EXECUTIVE PAY

Options in the Mirror, Bigger Than They Seem

By PATRICK McGEEHAN

WHEN **Lehman Brothers** told its shareholders in early 2001 how much it had paid its chief executive, Richard S. Fuld Jr., the numbers surely shocked some of them. The total package in 2000 was worth $28.3 million, a 68 percent increase over what he had received in the previous year and more than what some of his peers at other big Wall Street firms, like **Goldman Sachs** and **Morgan Stanley,** had received.

But only $9.5 million of Mr. Fuld's pay was delivered in cash that year. The rest was in options and restricted shares of Lehman stock, whose value the company's executives could only estimate.

Their best guess, it turned out, was not even close. In the end, it was off by more than $65 million.

When Mr. Fuld finished cashing in those restricted shares and options last year, his final take for 2000 turned out to be about $95 million, according to an analysis of the company's filings with the Securities and Exchange Commission. Much of that difference resulted from the extraordinary performance of Lehman's stock over the last several years. But a significant piece of it could be attributed to Lehman's consistent undervaluation of the stock awards it gives to its senior executives.

As Lehman's filings on Mr. Fuld's compensation illustrate, most companies do not directly tell their shareholders how much they actually paid their chief executives; they simply give the investors one rear-view measure of how much they had intended to pay out.

Brian Foley, a compensation consultant in White Plains, described Lehman's approach to estimating the value of its options awards as "sort of a persistent lowballing." He said Lehman, like other financial companies, uses its discretion to make assumptions about whether and when the options will be exercised that reduce estimated value.

Hannah Burns, a spokeswoman for Lehman, said that the gains realized "on the options granted in 2000 and 2001 are the result of the extraordinary performance of the firm and its stock price over this period, which has benefited all of our shareholders."

She added that "the value ascribed to these options at the time they were granted represents the appropriate market value in line with industry accepted valuation methodologies and, in fact, reflects the way these types of instruments would trade in the marketplace."

Daniel Acker/Bloomberg News

Richard Fuld, the chairman and chief executive of Lehman Brothers, was granted options that grew markedly in value during 2000.

In the case of Mr. Fuld's pay for 2000, by the time it was disclosed in the company's proxy statement in February 2001, it was worth far more than advertised. A year earlier, Mr. Fuld received 800,000 options to buy Lehman shares for $31.63 each. That was the closing price of the stock on the day the shares were granted, Feb. 18, 2000, and it was the lowest closing price for the stock in almost four months.

The options would expire in five years but Mr. Fuld could not exercise them for four and a half years, with one big caveat: He could exercise the options much sooner if Lehman's stock rose quickly, which it did. In less than six months, the stock price doubled and Mr. Fuld was free to exercise all 800,000 of his options, which were worth about $27 million by mid-August 2000.

Still, in the proxy statement it published six months later, Lehman ascribed a value of just $5.2 million to them. To arrive at that estimate, the company reduced their estimated value by 10 percent a year to account for the possibility that Mr. Fuld might quit or be fired before he could collect on them.

At that point, Mr. Fuld had been Lehman's chief executive for seven years but was only 54 years old.

"I would have thought the chances of the big guy leaving were between slim and none," Mr. Foley said. "So I would apply a forfeiture discount of zero," instead of the 10 percent discount Lehman has traditionally used, he said.

And, of course, there was no chance that Mr. Fuld would leave without exercising all 800,000 of the fully vested options, which by then were worth $34.5 million. But in its 2001 proxy, Lehman did not explain that the true value of the options had soared in the previous year.

The estimated value of stock options can miss by a mile.

Although many big companies do not discount option values, Lehman is not alone in doing so. Goldman Sachs applied a 40 percent discount to the estimated value of the 10-year options it gave to its executives last year. **Bristol-Myers Squibb** used a forfeiture discount of 3 percent a year.

Another assumption that Lehman made in valuing Mr. Fuld's pay in 2000 was that he would exercise the options two and a half years after receiving them. But Mr. Fuld had a history of holding onto his options until they were about to expire. Indeed, all 2.6 million options that Mr. Fuld has exercised since November 2003 were in the last year of their life when he did so. He kept some options that he had been granted in 1994 for their full 10 years, eventually reaping a pretax gain of more than $65 on each one.

If the company had assumed that he would hold the options for four or five years, their estimated value would have been higher. That is true because the longer an option's life, the greater the chance that the underlying stock price will rise.

Early last year, Mr. Fuld exercised his options from 2000 as their expiration date neared. He bought the 800,000 shares for $31.63 each and sold them for a pretax profit of about $50 million, according to company filings. At the end of last year, Mr. Fuld collected the rest of his pay from 2000 by converting 273,854 restricted stock units. Those units, which Lehman valued at $13.6 million when it granted them, became 273,854 shares of Lehman stock, worth $34.5 million.

Lehman's latest proxy statement shows that it has not really changed its ways. In fiscal 2005, which ended in November, it gave Mr. Fuld options to buy 450,000 shares of stock for $85.80 each. The company said it applied two discounts that together reduced the estimated value of the options by 29 percent, to $5 million. But Lehman's stock has been on a tear since then and is up to $151. Mr. Fuld will not be free to exercise his latest batch of options until Nov. 30, but if the stock rises no more until then, they will be worth more than $29 million.

Not that Mr. Fuld, 59, would be in any hurry to cash them in. The proxy shows that he has claims on 4.47 million shares of Lehman, which would be worth about $675 million. □

Pay for Performance? Sometimes, but Not Always

At many companies, changes in chief executives' pay roughly corresponded with changes in their shareholders' total return last year. Several exceptions were in favor of shareholders, but most of the outliers favored C.E.O.'s.

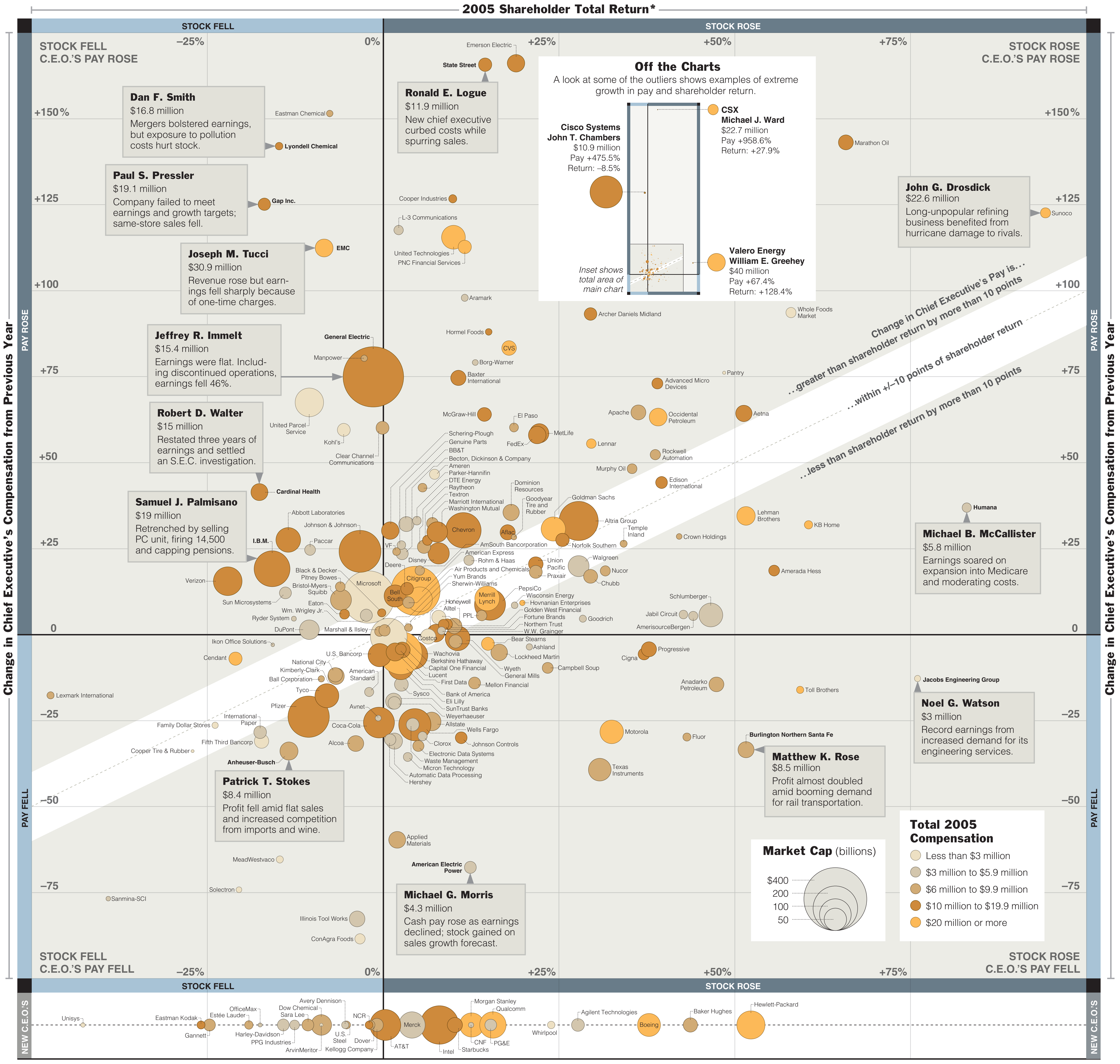
How to read the chart

The chart shows how chief executive pay changed against the shareholder return

SHAREHOLDER RETURN

CHANGE IN PAY

Stock fell, Pay rose	Stock rose, Pay rose
Stock fell, Pay fell	Stock rose, Pay fell



Source: Pearl Meyer & Partners

*For the company's fiscal year

Tommy McCall for The New York Times