs), taking the no-underwriter position in a similar context. (See the January-February 2000 issue of *The Corporate Counsel* at pg 4.) Thus, we don't expect the Staff will be giving Morgan (or Microsoft) much flak about Morgan's proposed hedging activity. It should be noted, however, that the scope of Morgan's hedging underscores that this kind of program would be unavailable to many companies that do not have a highly liquid market for their securities.

Morgan's 1933 Act Registration Rights

If and when Morgan exercises its Microsoft options, it will require that a 1933 Act registration statement be in effect covering resale of the shares (presumably, Morgan would resell the shares immediately following exercise—we are assuming that the options to be granted to Morgan will be non-transferable, not exchange-traded, and in any event that the options would not be publicly transferable).

Thus, Microsoft presumably will file (and keep in effect for the life of the options) an S-3 resale registration statement. (Perhaps unused S-8 registration fees, relating to the options that are repurchased, can be reused for the S-3—see the November-December 1997 issue of *The Corporate Counsel* at pg 8.) Where the selling security holder is a broker-dealer, as here, the Staff would require that the company be primary S-3 eligible rather than the lesser eligibility requirements for a resale registration (see the July-August 1992 issue of *The Corporate Counsel* at pg 6). This is not a problem for Microsoft, but could be for others that follow.

Section 16

Microsoft's insiders will be eligible to sell their options back to Microsoft on the same basis as others. The sale of options back to the company for value is reportable as shown in Model Form 92 in Alan Dye's all new *Section 16 Forms and Filing Handbook*, except that, because the insider is receiving cash (not stock as shown in Model Form 92), column 8 of Table II of Form 4 would reflect the dollar amount received per option share. (If, instead, the options were being sold to Morgan, that disposition would be reflected in Table II, using code "S", and column 8 would show the dollars paid per option share.)

All or None

We understand Microsoft is requiring that optionees who tender any of their eligible options tender all of them, both to reduce administrative burdens and to provide a critical mass of options for Morgan.

Restricted Stock Units vs. Restricted Stock

Microsoft will be granting restricted stock units instead of actual shares of restricted stock, as part of its new grant program. As our readers may recall, restricted stock "units" are merely an agreement to issue the underlying stock on (or sometimes after—see the January-February 1989 issue of *The Corporate Counsel* at pg 8) vesting. By utilizing units, Microsoft accomplishes several purposes, including: (i) eliminating the possibility of employees making a Section 83(b) election, avoiding administrative burdens and hassle, and risks to the employee if the stock price declines (see our May-June 2001 issue at pg 2), even though the employees' ordinary income (and the company's tax deduction) increases if the stock price increases, (ii) facilitating avoiding the payment of dividends during the vesting period (no small matter given the scope of Microsoft and the length of the vesting period, especially with the new tax incentive to pay increased dividends), and (iii) addressing international tax issues (*e.g.,* in those countries that don't wait until vesting to tax restricted stock grants).

Using units rather than stock does not affect earnings per share calculations. (See our January-February 2003 issue at pg 10.) Moreover, in the S-K Item 201(d) stock plan disclosure, units are treated the same as if the stock has been issued. (See the March-April 2002 issue of *The Corporate Counsel* at pg 2.) [As mentioned above, the shares underlying the options tendered back to Microsoft may be available again for new grants (of restricted stock/units or stock options or whatever securities the plan authorizes). Thus, those shares will move from column (a) (outstanding) to column (c) (available, etc.) in the stock plan disclosure. We haven't heard anyone say that Microsoft will be amending its plan to eliminate stock option grants.

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A Thank You

We thank Robbi Fox of Hewitt Associates, Paula Todd of Towers Perrin, and Ron Mueller of Gibson Dunn & Crutcher for helping us parse through Microsoft's program. Nevertheless, we only are responsible for the educated guesses and preliminary conclusions we have reached.

Upcoming NASPP Conference

We look forward to more (and updated) analysis on Microsoft at the upcoming NASPP Annual Conference. The timing of this year's Conference is fortuitous, in that we expect the details of Microsoft's program to be known by then.

The New ISO Proposed Regs— A Further Intrusion on Evergreen Plans, and Omnibus Plans

We have discussed previously the IRS's strict shareholder approval position on evergreen ESPPs under Code Section 423. In essence, the maximum number of shares authorized under the evergreen provision must be calculable upfront at the time of shareholder approval. Thus, an annual increase based on a percentage (*e.g.*, 1%) of the outstanding shares only works if the annual adjustment is based on the number of outstanding shares on day One (or if there is an overlying maximum number for each year's increase, or overall maximum increase, so that the evergreen formula increase ends up being the *lesser of* one percent of the outstanding shares or X shares). (See our March-April 2002 issue at pg 7.)

In the evergreen *stock option* plan context, the same approach would apply for an ISO-only evergreen plan. (See our November-December 1998 issue at pg 8.) But, most plans nowadays provide for both ISOs and NQSOs (and other stock awards), and until the new Proposed Regs came out it was considered sufficient to specify in the plan an overall maximum number of shares (gross—see below) for ISO grants; this provision [illegible] evergreen omnibus plans, because of net counting (see below.)

Now, however, in Proposed Reg 1.422-2(b)(6), the Service is saying the maximum number of shares must be specified (in the shareholder-approved plan) for all stock-based awards under the plan (e.g., NQSOs, restricted stock, etc.). No one seems to know why the IRS is proposing stricter shareholder approval requirements than the SEC (which, as our readers may recall, eliminated the Rule 16b-3 shareholder approval requirement for stock plans in 1996) and even the new SRO rules.

Under this new provision, an evergreen omnibus stock plan that includes ISOs must now have an IRS-approved evergreen mechanism as discussed above (e.g., one percent of the upfront outstanding shares or the lesser of approach); whether this portends the return of ISO-only and NQSO-only plans remains to be seen. It is noteworthy that the new SRO approval rules do not require the strict IRS approach of a known maximum number; the required numerical limit can be adjusted pursuant to an approved formula (so long as the plan term does not exceed ten years).

Not Just Evergreen Plans—the End of Net Share Counting for NQSO Plans That Include ISOs?

The new IRS approach will ratchet up the importance of counting all shares issued under a plan (not just shares issued on exercise of ISOs). We have discussed previously net counting (*i.e.*, on a stock-for-stock exercise the swapped shares are deducted from the exercised shares in determining the number of shares utilized under the plan) vs. gross counting (*i.e.*, on exercise of an option for 1,000 shares by delivery of 250 shares, all 1,000 shares are deemed utilized rather than 750).

Until now, we had thought that a plan provision that spells out that net counting is okay would satisfy concerns regarding the ability to utilize net counting, even under the new SRO rules (which are silent on the subject). Indeed, we suspect that many companies take advantage of net counting where the plan is silent. (We have discussed net counting in the context of the S-K Item 201(d) stock plan disclosure—see the March-April 2002 issue of the *Corporate Counsel* at pg 3—and Form S-8—see the July-August 1994 issue of *The Corporate Counsel* at pg 3.)

Now, the new Proposed Regs provide that, for plans with ISOs, net counting (even if authorized in the plan) doesn't work due to the uncertainty of how many shares will actually be swapped back and be available for further grants. Presumably, superimposing an overall maximum, e.g., an additional 1,000,000 shares, would work; that would be a conservative disclosure approach, too, in that the additional limit is a number that

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would be disclosed to the shareholders when they approve the plan. But, it would certainly create some "overhang" confusion, and we wonder whether the additional number would appear in column (c) of the stock plan disclosure table (or just footnoted). [The re-use of shares returned to a plan because of termination of an option should not pose a problem here, in that the IRS limitation is on shares *issued*.]

SARs. SARs (and some types of phantom stock) are another form of net counting. (As pointed out in our November-December 2002 issue at pg 5, SARs may soon be making a comeback, especially stock SARs.) The (net) number of shares issued on exercise of a stock SAR would, of course, vary based on the market price of the shares at the time of exercise (as would the amount of cash payable on exercise of a cash SAR; in the old days some of us said that even cash SARs utilized shares under a plan, but cash SARs are not poised for a comeback).

Amend Existing Plans? Separate Out ISOs?

The Proposed Regs technically do not go into effect until 180 days after publication of final Regs in the Federal Register. But, most tax practitioners try to follow Proposed Regs, as they have for 19 years with the original, 1984 ISO Proposed Regs that were never finalized. [Note that the Proposed Regs in the ESPP/ISO withholding context were accompanied by a moratorium. See our November-December 2002 issue at pg 11.] The IRS says the new ISO Proposed Regs may be "relied on" for grants beginning June 9, 2003.

The Proposed Regs are silent on whether preexisting plans are grandfathered from the new requirements. Based on past practice, we think practitioners will tilt toward complying with the new provision in new plans only. However, companies may want to consider bifurcating ISOs out of their stock plan right away.

Where a plan amendment is desired, fortunately, an amendment that adds a limitation (e.g., a fixed maximum [illegible] [illegible] shares), as adding a benefit should not be considered "material" under the new SRO rules and thus would not require shareholder approval (unless the plan amendment provision does). But, that doesn't answer whether the *IRS* would require the amendment to be approved by the shareholders (as it would for a new plan).

Foreign Companies

Art Meyers of Palmer & Dodge in Boston points out that it is common in some countries (*e.g.*, the UK) for companies to have evergreen plans that adjust based on a percentage of shares outstanding from time to time during the plan term. Thus, many foreign companies will be unable to grant ISOs (to their US employees) even though they meet the corporate governance requirements of their home country.

Comment Period and Public Hearing

The deadline for submitting comments to the IRS is August 12. A public hearing is scheduled for September 2.

Transfer of ISOs to Grantor Trust OK, But Not to Former Spouse

As our readers know, ISOs are not transferable. The Proposed Regs allow transfer of an ISO to a trust established by the ISO holder so long as the holder is the sole beneficiary of the trust. The idea here is that this does not constitute a transfer. On the other hand, we were extremely disappointed that the IRS took the opportunity to specifically reject a concept that we had urged, *i.e.*, that the divorce allocation of ISOs should not be deemed a transfer (especially in community property states). (See our January-February 2003 issue at pg 3.)

Expansion of the 12-Month Deadline for Shareholder Approval—What's Going On Here?

As our readers may recall, ISO plans must be approved by the shareholders within 12 months before or after adoption of the plan. Traditionally, "adoption" in this context has been considered to be the date of board approval. Customarily, the board adopts a plan "subject to shareholder approval" within 12 months. The IRS now says that in this situation the adoption date does not occur until the shareholders approve.

Thus, if the board adopts a plan with no shareholder approval condition, the deadline for approval is 12 months from board approval. If the board adopts a plan "subject to approval within 12 months" there is a board-imposed 12-month deadline that the IRS presumably would now allow the board to extend. If the board merely adopts the plan "subject to shareholder approval", there is no deadline as far as the IRS is concerned.

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We don't really understand what the IRS is getting at here, but they may unintentionally be raising an issue whether ISOs can be granted prior to shareholder approval, even if subject to approval being obtained later.

Fortunately, the IRS has not tinkered with what constitutes shareholder approval of a plan, *i.e.*, a majority of the votes cast. (See the November-December 1997 issue of *The Corporate Counsel* at pg 5.)

Thank You

Bruce Shnider of Dorsey & Whitney in Minneapolis, who is putting the finishing touches on a comment letter to the IRS that will be posted on NASPP.com, helped us with the foregoing. More on the Proposed Regs at the upcoming NASPP Annual Conference, in the annual Advanced Tax session with Bob Misner of the IRS.

Stock-for-Stock Exercises—For NQSOs, Only the Swap is Tax-Free

Several readers have suggested the need to remind our readers that, even though the swap on a stock-for-stock NQSO exercise is tax-free, the exercise itself is not.

On the delivery of already-owned shares to pay the exercise price of an NQSO, the spread is still taxable (unless, of course, the gain deferral technique is utilized—see the January-February 1996 issue of *The Corporate Counsel*). And, where additional already-owned shares are used to pay tax withholding, that involves a sale of those shares to the company, which is taxable if the cost basis for those shares is lower than the value of the stock on the exercise date. (Where shares are withheld from an NQSO exercise to pay tax withholding, there is no taxable gain on that sale because the cost basis for NQSO shares is the FMV on the exercise date.)

<u>Forms W-2 and 1099-Misc.</u> At year end, the employee's W-2 will include (in Box 1) the NQSO [illegible]

We thank Bonnie Dema of Motorola for edifying us about Form 1099-Misc.

ISO Swap Exercise May be Tax-Free

Because exercise of an ISO does not trigger regular income tax on the spread (only potential AMT), or payroll taxes, the swap exercise of an ISO would be tax-free provided that, if shares delivered to pay the exercise price were previously acquired on exercise of an ISO, the ISO holding periods on those shares have been met (see our November-December 1996 issue at pg 7).

Avoiding Variable Accounting (and More) by Switching to FAS 123 Before or After an Immediate Option Exchange/ Repricing

Switching Before Repricing—or Repricing After FAS 123 Becomes Mandatory

A company contemplating an immediate exchange of options without a six-month wait can avoid variable, mark-to-market accounting for the replacement options by switching to FAS 123 prior to the grant of the new options, incurring (only) a fixed charge amortized over the vesting period. And, the charge could even be [illegible]

[illegible]

The rationale here is that options granted after [illegible], even though the company was accounting for the options using APB 25. [illegible] Even though there was no accounting expense for the grant under APB 25 (because the exercise price equaled the FMV) the incremental charge here is [illegible]

Moreover, even though the (Black-Scholes, [illegible] if the company structures the exchange as value-

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Unvested Options—Charge for Unamortized Expense. The incremental concept also applies to the unvested portion of the old, repriced options (paragraphs 322-24 of FAS 123 cover unvested options). But, the

Options Granted On or Before December 15, 1995. Repriced options that were granted prior to 12/16/95 are not assumed

Impact of FAS 123's Three Transition Alternatives. As our readers may recall (see our January-February 2003 issue at pg 8), FASB adopted three transition methods last December for companies that elect to adopt 123: prospective (expense only future grants under FAS 123, with current amortization of prior grants continuing to be reflected in the FAS 123 footnote), modified prospective (expense both future grants and current amortization of prior grants), and retroactive (restate prior years, too). But, since any options granted after 12/15/95 are assumed to be granted under FAS 123 anyway, we don't think the transition alternatives would have any impact in the switch-before-the-repricing scenario. It will be interesting to see whether the same transition alternatives will be available when FAS 123 (or something similar) is made mandatory.

Switching After a Repricing

The other scenario is to switch to FAS 123 down the road after repricing. Previously repriced options are treated as regranted upon adoption of FAS 123.

Here, the accounting impact depends both

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Companies that become subject to variable accounting due to a repricing should consider adopting FAS 123 using the retroactive method. But, any company considering adoption of FAS 123 to assuage repricing charges should also consider the adverse effect of 123 on other company stock plans, *e.g.*, ESPPs (see our January-February 2003 issue at pg 8).

Six-and-One Exchanges

With a six-and-one exchange (which, as our readers know, does not trigger any charge under APB 25), if the switch to FAS 123 occurs [illegible] impact (there is no repricing).

The Irreversible Earnings Charge for Underwater Options—All May Not Be Lost

[illegible]accounting). Some might now argue that FAS 123 and its transition rules go too far the other way, almost facilitating repricings (absent [illegible]).

Thank Yous

In addition to more thanks to Robbi and Paula, Susan Eichen of Mercer Human Resource Consulting also helped us with this complex subject.

What Amazon Did (and Didn't Do) After its 2001 Repricing–And Why?

In its Form 10-K for 2002, Amazon stated in its MD&A that it anticipated expensing future stock-based awards. Initially, this was taken to mean Amazon would be adopting FAS 123. In fact, it turns out that Amazon was referring to its decision to transition in the future from stock option grants to restricted stock (see Note 8 of the Notes to Consolidated Financial Statements). Amazon has not adopted FAS 123.

In Note 1 and in the MD&A, both under the caption "Stock Based Compensation", Amazon states that its January 2001 option exchange program/repricing resulted in variable accounting for stock options totaling approximately 5,000,000 shares, consisting primarily of replacement options for approximately 4,000,000 shares at $13.75 per share expiring two years after grant. (The short expiration date is designed to cut off variable accounting after two years, not a bad move considering that Amazon's stock price has risen to over $40 resulting in potential charges of more than $100 million so far.)

Our readers may recall (see our March-April 2001 issue at pg 10) that Amazon also was required to impose variable accounting for options where optionees declined replacement, in that if an offer to reprice is made and declined, the option price of those options is considered "variable" and mark-to-market accounting applies. Variable accounting for these options (approximately 1,000,000 shares) would continue until the options expire, are exercised, forfeited, or canceled (however, the variable charge on those options doesn't kick in until the stock price rises above the actual option prices, which are substantially higher than $13.75).

The variable charges Amazon is accruing have caused us to wonder why Amazon hasn't made the switch to FAS 123 (*i.e.*, after the repricing, adopting the retroactive transition method). Maybe they feel they can make the switch in the future (or wait until the switch is made mandatory) and then use the retroactive method. And, in the meantime, they will continue to back out the mark-to-market (non-cash) charges from their non-GAAP numbers. Also, the big hit ends in January of this year.

Companies that Switch to 123 to Pressure Competitors

While last year's pace of 123 adoptions has slowed considerably, we note that motivations vary for doing so. In some cases, 123 might even produce *better* accounting results (*e.g.*, performance grants, repricing, the Microsoft scenario). Or, it might increase the company's governance score.

We have also heard of situations where a company wants to put pressure on a competitor, *e.g.*, where the competitor makes more liberal use of options. Hopefully, this will all be moot before long, as the FASB is proceeding with its project addressing mandatory expensing of stock-based compensation. (See our November-December 2002 issue at pg 5.) To date, the FASB (i) has decided that employee stock-based compensation should be recognized as an expense in financial statements (based on fair value measurement), (ii) formed an Option Valuation Group to advise on several FAS 123 option valuation issues, and (iii) agreed to explore the concept of "exchange date" measurement for non-employee stock-based compensation. Go to fasb.org for more details.

A Governance Practices Survey

Buck Consultants recently surveyed the Fortune 1000 to identify current trends in corporate governance practices.

Key Committees. All of the 146 respondents have an audit committee, and nearly all have a compensation and corporate governance/nominating committee (97% and 94%, respectively), a good thing given the coming SRO governance rules (see the January-February 2003 issue of *The Corporate Counsel* at pg 6).

Committee Charters. Fifty-one percent of respondents post their audit committee charter on their website. Eighty-five percent have a compensation committee charter (which soon will be required), but fewer than half of those (43%) post the charter [illegible].

Lead Director. Only 30% of the companies have a "lead director," but executive sessions are most often conducted by the lead director ([illegible], at 50% of the companies). We expect the incidence to increase here.

[illegible] Evaluations. Board committees conduct their own performance evaluation at [illegible] of the [illegible] reporting companies (the coming [illegible] governance rules will require evaluations of the audit, compensation [illegible] (70%) do not [illegible]

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Best Compensation Ideas

George Paulin, President of Frederic Cook & Co. (and one of only three people in the past 15 years to win our Best Compensation Idea Award) has just completed (with a little input from us) a very timely piece, written exclusively for us, with his latest recommendations: *Best Compensation Ideas, Features, and Practices.*

We think so much of the piece that we decided to make it available immediately to our readers as a prompt renewal (or new subscriber) 'thank you' for those who subscribe to *both The Corporate Counsel* and *The Corporate Executive*

A Restricted Stock Caution

There is a lot of confusion out there right now (especially in the wake of Microsoft) about good and bad uses of restricted stock. George raises important cautions in his article for issuers contemplating replacing stock options with restricted stock. [Note that George points out that, unlike many companies, Microsoft does not pay high salaries and doesn't provide a retirement plan.]

A Trial Subscription for the Critical Months Ahead

Those readers who may not yet subscribe to both newsletters are encouraged to take advantage of the enclosed no risk trial so that you are not caught unprepared in those critical months ahead.

[Those few subscribers that may not currently subscribe to *The Corporate Executive*, (or *The Corporate Counsel*) may simply take advantage of the no-risk trial to qualify for the Paulin bonus article. You may always, even after one full year, cancel your trial subscription and receive a full refund. And you may still keep the bonus as our thank you for having given it a try.]

See You at The Upcoming NASPP Conference

With so much going on right now affecting executive compensation, the upcoming NASPP Conference will be essential. Those lawyers who have not yet discovered this Conference (which draws over 1,500 people, many of whom are in-house and outside counsel, should not miss this year's Conference. We will be there (both as an attendee and a presenter).

See you there next month! [For more information and to sign up, go to www.naspp.com.

—*J.M.B.*

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