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Maestro: Director Valerie Jarrett Orchestrates Key Comp Plan

Jarrett led USG comp committee's push for management's post bankruptcy pay pack

By Karen Murray

“We’ve had the most frank and candid discussions at USG but never a rude moment,” says Valerie Jarrett. As chair of USG Corporation’s compensation and organization committee, Jarrett led the effort to redesign executive pay after the company emerged from bankruptcy.

“Valerie did a terrific job of leading the board and management through the process,” says fellow USG compen-

sation committee member Judy Spriser. “She did it with incredible finesse. She has an ability to accomplish things without breaking any china.”

USG, maker of No. 1 wallboard brand Sheetrock, spent five years in Chapter 11 because of asbestos-related litigation. Faced with mounting personal-injury claims, the company filed for bankruptcy protection in June of 2001. The filing created considerable

uncertainty about the company’s future. This meant that the usual long-term compensation incentives, such as options and restricted stock, no longer made sense. Instead, the board approved a key employee retention plan that awarded cash bonuses for achieving performance goals.

“We tried to pretend we were not

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in bankruptcy,” says Jarrett, smiling. The company focused on earnings. “We had to generate the cash to pay off the asbestos liability,” she continues. “But we continued to invest in our facilities.” By all accounts, the cash incentives worked. Revenues reached \$5.8 billion in 2006, up from \$3.8 billion in 2000, the year before the bankruptcy filing. And the company’s stock, which hit a low of \$2.80 in 2001, topped \$99 in early 2006. In June 2006, USG emerged from bankruptcy, paying off all its obligations while keeping existing shareholders’ stakes intact.

“We came out with a strong balance sheet,” says Bill Foote, chairman and CEO of USG. “Current shareholders retained all of their interest in the company. That’s quite atypical in a bankruptcy. Usually the old shareholders get wiped out.” This success brought praise from famed investor — and USG shareholder — Warren Buffett, who had bought a 15% stake in USG in December of 2000. “It’s the most successful managerial performance in bankruptcy that I’ve ever seen,” Buffett told the *Wall Street Journal*. The shares he had purchased grew more than five times in those five years.

Seeing the light at the end of the tunnel, Jarrett and the compensation committee had begun to work on a new compensation plan almost a year before the bankruptcy ended. They knew that they would have to add equity components to the executives’ pay and incentives. But how to do that? And how much should the executives earn? “Everyone said, ‘We’ve accomplished a Herculean task,’” says Jarrett. “The committee had to decide what fair and reasonable compensation was for that achievement.” The job wasn’t made any easier “when you had Warren Buffett saying you walk on water,” she says with a grin.

“We wanted to reward management but without giving away the store,” agrees Sprieser. Now that equity was a

realistic component of compensation, a plan had to be devised that would make the executives want to stay at USG and further the company’s growth. Yet the board wanted to adhere to the standards of compensation and governance that had developed in the past five years. The committee decided to hire its own com-

rett for managing the process and the personalities. “Bringing disparate views together was her strength,” he notes. Jarrett’s style was evident from her first meeting as compensation committee chair. “I told them, ‘I want everyone to feel that this is a safe place to be as candid as you can be.’ I’ve learned the importance of communi-

DIRECTOR’S SNAPSHOT

Born: November 14, 1956, Shiraz, Iran

Education: AB, Stanford University; JD, University of Michigan

Career Highlights: Federal Court Appointed Receiver for the Chicago Housing Authority; Commissioner of Planning and Development for the City of Chicago in the administration of Richard M. Daley; Chairman of the Board of CHX Holdings; Chairman, Chicago Stock Exchange

Hometown: Chicago, Ill.

Family: One daughter, Laura (21)

Most Memorable Summer Job: Clinic Coordinator at the University of Chicago Medical Center

Most Recent Book Read: *Dreams from My Father* by Barack Obama (second time)

Favorite Composer: Mozart



Jarrett and Barack Obama at political event

Favorite Charity: University of Chicago Medical Center

Something Most People Would Be Surprised to Know About Me: “I am very shy.”

Won’t Leave Home Without: Blackberry

Most Recent Vacation: Anguilla with Laura

Current Public Company Boards: USG Corporation, Inc.; Navigant Consulting, Inc.

penetration advisor, separate from the advisor that management was using. They tapped Watson Wyatt’s Andy Goldstein. While the committee’s normal schedule calls for four meetings per year, the USG committee met 13 times in the year leading up to the new plan taking effect.

Jarrett’s task wasn’t easy. “There were all kinds of different opinions,” she acknowledges. Fellow director and compensation committee member Dave Fox credits Jar-

rett for managing the process and the personalities. “If someone feels uncomfortable, I want them to speak up,” she says.

“The committee viewed it as a clean sheet of paper, a once-in-a-lifetime opportunity to look at employment agreements, cash compensation, equity compensation and retirement plans,” says Goldstein. He credits Jarrett’s methodical process for keeping things on track.

The committee prepared a calendar of the different issues, and tackled one or

two at each meeting. “We never, ever introduced a subject and voted in the same meeting,” says Jarrett. “We always asked, ‘What are we trying to accomplish?’ We would discuss policy before details.”

In the first meeting, a topic would be introduced and the committee would decide what information it needed. In the second meeting, the information would be presented to the board for discussion. In the third meeting, the committee would vote. “By starting the process well in advance, it gave people time to stop and think,” Jarrett explains. “If you move too fast, people get locked into their views.”

In order to quickly align management’s interest with the shareholders’, the committee moved to make significant initial option grants to the executives. Management had lacked an equity stake in USG for five years, and that had to be remedied. But even that generated debate, says Sprieser. “Do you award equity at the current recovering stock price? Do you award it retroactively? Neither one was philosophically right or wrong,” she adds. In the end, the board approved an initial option grant in August 2006 at the current stock price.

USG’s executive officers received non-qualified option grants that vest at a rate of 20% per year and restricted-stock units that vest at 25% per year. “During bankruptcy, management had the certainty of cash. Options they owned could have been underwater. On the other hand, with a cash plan, they missed out on appreciation,” Jarrett explains. Another option grant was made in March 2007 as part of the new long-term incentive plan, which also included grants of restricted-stock units and performance shares.

Fox adds, “We were trying to establish competitive compensation, but to have the shareholders look at it and say, ‘This is fair. They’ve delivered value for the shareholders.’”

Having two consultants — one for management and one for the com-

mittee — was somewhat unusual and had the possibility of adding tension to the discussions. “Someone coined the phrase that we didn’t want to have ‘dueling consultants,’” Fox says. Jarrett concedes that “initially there was some nervousness among management, but within two meetings, that evaporated.” She made sure not to ask Goldstein and management’s advisor to do the same tasks. “We weren’t duplicating efforts. Both consultants worked hard to not play the ‘I gotcha’ game.”

When it came to designing long-term incentives, the committee knew that governance trends were pointing

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Judy Sprieser, fellow USG director and USG compensation committee member

to performance shares as the most effective tool. These are restricted shares of stock that executives earn only if certain company goals are met. “We wanted to put them in place,” says Sprieser. “Our consultant advised it. Directors on other compensation committees were using it.” But USG’s management had no experience with performance shares.

“There was philosophical agreement on performance shares. Where it got difficult was in figuring out performance measures,” relates Jarrett. “We wanted to appropriately align management interest with shareholders’.” That isn’t easy in a cyclical industry such as building materials. “Our management is working just as hard today, but the price of wallboard has dropped,” Jarrett adds. Today, approximately 70% of USG executives’ pay is variable, based on earnings levels, growth, stock price and operating objectives.

Another issue arose when the committee decided to give special cash awards to Foote and his two top lieutenants, CFO Rick Fleming and general

counsel Stan Ferguson, for their leadership during the Chapter 11 proceedings. Foote was given \$1 million, and Fleming and Ferguson each earned \$500,000. “They all did both jobs — restructuring and running the business,” explains Jarrett. The board felt they deserved to be rewarded. But “we knew that this was going to be in our disclosure documents. We asked ourselves, ‘Can it stand up to the shareholders reading it?’” The plan was detailed in the March 2007 proxy and did not generate any controversy among shareholders.

Ultimately, Jarrett and her committee finalized the plan, which took effect

after USG emerged from bankruptcy a year ago. “I think we struck the right balance,” she says. The company retained the talented key employees who helped it succeed. The executives have appropriate incentives to maximize shareholder value. And the shareholders gave the plan a strong vote of confidence.

Goldstein credits her extensive background in politics as making Jarrett so effective. Jarrett is a dyed-in-the-wool Chicagoan, having served as the commissioner of Planning and Development for the city of Chicago under Richard M. Daley and as federal court-appointed receiver for the Chicago Housing Authority. Currently she is on the committee seeking to bring the 2016 Olympics to Chicago “She is a consensus builder,” Goldstein says. “She knows when to seek input and knows how to bring things to closure.” ■

Valerie Jarrett will speak about “Compensation: How to Attract the Best and Avoid Becoming a Target” at ODX Chicago on October 24, 2007. Please call Ajay Bhambri at (212) 542.1229 to attend.