Since my June column on the avalanche of stock option dating investigations and lawsuits, the toll has mounted: More than 60 companies are now the subject of SEC, Department of Justice or IRS inquiries, grand jury investigations, shareholder lawsuits or internal investigations. Given the post-option-grant stock price performance anomalies at many other companies being looked at by securities analysts and finance professors – as well as the increasing scrutiny on option practices by auditors and the looming Form 10-Q deadline for filing June 30 financials – there is every reason to believe that the carnage will continue.

As new terms like “bullet dodging” and “spring loading” join the executive comp lexicon, the investment community and the SEC have renewed their focus on the possible timing of non-backdated option grants and/or releases of material company information in order to enhance option values. While it will take years to resolve these cases (and for novel legal issues to be decided), some lessons have already emerged and are worthy of consideration by companies and Compensation Committees.

**Don't backdate option grants.** Companies shouldn't date an option grant as of a date before the actual grant date. If the value of the stock is lower on the retroactive effective date, the option is a discounted option and creates all of the problems discussed in last month’s column. If the value is higher, it can create confusion. In most cases, simply adjusting the vesting schedule of a contemporaneously granted option accomplishes the objectives of making a retroactive grant (except providing a discount) much more cleanly.

**Don't grant discounted options.** Many plans require that options have an exercise price that is at least equal to the fair market value of the stock on the date of grant, and Code Section 409A imposes punitive income taxes on optionees who receive discounted options unless the options satisfy all of the requirements of Section 409A. Absent extraordinary circumstances and careful planning, discounted options should be taboo.

**It’s safest to grant options at meetings.** While most plans permit option committees to grant options either at a meeting or without holding a meeting, by acting by unanimous written consent, the former is far safer. This is because, under some state laws, a consent may not be deemed effective until the last member has signed and it has been delivered to the company. This could cause misdating and discounted option problems if the stock appreciates between the purported effective date and the date the fully executed consent is returned to the company.

**Regularize option grants.** The current option imbroglio has demonstrated that granting options can be risky business. It should be done deliberately and carefully, and preferably on a regular pre-determined basis in order to minimize risk. Out-of-cycle grants should be minimized and made only after full documentation is prepared and full consideration is given to market timing issues and legal risks. New-hire grants are best bundled and awarded on a regularly scheduled basis.

**Be careful with grant delegations.** While most applicable state laws and plans permit Boards and their committees to delegate the granting of options...
to other Board members, company officers and other employees, care should be taken to ensure that the delegations comply with state law and plan provisions and aren’t used haphazardly. State laws and plans often limit the persons to whom delegations can be made and require limits on the delegated authority. Violations of these rules can create “ultra vires” grant problems, where officers act outside the powers granted to them by law or plan documents. Further, any recipient should understand all of the legal and regulatory requirements applicable to option grants and the consequences of violations.

**Pay attention to the paperwork.** Option grants should be contemporaneously and carefully documented by minutes or written actions by the granting committee or designated officer. At a minimum, the minutes or action should name the optionees and state the number of shares subject to each option and its exercise price.

**Consider D&O insurance issues.** Director and officer liability insurance policies are full of exclusions, exceptions, conditions and limitations, so companies and Boards shouldn’t assume that insurance carriers will cover the costs of option timing investigations, lawsuits and damages. Companies with possible exposure should consider putting their carriers on notice, especially if their policies are about to expire or are being renewed. You can read more about this in a Latham & Watkins Client Alert on D&O issues on our website (www.lw.com).

**Review option grant practices and internal controls.** All of the above lessons make it imperative that every public company review its option grant practices and internal controls to address any prior issues and minimize the risk of future problems. And lastly, for a detailed analysis of all of the legal and regulatory considerations, companies and Compensation Committees should consult with their executive compensation attorneys.

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