Kmart files for Chapter 11

Move paves way for possible store closings and layoffs

By Becky Yerak
The Detroit News

TROY -- Kmart Corp. today declared bankruptcy, seeking court protection to guide the Troy-based discount store chain through a massive restructuring plan, which could include the closure of hundreds of stores and thousands of layoffs this year at its stores and corporate headquarters.

Kmart's bankruptcy may be the largest in retail history, topping Federated Department Stores, which filed in 1990.

All of Kmart's 2,114 stores are open for business during its Chapter 11 reorganization, officials said. The company's employees will be paid and their benefits are expected to continue as usual.

Kmart's board of directors, which met for two days last week, held an emergency meeting Monday night to hammer out the details, sources say.

Kmart received $2 billion in debtor-in-possession financing from four lenders, which will allow the company to fund its turnaround. Kmart will remain in control of its day-to-day operations.

In its filings in the U.S. Bankruptcy Court in Chicago, the retailer listed total assets of $17 billion and total liabilities of $11.3 billion as of Oct. 31.

Officials said Kmart is committed to reorganize "on a fast-track basis and has targeted emergence from Chapter 11 in 2003."

"We are determined to complete our reorganization as quickly and smoothly as possible, while taking full advantage of this chance to make a fresh start and reposition Kmart for the future," said Kmart Chief Executive Officer Chuck C. Conaway.

"I also regret the impact of our filing on all Kmart shareholders, including many of our associates," Conaway said. "But after considering a wide range of alternatives, it became clear that this course of action was the only way to truly resolve the company's most challenging problems."

Kmart announced it had appointed Ronald B. Hutchison as executive vice president and chief restructuring officer to supervise the bankruptcy process. Hutchison, 51, was most recently chief financial officer of Advantica Restaurant Group Inc., where Kmart's new chairman, James B. Adamson, formerly served as chairman and CEO.

The filing marks the darkest period in the century-old retailer's history, which began with Sebastian Spering Kresge's first five-and-ten cent store in downtown Detroit. The S.S. Kresge Co. opened its first Kmart in 1962 in Garden City.

The chain of discount stores became so popular that the company's name was changed to Kmart Corp. in 1977. For the next two decades, Kmart was a retailing phenomenon, creating such American icons as the Blue Light Special, a limited-time sale on everything from black socks to floor lamps.

But fierce competition from Sam Walton's Wal-Mart stores, a declining store base and poor public image caught up with Kmart during the 1990s, sparking a series of turnaround strategies that never quite clicked with consumers.

The latest effort by Chief Executive Officer Chuck C. Conaway, a Lapeer native and former president of CVS Corp., seemed to show potential when he joined Kmart in May 2000. The 42-year-old Conaway brought new life to Kmart when he promised to "fix the business" within two years.

Conaway's plans began to crumble last fall as Kmart's sales started to decline. Without enough money to operate the business, Kmart turned to its $1.5 billion line of credit for help, but that source held off hungry suppliers for only so long.

Kmart's top groceries supplier on Monday stopped shipping goods to the troubled retailer because it failed to make a $78 million payment.

Observers say the move by Fleming Cos., a food wholesaler that gets more than 20 percent of its revenues from Kmart, was the final blow to Kmart, has been caught in a financial downdraft since announcing disappointing holiday sales.

And more bad news came with another debt downgrade from Moody's Investor Service. The credit rating agency said that a "lack of clarity" about its liquidity position and business plan for 2002 prompted it to lower Kmart's debt ratings deeper into "junk" territory. The downgrade could increase Kmart's borrowing cost.

"Kmart's options are narrowing and its prospects of being able to secure financing outside of bankruptcy are diminishing," Moody's analysts said in a statement.

Industry analysts feared that the defection of Fleming, Kmart's sole groceries dis-

tributor, would have a snowballing effect and prompt more suppliers to stop shipments as well.

"Failure to have groceries in the store is just not acceptable," said Kurt Barnard of Barnard's Retail Trend Report in Upper Montclair, N.J. "It brings Kmart to the point where there aren't many options left."

The situation deteriorated as Kmart remained silent on its plans except to say it is attempting to renegotiate its current $1.5 billion debt and obtain more capital to pay for its ongoing restructuring.

Kmart shares have lost two-thirds of their value since the beginning of the year. The stock closed at $1.74 Friday, up 18 cents. Financial markets were closed Monday in observance of Martin Luther King Day.

In early trading on Tuesday, Kmart's shares slumped to 66 cents on the Instinet electronic brokerage system; it had traded as low as 61 cents.

Analysts believe the company needs to close 250 or more of its poorer-performing stores, lay off thousands of its 250,000 workers and invest more heavily in superstores to compete with rivals Wal-Mart and Target.

Last week, the company announced a management shake-up. It named outside director Adamson to replace Conaway as chairman. Conaway will remain as chief executive officer. In addition, Michael Schwartz, a Conaway hire, was dismissed as president and chief operating officer.

Quick plan needed

The adverse developments intensify pressure on Kmart to quickly choose among its narrowing options and make public a new turnaround plan.

"On very fast order, Kmart must have a strong injection of confidence into its vendors because if vendors lose confidence, then Kmart will be left without merchandise," Barnard said Monday.

Kmart on Monday tried to put the best face on the new developments as it scrambled to come up with a new business plan to buy itself time with lenders and suppliers.

"We look forward to resuming our critical business relationship with Fleming once we work through these financial issues and are able to provide Fleming with adequate assurance of payment," Conaway said in a statement.

The move by Fleming, one of the nation's largest grocery distributors, was a significant setback. Just last week, the company issued a statement in support of Kmart. But Neal Rider, executive vice-president of Fleming, said the company had to act to protect its interests.

Rider said that "Fleming is working with Kmart as they navigate through their current financial problems, and we intend to resume delivery of food and other consumable products to Kmart upon receiving satisfactory assurance of Kmart's performance."

By some analysts' estimates, Kmart needed to boost its borrowing capacity from $1.5 billion to $3 billion to fund continuing operations. Adamson, who is serving as non-executive chairman and adviser to Conaway, is reputed to be an expert at arranging turnaround financing -- as well as bankruptcy protection.

But Kmart's continued refusal to publicly discuss its recovery options has exacerbated a downward spiral that began earlier this month with a negative report and bankruptcy speculation by Prudential Securities.

Shipments slow

On Monday, a random check indicated that some Metro Detroit Kmart stores appear to be running low on staples like milk, butter, bottled water and juice.

Tina Weidner was out of luck when she stopped at the Super Kmart store on Gratiot and 10" Mile in Roseville to purchase Dreft laundry detergent.

"They are out of a lot of stuff -- it's a mess in there," said the Warren resident, while loading 2-year-old daughter Taylor into their SUV. "I wound up buying an off brand.

Fleming said only perishables already en route to Kmart stores will find their way onto the shelves. The rest of the merchandise in transit will be retained by Fleming until payment arrangements are resolved.

Scotts Co., a lawn and garden products supplier that gets about 10 percent of its revenues from Kmart, also has delayed shipments to the retailer, but said only 3 percent of Scotts' annual shipments to Kmart occur in January anyway.

Some factoring companies, which provide short-term financing for suppliers, have stopped extending new insurance for orders related to Kmart.

"We are not approving orders for Kmart" until the situation is clearer, Adam Winters, senior vice-president of Merchant Factors Corp., told Bloomberg News. "I'm advising my clients to hold off. The situation will resolve itself soon."

Other major suppliers, however, aren't yet ready to jump ship. Procter & Gamble spokesman Damon Jones said Monday that P&G is "receiving payments from Kmart and is still shipping products to Kmart." Martha Stewart, whose brand of housewares is sold exclusively in Kmart stores, also has expressed support for the company.

Detroit News Staff Writers Jennifer Chambers, Santiago Esparza and Joel Smith contributed to this report. You can reach Becky Yerak at (313)222-2760 or byerak@detnews.com.

For more information

Kmart Corp., which filed for Chapter 11 bankruptcy protection today, will have more information available on its situation at the following toll-free numbers:

- Employees: (877) 638-8856
- Customers: (877) 475-6278
- Vendors and suppliers: (877) 453-5693

Source: Kmart Corp.

About Kmart

Facts about discount retailer Kmart Corp., which on Tuesday filed for Chapter 11 bankruptcy protection:

- Headquarters: Troy, Mich.
- Employees: About 275,000.
- Stores: More than 2,100 in all 50 states, Puerto Rico, U.S. Virgin Islands, Guam.
- Financial: Lost $224 million during third quarter ended Oct. 31, 2001. Fiscal year ended Jan. 2.
- CEO: Chuck Conaway
- Chairman: James B. Adamson

Kmart loses $2.4 billion

Feds conduct criminal investigation into financial practices

By Karen Talaski,
The Detroit News

TROY -- Kmart Corp. reported a record loss of $2.42 billion for 2001--10 times its loss for 2000--and acknowledged it is the subject of a federal criminal investigation of its financial practices.

Experts said the results, which contributed to Kmart's bankruptcy filing Jan. 22, amount to a grim lesson for the discount retailing chain on the dangers of aggressive accounting. Concerns about accounting practices at Kmart are part of a crisis of confidence affecting American business in the wake of the Enron Corp. collapse.

The Troy-based company said it is cooperating with the U.S. Attorney's Office for the Eastern District of Michigan in an investigation that began earlier this year. Jack Ferry, a Kmart spokesman, called it an ongoing review of the company.

Kmart losses

Kmart Corp.'s loss for the 2001 fiscal year ended Jan. 30 increased 10-fold over the previous year's loss:

	FISCAL YEAR, IN MILLIONS 2000	2001
1st quarter	$22	-$233
2nd quarter	-$448	-$377
3rd quarter	-$67	-$235
4th quarter	$249	-$1,573
Net loss	**-$244**	**-$2,418**

Source: Kmart Corp.

Neither Ferry nor the U.S. Attorney's office would discuss the matter in detail. The Securities and Exchange Commission also has been conducting an inquiry.

"I can acknowledge that the FBI is looking at this situation with Kmart to determine if there are any criminal violations for potential prosecution," said FBI spokewoman Dawn Clenney. "There is a significant amount of work to do. There are a lot of documents to review."

She declined to say whether any subpoenas had been served on Kmart or what specific aspect of Kmart's finances were the subject of the probe.

Kmart itself is in the midst of a so-called stewardship review of its management, severance agreements and retention loans.

The company said it expects both its accounting investigation and the stewardship review to be completed by September.

Loans reviewed

Part of the stewardship review focuses on Kmart's decision to grant $28.8 million in loans to 26 of its top executives, including a $5 million loan to former Chairman Charles C. Conaway. The vast bulk of the loans were made in November and December as an incentive to executives to remain with Kmart through its financial troubles.

Since then, 18 of the executives have left the company, either through voluntary resignations or terminations.

Kmart attributed much of its loss for the fiscal year to the failure of its BlueLight Always program -- which lowered prices on 30,000 items in an effort to compete with rival Wal-Mart Stores Inc. Kmart also slashed its advertising budget, a measure meant to offset additional expenses for higher utility rates and employee compensation.

"It killed gross margin in the fourth quarter," said Kmart Chief Financial Officer Al Koch. "What happened was we lowered prices, but we also had less traffic. It was operationally a catastrophic move."

Of the 2001 loss, $1.43 billion came from discontinued operations and special charges related to its restructuring and damage to its business.

The retailer's earnings report also included a restatement of its fiscal 2001 quarterly financial data, the

result of an accounting review that included the SEC and the company's accountants, PricewaterhouseCoopers LLC. The restatement showed that Kmart had significantly underreported the size of the losses it was incurring last year.

Kmart had assumed it would receive significant "vendor allowances," or payments from its suppliers for better shelf space and the like. Koch said the company anticipated $2 billion in allowances but experienced a shortfall of $450 million.

"Our ability to collect vendor allowances basically presupposes you are paying your vendors," Koch said. "But the (bankruptcy) law prohibits that. So our ability to collect these allowances just evaporated."

Kmart estimates its vendor allowances based on discussions with vendors and the company's own historic data, Koch said. Because most of Kmart's business takes place around the holidays, most of those agreements were not put to paper until the fourth quarter or shortly after the end of the year, Koch said.

The company's new management determined it should change this practice during the fourth quarter. That requires the company to go back and restate its entire year, Koch explained.

"We changed from an acceptable accounting method to one that is preferable," Koch said.

Koch said Kmart will no longer include vendor allowances in its financial statements until it formally agrees upon terms with a supplier and fulfills its performance obligations.

Record bankruptcy

Kmart's filing for protection from creditor lawsuits under Chapter 11 of the U.S. Bankruptcy law made it the largest retail bankruptcy in history.

The company was supposed to file its annual earnings report April 30, but it received a one-time extention from the SEC.

For the 52-week year ended Jan. 30, Kmart's net sales dropped to $36.15 billion from $37.03 billion for the 53-week period ended Jan. 31, 2001, a decrease of 2.4 percent. The company's loss for the most-recent fiscal year amounted to $4.89 a share for the year. In the prior year, the company had a loss of $244 million, or 48 cents.

Kmart's same-store sales declined 0.1 percent from the previous year. Same-stores sales are considered the best judge of a retailer's strength because they don't include new locations or stores that are closing. Wal-Mart reported a same-store sales increase of 5 percent for 2001.

Eugene (Tripp) Bosart III, senior managing director of McDonald Investments in Birmingham, described Kmart's same-store sales decline as "a death spiral."

Koch acknowledged that same-stores sales are important, but his main priority is Kmart's gross margin, or how much the company makes from the items it sells. Last year, Kmart's gross margin was a disappointing 17.4 percent compared to a healthier 20.9 percent in 2000.

"At the end of the day, what a retailer sells is important. But you need to sell it at margin or you're kidding yourself," Koch said.

Reporters Joel J. Smith and David Shepardson contributed to this report. You can reach Karen Talaski at (313) 222-2319 or at ktalaski@detnews.com

Kmart investigates its former executives

Severance pay suspended for key players while board examines their stewardship

By Hawke Fracassa
and Karen Talaski
The Detroit News

TROY -- Kmart Corp. directors have suspended severance payments to an undisclosed number of former senior executives while they review how the previous management team ran the company, spokesman Jack Ferry said Thursday night.

Ferry would not say how much money was involved, how many former executives are getting their deals changed or why Kmart froze action on agreements that were already made.

The Troy-based retailer will ask up to 62 former executives to pay back millions of dollars in loans, a Kmart official said. Separation packages from Kmart that include what were intended to be "retention loans" have ranged from $200,000 up to $750,000, records show.

The suspension of severance pay does not apply to former Chairman Chuck Conaway, who received $4 million as part of his separation agreement. Kmart also

Adamson

Conaway

has forgiven a $5-million loan it gave to Conaway last year.

The move to suspend severance packages was made by the Kmart board after a meeting with creditor committees Thursday in Chicago. It appears to be part of the company's attempt to scrutinize the business practices and decisions of Conaway and his managers. Kmart filed for bankruptcy Jan. 22.

"The board has authorized a review of stewardship of the company by the previous management," Ferry said. "(Directors) are looking at how the company was managed" under Conaway, who was chairman and chief executive officer of Kmart from May 2000 to last January.

At that time, board member James Adamson became chairman and Conaway was demoted to chief executive officer. Conaway resigned as CEO on March 9 and Adamson assumed those duties as well on March 11.

Court records show Kmart made more than $30 million in loans to 63 executives last year. One of the executives is repaying his loan now, a company lawyer said.

Kmart spokesman Michael Freitag said in one case Kmart wants to recover a loan made to a top executive who resigned. The merchandising executive is Lorna Nagler, who received a $750,000 "retention loan," left in April to join Catherines Stores Corp., a plus-size women's apparel company.

Two other top executives, the company's president and chief operating officer Mark S. Schwartz, and chief financial officer John T. McDonald Jr., were among those leaving Kmart in January shortly before the bankruptcy filing.

Also Thursday, U.S. Trustee Katie Gleason questioned how Kmart uses its corporate fleet of aircraft. Kmart Chief Financial Officer Al Koch told Gleason that some planes are primarily used for business purposes, but that the company is evaluating those uses and may dispose of some of them.

The management review, which officials expect to conclude by fall, focuses on "stewardship of members of the company's former management team," Kmart lawyer Jack Butler said.

Butler told reporters in Chicago that Kmart is investigating the executives' contracts to see if the way they left the company makes loans made to them "forgivable."

"From a creditor's perspective, that's excellent. For every dollar that's not spent, it's money that can be used to satisfy legitimate debt," said Charles Tatelbaum, an attorney for some of Kmart's suppliers.

Kmart on Tuesday was late with its financial report. It's seeking an approved extension from the Securities and Exchange Commission. The Adamson management team says it needs more time to review Kmart's accounting

records. Butler said Kmart hopes to finish the accounting probe by May 15.

Kmart officials said a review of its accounting practices may require the company to restate its fiscal 2001 sales and income reports.

The company also is looking into the way it recorded discounts and rebates from suppliers. Merchants often take deductions on payments to vendors by claiming some goods were damaged or weren't delivered properly, analysts said. The method reduces a retailer's cost of goods.

The company also said its its operating results for the year ended Jan. 30 were expected to include a loss "significantly higher" than the $244 million loss reported for the previous fiscal year.

One analyst said he believes Kmart overestimated its potential cost savings in several areas. The result may be losses that could reach $1 billion, based on financial statements Kmart already has filed with regulators and the bankruptcy court.

Kmart launched the review after the U.S. Securities & Exchange Commission, the retailer and its accountants -- PricewaterhouseCoopers LLP -- received an anonymous letter questioning Kmart's accounting methods. The letter arrived shortly before the company sought court protection Jan. 22 from its creditors under Chapter 11 of federal bankruptcy law.

Kmart said it is investigating its general liability reserves and vendor allowances and rebates.

Kmart also said the accounting investigation prompted it to delay the filing of its annual report. The SEC requires companies to file what is known as a 10-K report within 90 days after the close of a fiscal year. Kmart on Wednesday asked the SEC for a 15-day extension, allowing the company more time to complete its investigation.

In early March a New York law firm filed a class action lawsuit against Conaway on behalf of Kmart shareholders. The firm, Rabin & Peckel LLP, charges that Conaway misled investors about Kmart's financial prospects and other issues and seeks to represent shareholders who purchased Kmart common stock between May 17, 2001 and Kmart's Jan. 22 bankruptcy filing.

The Associated Press and Bloomberg News contributed to this report.

Kmart board's inside inquiry raises doubts

Review should include more than directors, experts say

Kmart executive loans

Kmart Corp, which filed for bankruptcy Jan. 22, is reviewing $28.8 million in retention loans made to 26 current and former Kmart employees. The following executives received retention loans of more than $1 million. All but one has since left Kmart.

Charles Conaway

Former chairman, chief executive officer

Loan amount: $5 million

Date: 5-30-01

Mark S. Schwartz

Former president and chief operating officer

Loan amount: $3 million

Date: 12-3-01

Anthony D'Ofino

Former executive vice president and chief supply chain officer

Loan amount: $2.5 million

Date: 12-3-01

John T. McDonald

Former chief financial officer

Loan amount: two totaling $2.5 million

Dates: 12-3-01 and 1-16-02

David Rots

Former chief administrative officer

Loan amount: $2.5 million

Date: 12-3-01

Cecil Kearse

Executive vice president, marketing

Loan amount: $2.5 million

Date: 12-3-01

By Karen Talaski, and Francis X. Donnelly
The Detroit News

TROY -- The Kmart Corp. board's investigation of management stewardship before the retailer's Jan. 22 bankruptcy filing centers on two dozen unusual compensation awards the board itself authorized last year and in January.

According to a company spokesman, the board inquiries are being conducted by outside directors who serve on the board's audit and compensation committees.

It was the compensation committee that originally recommended the severance packages and loans, company officials said.

The board's entanglement in the original decision-making raises questions about its lead role in investigating the compensation decisions, according to corporate governance experts. Authorities on corporate compensation argued that at least the board's inquiry ought to involve a combination of outside directors and company employees.

The awards include multi-million-dollar executive severance packages and $28.8 million in loans made to senior officers in an effort to retain their services as Kmart struggled to the end of a catastrophic year. But of 24 officials who were granted the loans late last year, nine left anyway.

The details about Kmart's executive awards emerged in documents filed as part of Kmart's reorganization under U.S. bankruptcy law. As a result of what is the seventh-largest bankruptcy in U.S. history, the largest bankruptcy by a retailer, 22,000 employees have lost their jobs and 283 stores have been closed.

Throughout the bankruptcy proceedings, Kmart's creditors and the U.S. Trustee supervising the case have questioned how cash-strapped Kmart could afford the expensive executive packages it handed out, including salaries and bonuses. Representatives for the creditors' committees declined to

discuss the case with The News.

Kmart on Thursday said it suspended severance payments to several top executives during the board's inquiry, although the company wouldn't say which executives were involved.

Kmart hasn't decided whether the retention loans for the nine departed executives will be forgiven, although under certain conditions they could be, according to court filings.

In addition to the loans to 24 executives authorized late last year and early this year, the board in May 2001 endorsed a similar $5-million loan to former Chairman and Chief Executive Officer Charles C. Conaway. That loan was forgiven, according to company documents. Conaway also received $4.5 million in severance payments. The company declined to give details of severance packages for other executives.

Retention loans are used by companies to encourage executives to stay whose departures would particularly hurt its operations, said experts in corporate governance and crisis management. They became popular in the late 1990s.

Such loans can be handled in various ways. In Kmart's case, the loans apparently were made up front, with the executive then expected to earn the right to have them forgiven over a period of time, said Gary Giumetti, president of McTevia & Associates in Eastpointe, a corporate turnaround specialist. In addition, such loans can be forgiven if the executive is fired without cause or leaves for reasons spelled out in his employment contract.

The number of retention loans and the amounts made by Kmart appear to be higher than those made by other companies, the experts said, although they acknowledged that Kmart's mounting liquidity crisis and dismal sales made the circumstances unusual. Giumetti and others also said the large number of retention loans could reflect the size of the company.

In addition to Conaway, retention loans went to Kmart's six most senior executives. Five of them have since departed. They are: Mark S. Schwartz, former president, $3 million; Anthony B. D'Onofrio, former executive vice-president, David Rots, former chief administrative officer, and John T. McDonald, former chief financial officer, $2.5 million each; and Hector Dominguez, former executive vice-president, $750,000.

Other loans went principally to senior vice-presidents and division presidents. Two of them have left: Lorna Nagler and John Owen, both senior vice-presidents, $750,000 each. But two vice-presidents who have since departed also got loans: Timothy Crow, $640,000; and Leo Anguiano, $500,000.

None of the executives could be reached for comment.

The severance package and forgiven loans for Conaway -- totaling $9.5 million -- have been widely criticized as overly generous. "To shareholders and employees and wage earners, it's an absolutely staggering number," Giumetti said.

Giumetti said it is highly unusual for a company to suspend severance payments. He said he had never heard of it before.

Kmart spokesman Jack Ferry said the board launched its review of the compensation decisions "because of all that's happened at Kmart in the last year." The company is calling it a "stewardship review," but it hasn't disclosed what the investigation encompasses or what stewardship is meant to imply.

The compensation review is expected to conclude by the summer, officials said.

Kmart's audit and compensation committees are four- and five-member groups that meet regularly. Until recently, Kmart's audit committee was led by James B. Adamson, who left the committee when he became Kmart's chairman and chief executive officer.

Other audit committee members are: Lilyan Affinito of the Maxxam Group Inc.; Joseph P. Flannery, chairman of Uniroyal Holding Inc.; Thomas T. Stallkamp, chief executive of MSX International; and Robin B. Smith, chairman of Publishers Clearing House.

Kmart's compensation committee includes: Robert D. Kennedy, chief executive officer of Union Carbide Corp.; Richard G. Cline, chairman of Hawthorne Investors Inc.; Willie D. Davis, president of All Pro Broadcasting Inc.; and Richard J. Statuto, president of St. Joseph Health System.

None of the board committee members contacted returned phone calls from The News.

Cindy Schipani, professor of business law at the University of Michigan Business School, said it would be better if the review were conducted by a committee including both outside directors and company insiders. That way, she said, the outsiders could guarantee an objective probe while the insiders could ensure access to key players in the company.

But Schipani said she believes Kmart must make an honest effort for the inquiry to be taken seriously.

"If it's just washing my hands to show I'm not responsible, that raises a red flag," she said.

In a separate review, Kmart also is examining its accounting practices and has said it may have to restate all of its 2001 earnings. Last week, Kmart said it would postpone its annual report until May 15 to complete that investigation.

The inquiries have surprised even Kmart analysts, who watch nearly every move Kmart makes so they can make judgments on whether people should invest in the company.

In a research note to investors Friday, Morningstar analyst Mike Porter said: "If we were Kmart, we would be expecting a call from the Securities and Exchange Commission; if we were investors foolish enough to still be holding on to shares of a bankrupt company, we'd be dumping them."

You can reach Karen Talaski at (313) 222-2319 or ktalaski@detnews.com.

Kmart compensation

Last fall Kmart Corp. awarded its top 26 employees with $28.8 million in retention loans, or bonus payments intended to keep these executives at the company, in the months before it filed for reorganization protection. Former Chairman Charles C. Conaway also received $4.5 million in severance payments.

NAME	TITLE	LOAN DATE	LOAN AMOUNT
Charles Conaway	Ex-Chairman, Chief Executive Officer	5/30/01	$5,000,000
Mark S. Schwartz	Ex-President	12/3/01	3,000,000
Anthony B. D'Onofrio	Ex-Executive Vice President, Supply Chain	12/3/01	2,500,000
Cecil Kearse	Executive Vice President, Merchandising	12/3/01	2,500,000
David Rots	Ex-Chief Administrative Officer	12/3/01	2,500,000
John T. McDonald	Ex-Chief Financial Officer	1/16/02	1,750,000
Hector Dominguez	Ex-Executive Vice President, Supercenters	12/3/01	750,000
John T. McDonald	Ex-Chief Financial Officer	12/3/01	750,000
Enio Montini	Senior Vice President and GMM*, Drug Stores	12/3/01	750,000
David Montoya	Senior Vice President, Specialty Operations	12/3/01	750,000
Lorna Nagler	Ex-Senior Vice President and GMM*, Apparel	12/3/01	750,000
John Owen	Ex-Senior Vice President and GMM*, Hardlines	12/3/01	750,000
Gregg Treadway	Executive Vice President, Store Operations	12/3/01	750,000
William Wulfers	Division President, Southeast	12/3/01	750,000
Paul Springthorpe	Senior Vice President, Distribution Operations	12/3/01	700,000
Timothy Crow	Ex-Vice President, Human Resources, Operations	12/3/01	640,000
Leo Anguiano	Ex-Vice President, Asset Protection	12/5/01	500,000
Michael Frank	Senior Vice President and GMM*, Food/Consumables	12/3/01	500,000
Douglas M. Meissner	Division President, Northeast	12/12/01	500,000
Paula Paquette	Senior Vice President and GMM*, Home	12/3/01	500,000
Paul J. Hueber	Division President, International	11/30/01	400,000
Michael S. Jardina	Division President, SuperCenters	12/3/01	400,000
Janet Kelley	Executive Vice President, General Counsel	12/3/01	400,000
Mariana Keros	Vice President, Trend/Product Development	12/5/01	400,000
John Foster	Senior Vice President, Real Estate Management	12/3/01	300,000
Leland M. Viliborghi	Division President, West	12/3/01	300,000
TOTAL			**$28,790,000**

* GMM=General Merchandise Manager

Source: Kmart Corp.

The Detroit News

SEC seeks documents from Kmart

Anonymous letters raise questions about management

By Karen Talaski and David Shepardson
The Detroit News

TROY -- The Securities & Exchange Commission has subpoenaed more than 100,000 pages of documents from Kmart Corp. in its investigation of the company's accounting practices, people familiar with the investigation said.

The review, along with an independent, internal investigation at Kmart, is being fueled in part by a series of anonymous letters that purport to be from workers in the company's finance department.

Kmart officials have confirmed that the company is using the anonymous documents to investigate the practices of its past management.

The letters, which began to arrive in early January, have continued to appear on a regular basis. So far, more than a dozen letters have been sent to parties including Kmart's board of directors, its outside legal counsel and its auditing company, PricewaterhouseCoopers LLC.

The SEC investigation is wide-ranging and involves a large volume of documents because it covers Kmart's accounting methods over a series of years, people close to the situation have said.

Kmart officials have said the company is cooperating with the investigation.

The letters sparked a separate review by the Federal Bureau of Investigation, which is investigating the claims under the direction of the U.S. Attorney for the Eastern District of Michigan.

The series of letters appear to be from the same author and demonstrate an intimate knowledge of the company, accounting experts say. However, the anonymous authors have yet to come forward despite public requests by investigators that they do so.

"We're always open to receiving information from people that have knowledge related to an investigation," said Assistant U.S. Attorney Steve Robinson, a lawyer in the economic crimes section assigned to the Kmart probe.

"The people who sent the letters (to Kmart) are smart enough that if they want to get in touch with us, they know how to do so. We're in the phone book."

The investigations, along with the anonymous letters, may paint a clearer picture of the financial dealings that led Kmart to seek protection from its creditors Jan. 22 under Chapter 11 of the U.S. Bankruptcy law.

Since its filing, Kmart has closed 283 stores and idled 22,000 workers. Kmart has said it may seek to close more locations next year as the company reorganizes.

In one letter, dated Feb. 15, the writers say that Kmart executives considered some sort of financial restructuring, possibly a bankruptcy filing, as early as July 2001, according to a copy obtained by The Detroit News.

Kmart officials declined to verify the allegations in the letter.

However, Kmart spokesman Jack Ferry said the letters have been helpful to Kmart's internal investigation.

"The letters were referred to the audit committee of Kmart's board of directors, which engaged outside counsel to review and investigate the matters set forth in the letters," Ferry said.

The first letter, dated Jan. 9, was sent to the SEC's Division of Enforcement. It claims that Kmart's senior executives directed finance-department employees to deviate from standard accounting practices throughout 2001, mis-

Adamsom

Feb. 15 letter

An anonymous letter to Kmart Chairman James B. Adamson said to be from Kmart employees includes the following allegations of mismanagement over the past two years at the Troy-based retailer.

- "Public statements issued by the company in the period immediately prior to the filing were misleading and deceptive."
- "Since the filing (Kmart) has allowed the public to believe Kmart's problems resulted primarily from the competitive environment without mention of management actions that directly caused the failure."
- "We believe that an unbiased investigation of the facts will challenge the viability of the current executive team and should lead to consideration of replacement of the company auditors, PricewaterhouseCoopers, both of whom had specific knowledge of unacceptable accounting practices."
- "We attempted to communicate what appeared to us to be an escalating pattern of deception in early January, but we did not anticipate the filing to occur so quickly in contrast to statements of confidence made by the company."

leading Kmart shareholders about the company's financial health.

The Jan. 9 letter further alleges that Kmart's accountants, PricewaterhouseCoopers LLC, knew of these alleged distortions and did not act on them.

PricewaterhouseCoopers has declined to comment on the allegations.

The four-page Feb. 15 letter, addressed to Kmart Chairman James B. Adamson, makes specific allegations of mismanagement against former chairman Charles C. Conaway, former president Mark S. Schwartz and others.

The writers of the unsigned letters say they are a group of employees who are concerned about Kmart's actions in the months before its bankruptcy.

"We believe any unbiased investigation of the facts will challenge the viability of the current executive team and should lead to consideration of the replacement of the company auditors, PricewaterhouseCoopers, both of whom had specific knowledge of unacceptable accounting practices," the Feb. 15 letter says.

The letter says the executives reviewed at least one business plan that forecast hefty bonuses for 2001 performance and recommended a second-quarter 2002 bankruptcy filing.

Last fall, Kmart's board approved $28.8 million in retention loans, including $5 million for Conaway and $3 million for Schwartz. Both debts have since been forgiven as part of the executives' severance deals.

It is unclear whether Kmart will recover millions of dollars in loans granted to other now-departed employees.

"Unchecked spending may be the primary reason the filing date was escalated from the July model," the letter says.

"Although we suspected something was very wrong based on our knowledge of a pattern of financial transactions being made, the filing on Jan. 22 tied together events we were aware of and participated in."

Much like the first letter, the Feb. 15 correspondence ends: "Something continues to be very wrong at Kmart."

Since the letters began arriving, Kmart has made a number of high-profile changes to its management and accounting practices.

Kmart has replaced virtually every member of its senior management team, including Conaway, Schwartz and most of the employees the two executives hired between May 2000, when Conaway arrived, and January 2002.

Kmart has also launched a management review and has frozen some severance payments to Conaway and other executives until further notice.

Should the letter writers come forward, there are a number of protections available to them, said attorney David L. Haron of Frank, Stefani, Haron & Hall, an employment law firm in Troy.

The Michigan Whistleblowers' Protection Act prevents employers from firing or otherwise discriminating against an employee who reports a violation of state or federal law.

"Whistleblowers tend to be people who are really dedicated and have been with a company a long time. They try to get the problem fixed from the inside. But sometimes they have to go outside of the company to get someone to take action," Haron said.

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Brash Kmart exec accepts no blame

By Bill Vlasic, Mark Truby and Karen Talaski
The Detroit News

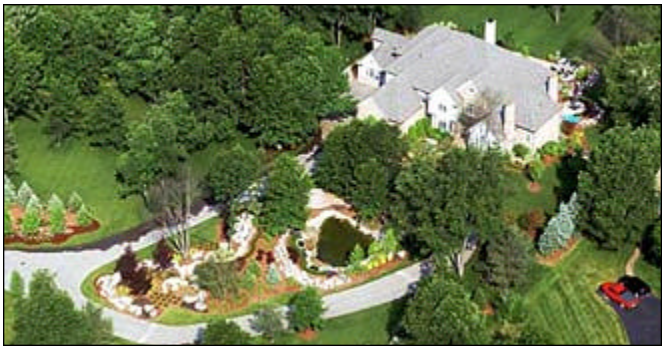
SPEARFISH, S.D. -- The newest entrepreneur in town works out of a cramped, box-strewn office tucked on the second floor of the old City Hall.

To the residents of this remote, resort community nestled in the Black Hills, Mark Schwartz is an anonymous, white-collar refugee buying up convenience stores in western South Dakota.

But to many employees, shareholders and creditors of bankrupt Kmart Corp., Schwartz represents everything that went wrong at the giant, Troy-based discount retailer.

Fired as Kmart's president on Jan. 15, Schwartz and former Chairman and Chief Executive Charles Conaway are under scrutiny in a widening investigation of accounting and management practices at Kmart by the company, the FBI and the U.S. Securities and Exchange Commission.

Hailed as an experienced turnaround expert when Conaway recruited him to Kmart in September of 2000, the swaggering former Wal-Mart executive is now blamed for driving Kmart into a ditch before walking off with a controversial $3-million retention loan.



Charles V. Tines / The Detroit News

After Kmart fired him in January, Mark Schwartz walked out with $3 million in severance and put his $3.25 million Rochester Hills home on the market.

Mike Wolforth

Schwartz landed in tiny Spearfish, S.D., where he started the Fresh Start Convenience Stores Inc., a chain of a dozen roadside outlets selling beer, gas and buffalo meat. His partner is John Owen, a former Wal-Mart cohort and fired Kmart senior vice president.

But the collapse of Kmart has hardly humbled Schwartz. Defiant and unapologetic, the 41-year-old native Texan said he welcomes any investigations and defends the risky strategies he pushed at Kmart. He also said a series of anonymously written letters to authorities, Kmart's board and The Detroit News accusing him of defrauding the company are "ludicrous."

"I gave Kmart every ounce of my energy and know-how," Schwartz told The News in his first interview since his firing. "I still think the things we were doing were the right things."

While he declined to discuss specific allegations in detail, Schwartz strongly defends his tenure at Kmart. Yet his business career is littered with failure and controversy.

The Detroit News

In court records, lawsuits and interviews, a portrait emerges of a volatile executive who led three other companies into bankruptcy and left a trail of angry shareholders before he joined Kmart in September of 2000.

Industry experts lay much of the blame for Kmart's downward spiral into bankruptcy on Schwartz's obsession with competing head-to-head with Wal-Mart, his one-time employer and the juggernaut of the retail world.

"In retailing, you can't go with showboats," said Ulysses Yannas, a retail analyst with Buckman, Buckman & Reid in New York. "Their heads get blown out of proportion. In the end, they can't

perform."

Schwartz scoffs at the notion that he was in over his head at Kmart, which lost $2.4 billion last year on sales of $36.2 billion.

"There were more good things done in the last 12 months than there had been done in 15 years," he snapped. "The company was a mess. This place was a dump."

Schwartz said the already fragile Kmart was pushed into Chapter 11 reorganization by several factors, including Sept. 11, a horrid holiday selling season and the panic caused by an analyst's report predicting Kmart would enter bankruptcy.

Kmart's current chairman and chief executive, James Adamson, was unavailable for comment on Schwartz. The company has been tight-lipped about its former president, citing the sensitivity of its ongoing internal investigation and probes by the FBI and the SEC. Kmart's internal probe is expected to be completed by September, said Kmart spokeswoman Lori McTavish.

Sources close to Kmart say that Schwartz and his former boss Conaway, who resigned under pressure in March, are the prime targets of the wide-ranging inquiry into questionable accounting of vendor allowances and inventory levels during the second and third quarters of 2001.

In addition, investigators are pouring over the details of a controversial loan program that rewarded 25 executives, including Conaway and Schwartz, with $28.8 million in cash payouts last December, a month before Kmart filed for Chapter 11 bankruptcy. Conaway obtained a $5 million loan which has been forgiven.

Mike Wolforth

Mark Schwartz runs his Fresh Start Convenience Stores Inc. out of a cramped second-floor office in Spearfish's old City Hall.

Conaway could not be reached for comment.

The Kmart investigations are unfolding as corporate America is under increasing scrutiny for financial improprieties and executive misconduct. Investor trust in business institutions has been shaken by scandals at such major companies as Enron, Tyco, Dynergy and ImClone.

Fresh start

At Kmart, it was Schwartz's combative style that rattled the discount chain's long-time employees accustomed to decades of staid and conservative management.

Managers tell of Schwartz's profanity-laced tirades on store visits. Insiders complain of Schwartz's unfettered hiring of former Wal-Mart colleagues, and their seemingly unlimited expense accounts and use of Kmart's corporate jets for personal travel.

Above all, Kmart veterans blanched at Schwartz's macho assault on mighty Wal-Mart, going so far as to post a huge Kmart billboard ("The BlueLight is Back") across the street from Wal-Mart's Bentonville, Ark., headquarters.

"He was brash, egotistical, arrogant," said Phil Adams, a former Kmart store manager in suburban Detroit. "There was no budget as far as execs were concerned."

Now Schwartz's high-flying Kmart days seem as far away as the tiny town of Spearfish, a Wild West outpost where prospectors, gamblers and gunslingers cavorted during the gold-rush era of the late 1800s.

Schwartz's new venture is the aptly named Fresh Start Convenience Stores Inc., a

chain of a dozen roadside outlets peddling beer, gas and buffalo meat. His partner is John Owen, a former Wal-Mart cohort who was fired as a Kmart senior vice president in March.

Yet while Schwartz seeks a new beginning, he can't escape the lingering questions about Kmart. In his mind, Kmart was the problem child of discount retailing, and one that even he could not fix.

"Did I think I could turn it around? Hell, yeah," he said. "You try to make changes. When they work, you are a genius. When they don't, everybody points fingers."

A retail wunderkind

Schwartz was a 21-year-old college dropout in 1982 when his life took a fateful turn.

He was managing a Woolco discount store in Texas when the 336-store retail chain abruptly went out of business. According to Schwartz, he was ready to return to the University of Texas when Sam Walton walked into his store and asked him to join Wal-Mart.

The legendary Walton was in the midst of a huge expansion of Wal-Mart and needed young, energetic store managers. Schwartz, a sturdy 6-footer with a shock of thick brown hair, fit the bill perfectly. Within months he was one of the youngest managers in the Wal-Mart chain and on the fast track to an executive position in the company's burgeoning Supercenter division.

But even as he rose to become a senior vice president in the Supercenter unit, Schwartz harbored other ambitions. While at Wal-Mart in the mid-1990s, he started a real-estate development firm to build residential subdivisions near Wal-Mart's headquarters in northwest Arkansas.

The firm, MPG Enterprises Inc., went bust in 1996 and filed for Chapter 11 bankruptcy, citing $11 million in claims by its creditors. The company would ultimately be liquidated.

"Schwartz was the one who created it, and he was in charge of it when it went down," said Ben Barry, the court-appointed trustee in the case.

In court, charges of conflict-of-interest surfaced against Schwartz and family members who doubled as MPG executives and commissioners of a local improvement district whose bond sales benefited MPG.

"There's evidence right now of civil conspiracy," U.S. Bankruptcy Judge James Mixon said at a hearing in the case.

No charges were brought, but Schwartz made headlines in Bentonville when it was revealed that Wal-Mart guaranteed $1.1 million in loans that MPG owed. Wal-Mart spokesman Bill Wirtz confirmed that the retailer guaranteed the loans to help Schwartz.

"It was to help him restructure his debt and withdraw from (MPG)," Wirtz said.

After MPG went bankrupt, Schwartz was transferred to Wal-Mart's Supercenter operations in Mexico City. He didn't stay long. In 1998, Schwartz was named CEO of Hechinger Co., a troubled home-improvement chain based in Largo, Md.

Bankruptcies and lawsuits

Schwartz was a whirlwind at Hechinger, plastering motivational posters on office walls, calling 5 a.m. executive meetings, and pouring money into store renovations. Money seemed no object. One former executive recalled how Schwartz called an emergency meeting of some 270 store managers at a cost of $3 million. The executive said Schwartz's spending was lavish and he did not tolerate dissent.

But with losses mounting at Hechinger, Schwartz quit in early 1999 to become the CEO of Big V Supermarkets, a 32-store supermarket chain doing business as ShopRite in upstate New York. Four months later, Hechinger filed for Chapter 11 bankruptcy.

At Big V, Schwartz plunged into a grand expansion plan, building stores in new markets and adding garden centers and hardware departments to its supermarkets. He heaped new costs on Big V, even as it struggled to service a long-term load of $200 million.

He also began bringing in troops of former Wal-Mart staffers. Neal Madera, a former Big V executive, told of one staff meeting when

Checkered past

Former Kmart President Mark Schwartz was a rising star at Wal-Mart early in his career but his resume was marred by a number of high-profile bankruptcies.

MPG Enterprises: While at Wal-Mart in 1996, Schwartz also was president of MPG, a real estate investment firm. The company filed for bankruptcy and then went belly-up in 1997. The firm's collapse was controversial and Wal-Mart stepped in to guarantee $1.1 million in loans to help Schwartz restructure the debt. Schwartz was soon reassigned to Wal-Mart's Mexican operations, and he left Wal-Mart in 1998.

Hechinger: In 1998, Schwartz was named CEO of the home improvement retailer Hechinger Co. It reported a $93-million loss that year. In February 1999, Schwartz decamped for Big V Supermarkets. In June 1999, Hechinger filed for Chapter 11 bankruptcy protection. Two months later the company liquidated.

Big V Supermarkets:

Schwartz was named CEO of the 32-store chain in upstate New York in February 1999 and began expanding. In September 2000, with Big V slumping, Schwartz resigned and joined Kmart. That November, Big V filed for Chapter 11 bankruptcy.

Kmart: Schwartz joined Kmart as executive vice president of store operations in 2000. In March 2001, he was promoted to president and chief operating officer. Schwartz was fired Jan. 15, 2002, following a dismal holiday selling season. Kmart filed for Chapter 11 Jan. 22.

Schwartz bluntly said that he planned to "get rid of" 30 percent of the old management "He came into town like a circus caravan with all his people," said Madera, a former Big V senior vice president and general counsel. "He expanded stores and built stores that just didn't make sense."

In 18 months Schwartz decamped for Kmart, where he was named executive vice president of store operations in September 2000. Two months later, Big V filed for Chapter 11 bankruptcy. In the aftermath, Madera and two other former Big V executives sued Schwartz and other company officials for fraud and destruction of shareholder value.

Madera, whose $1.2 million in Big V stock is worthless now, laid the blame squarely on Schwartz.

"This guy ran a great company into the sewer," Madera said. "I can tell you now, I saw what was coming at Kmart."

Attacking Kmart stores

Schwartz arrived at Kmart on a wave of goodwill. A few months earlier, Conaway, a top executive at the CVS drugstore chain, had been hired as Kmart's new chairman and CEO. He and Schwartz, who was hired as executive vice president of store operations, clicked immediately -- two hard-charging executives in their early 40s determined to shake Kmart out of the doldrums of a decade of sliding market share at the hands of archrival Wal-Mart.

Never one to mince words, Schwartz describes Kmart as "in terrible shape" when he arrived.

"There was five years of old inventory in the back rooms," he said. "The inventory had not been managed or taken care of. The supply chain was so antiquated. Ads were used as a crutch and paid for by cutting labor in the stores."

Schwartz didn't so much manage the 2,100 Kmart stores as he attacked them. His store visits were feared. One manager recalled a tense scene when Schwartz chewed out employees with such profanity that shocked customers began to complain.

He also put workers at Kmart headquarters on edge. Some veteran staffers stopped wearing their gold Kmart longevity pins, afraid that Schwartz and Conaway would hold their years of service against them.

Schwartz, for his part, doesn't deny that he cast a critical eye on long-time Kmart practices.

"The company would not have been in the competitive position it was in if the people were running it appropriately," he said.

By March 2001, Schwartz had supplanted Andy Giancamilli as president and chief operating officer. Giancamilli left the company, as did Kmart's former vice chairman and chief financial officer. Schwartz then stepped up his recruitment of ex-Wal-Mart staffers and geared up for an assault on his former company.

Taking on Wal-Mart

Conaway was the cheerleader, an almost hyperactive executive known to jump on tables at meetings and exhort his staff to "beat Wal-Mart's ass," according to Kmart insiders. But Schwartz seemed even more driven to tackle Wal-Mart head-on.

At regular Friday executive meetings, the proceedings would routinely stop at a certain point for a video. In the darkened auditorium, Kmart workers watched film clips of old war movies portraying a pilot about to bomb a target. As the bomb fell the film froze, and "Wal-Mart" was superimposed on the exploding building.

With Kmart struggling to fix its age-old inventory and merchandising problems, some investors worried about the growing fixation on fighting Wal-Mart.

"Every time I heard them talk about Wal-Mart, I got nervous," said Ron Burkle, a billionaire investor and Kmart's largest individual shareholder.

While he ran Kmart operations with an iron hand, Schwartz enjoyed the fruits of his new position. He bought a million-dollar, 10-acre estate in Rochester Hills a few miles from Conaway's 14,000-square-foot mansion in Oakland Township. Expensive Jaguar sedans became the Kmart company car of choice for its new leaders. Old-line Kmart employees dubbed the new regime the "frat boys," with Conaway and Schwartz as the unquestioned leaders.

At a corporate party last summer at Conaway's lavish home, groups of managers and their spouses milled about the pool when a sound system blared out the party tune "YMCA." As the music rose, out of the house came Conaway, Schwartz and two other executives, dancing and miming the song to roars of laughter from their subordinates.

The high spirits seemed to fuel Schwartz to take bolder, more aggressive chances. He conceived of a new marketing program called "BlueLight Always" that dramatically slashed prices. According to sources close to Kmart, the company's board agreed to a

limited, test-run on about 8,000 store items.

That didn't stop Conaway and Schwartz from expanding "BlueLight Always" to an estimated 40,000 store items. They also took the fight to Wal-Mart's front door, spending millions to expand an aging Kmart store in Bentonville directly across the street from Wal-Mart's flagship, hometown Supercenter.

In a blatant challenge, a big Kmart billboard was installed across from Wal-Mart headquarters. In retrospect, even Schwartz's loyalists wondered about the wisdom of that move. "We may have gone too far in some instances," said Owen, the former executive who now works with Schwartz in Spearfish.

"BlueLight Always" backfired, creating huge losses when Kmart was already awash in red ink. Investors and suppliers grew increasingly nervous last fall. Some vendors were not getting paid. With Kmart's stock price dropping, Conaway and Schwartz tried to restore confidence with key investors, including Burkle.

Last November, they invited Burkle to meet them at a new Kmart Supercenter in Arizona. The trip was supposed to show off Kmart at its best. But Burkle secretly visited the store a week earlier and was horrified at its sloppy merchandise and the excess inventory hidden in back rooms.

"It was a disaster," Burkle said.

Sweet severance deal

The end was near for Schwartz. Anxious vendors geared up to withhold shipments if they went unpaid. Investors shuddered when Jeff Boyer, the respected chief financial officer brought in from Sears, quit abruptly last November. An influential retail analyst, Wayne Hood of Prudential Securities, published an incendiary report recommending bankruptcy as Kmart's best business strategy.

One of Schwartz's last deeds was to secure a $3 million "retention" loan last December designed to keep him at the company. A month later, he was fired. As part of his severance package, the loan was forgiven.

Schwartz bristled when asked about the retention loans given to him and 24 other Kmart executives. "Was I going to just freely come to Kmart without compensation?" he said. "You can't even recruit people to Kmart. That's just ridiculous."

In little Spearfish, people are quietly aware of the big-time executive holed up in the old City Hall. "This is a place where everybody knows everybody's business," said Tom Griffith, a local writer and historian.

Schwartz says he isn't hiding, nor does he fear a visit by FBI agents or SEC investigators.

"At the end of the day the truth will come out," he said. "I welcome that. I have nothing to hide."

With that he ended the hour-long interview and walked out of the Holiday Inn coffee shop. He had, he said, to attend to Fresh Start business.

Joel Smith also contributed to this story. You can reach Mark Truby at (313) 222-2082 or mtruby@detnews.com; Bill Vlasic at (313) 222-2319 or at bvlasic@detnews.com; and Karen Talaski at (313) 222-2319 or at ktalaski@detnews.com.

Charles "Chuck" Conaway

The retailer's former chairman, fired in March, earned nearly $23 million in compensation during his almost 22 months on the job. He renegotiated his job contract five times and demanded a $5 million retention loan after his first year.

Mark Schwartz

Kmart's former president, fired in January, was paid $10.8 million for 16 months of work. He got a $1 million retention bonus a few months after he was hired and a $3 million retention loan a year later.

Nests feathered as Kmart failed

FBI makes probe of execs a top priority; grand jury meets

Max Ortiz / The Detroit News

Blunders by former Chairman Charles Conaway and President Mark Schwartz led Kmart into bankruptcy. The retailer had to close 284 stores, including this one in Novi, and lay off 22,000 workers.

By Bill Vlasic, Mark Truby and David Shepardson
The Detroit News

TROY — They lived the good life of gated estates, a 47-foot yacht, corporate jets at their beck and call, and multiple pay hikes, perks, bonuses and loans.

But even as Kmart Corp. struggled for survival, its chairman, Charles Conaway, and president, Mark Schwartz, wanted more, renegotiating employment contracts that would ultimately net them a combined $34 million in less than two years.

Conaway and Schwartz, the leaders of the $37-billion-a-year retail giant that lost $3.9 billion in its past five quarters and laid off 22,000 workers this year, are now central figures in the company's demise.

Their management blunders led Kmart into bankruptcy, and questions abound as to whether they hid the company's financial condition from its board of directors, employees and sharehold-

ers.

But one thing is clear: As Kmart spiraled downward, Conaway and Schwartz grew richer.

With Kmart now mired in bankruptcy, the payouts to Conaway and Schwartz have come under scrutiny in a federal criminal investigation of accounting practices at the Troy-based retailer.

Federal investigators are zeroing in on the personal finances and compensation deals struck by Conaway, Schwartz and other former Kmart executives in the months leading up to the company's Jan. 22 Chapter 11 bankruptcy filing in Chicago.

The U.S. Attorney's Office has impaneled a federal grand jury in Detroit, and more than 20 subpoenas have been issued for witnesses, bank records and other documents, federal officials told The Detroit News.

Conaway and Schwartz, both of whom were fired earlier this year, have been interviewed by the FBI, according to federal sources. Neither Schwartz nor an attorney for Conaway returned telephone calls last week.

The FBI recently added two agents to the Kmart probe, bringing to three the number of full-time agents on the case. While the agents declined to comment on specifics of the investigation, federal sources said the Kmart investigation is the top priority — after the war on terrorism — for the Detroit bureau.

"The public can rest assured that we are actively and aggressively pursuing this matter," said Detroit's FBI spokeswoman Dawn Clenney.

The Kmart investigation is heating up in the wake of accounting scandals at corporate giants such as Enron Corp., WorldCom Inc., and Tyco International Ltd. At the behest of President Bush, the Justice Department has created a task force to crack down on corporate fraud.

Charles V. Tines / The Detroit News

Former Chairman Charles Conaway lived in this 29-room Oakland Township mansion, yet billed Kmart $523,000 for "temporary housing and living costs." The compensation deals struck by company execs are under scrutiny.

At Kmart, Conaway and Schwartz on multiple occasions leveraged new employment deals out of the company's board. They billed the company for extravagant housing costs and personal travel on corporate planes.

They also purchased two new corporate jets for the Kmart fleet and approved a company vehicle program that allowed executives to drive pricey Jaguars and Land Rovers.

Investigations on several fronts are seeking to unravel the facts behind the biggest bankruptcy in U.S. retail history, and to determine if Conaway, Schwartz or other executives will face charges in connection with its downfall.

The FBI is working in tandem with agents from the Securities and Exchange Commission, and a U.S. House subcommittee is gathering documents and evidence for a full-scale Kmart inquiry.

Kmart's own "stewardship review" of former management also is moving forward. According to sources close to the company, Kmart may sue Conaway, Schwartz and other former executives to recover money paid out in various forms of compensation.

Kmart's internal audit team and federal investigators are combing through records to determine if Conaway, Schwartz and their subordinates simply took advantage of a lax corporate board — or demanded more money when only they knew Kmart was about to crash.

From his hiring in May 2000 until his firing on March 11, Conaway collected nearly $23 million in compensation, according to SEC filings. He renegotiated his employment contract five times, and pushed for a $5 million 'retention loan' after only one year on the job. He lived in an opulent 29-room mansion in rural Oakland Township, yet billed Kmart for $523,000 in "temporary housing and living costs."

Kmart hired Schwartz in September 2000 and fired him Jan. 15. During those 16 months, he pocketed $10.8 million, including a $1 million retention bonus in December 2000, a $3 million retention loan a year later, and $1.4 million for unspecified housing costs.

During his time at Kmart, Schwartz owned homes in Michigan, New York and Arkansas. He spent $100,000 on an indoor pool and other

renovations at his 10-acre Oakland Township estate. He bought a $500,000 Bayliner motor yacht — christened "I Am Blessed" — and $240,000 worth of land in South Dakota, where he now lives, according to publicly filed deeds, building permits and boat registrations.

Since his firing, Schwartz has invested $350,000 to start a chain of convenience stores in South Dakota, and taken out a $7.9-million line of credit from First National Bank in Pierre, S.D., according to court records in Lawrence County, S.D.

Beyond their own pay packages, Conaway and Schwartz orchestrated the payment of more than $20 million in retention loans to 23 other Kmart executives, 17 of whom have been fired since the company went bankrupt.

Under the federal bankruptcy code, Kmart has broad powers to re-examine transactions with its former executives and recover money already paid out. The court, for example, can review payments made to executives and determine whether they were proper given the corporation's other financial obligations.

"If it is determined that there is wrongdoing, then we will take appropriate action," said Lori McTavish, Kmart's vice president of communications.

Federal officials told The News that as many as 200 subpoenas could be issued in their investigation, which could last up to another six months.

James Adamson, the outside director who replaced Conaway as chairman and CEO earlier this year, has promised full cooperation with federal investigators.

But Adamson acknowledged that he and other directors don't have answers to many of the questions swirling around Conaway and Schwartz.

"We weren't told everything," Adamson said in late July. "There are a lot of things that took place where I wish that the management team had been more forthright."

The Detroit News

In May 2001 Conaway promised shareholders that Kmart will be "fixed structurally and culturally" the same day he secured a $5 million loan to keep him from leaving.

Associated Press

In June 2001, New York Stock Exchange President William Johnston, left, applauds along with Martha Stewart, center, a new Kmart-Martha Stewart agreement. Conaway, right, seemingly could do no wrong his first year.

Conaway pledged success

In his first year as Kmart chairman and CEO, Conaway seemingly could do no wrong.

A 39-year-old Michigan native who grew up on a small farm in Lapeer, Conaway rode into Kmart on a wave of goodwill when he was hired away from a top executive post at the CVS Corp. drugstore chain.

He signed a lucrative employment contract in May 2000, complete with a $1.4 million annual salary, $6 million in up-front cash and stock bonuses, and a restricted stock award worth $5.4 million at the time. By comparison, Kmart's previous CEO, Floyd Hall, earned about $3 million in salary, bonus and other compensation

in 1999.

But there was more. Over the next five years, Conaway also was promised an additional $15 million in cash and stock to cover "foregone compensation" at his previous employer.

Just 12 months later, Conaway demanded a new deal.

On May 15, 2001, Conaway stepped onto the stage of the Detroit Opera House for his first annual meeting as Kmart CEO. Blue and red lights flashed and employees waved pom-poms as Conaway pledged to "close the gap" on rival discounters Wal-Mart and Target.

"My commitment is within 720 days to get the business fixed structurally and culturally," he said. "We're definitely on track."

Yet on the very day he promised success in the future, Conaway received a $5-million retention loan to keep him from leaving the company.

Adamson and other Kmart directors have declined comment on why Conaway was given the loan. Since his firing five months ago, Conaway has been unavailable for interviews. An attorney representing Conaway in a Kmart-related lawsuit, Sharon Woods, did not return calls from The News.

Conaway's original Kmart contract contained incentives based on undisclosed corporate performance targets. But by May of 2001, it was a clear that earning a bonus was a long shot.

Moreover, with Kmart's shares plunging, Conaway's stock-laden long-term compensation package was withering.

Daniel Mears / The Detroit News

Current CEO James Adamson says Kmart is still looking for answers to many questions about Conaway and former Kmart president Mark Schwartz.

Despite Conaway's upbeat address to shareholders at the annual meeting, Kmart was losing more money than investors knew. While it reported combined losses of $120 million in the first two quarters, the figure would prove to be much higher when Kmart restated its financial results this past May.

According to SEC filings, Kmart booked an estimated $420 million in vendor allowances — rebates paid by suppliers to the company — in the first two quarters that had not yet been collected. While those payments were expected later in the year, they were a hidden liability on an already shaky balance sheet.

Kmart was also about to embark on one of the riskiest marketing programs in modern retail history. Behind the scenes, Conaway was laying plans for an all-out assault on Wal-Mart Stores Inc., the king of the discount industry.

The plan, dubbed BlueLight Always, called for slashing prices on 38,000 store products virtually overnight. The program had the potential to create enormous short-term losses, and kill any chance Conaway had to earn a performance-based bonus.

More online

Read more about the Kmart saga and its key players at www.detnews.com/specialreports

detnews.com

Kmart directors, particularly Adamson and former Chrysler Corp. President Thomas Stallkamp, balked at the size of the price-chopping program. Adamson told The News that the board approved only a limited trial-run of BlueLight Always.

"BlueLight didn't work, Adamson said. "They carried it too far without the board's knowledge."

But by the summer of 2001, the board seemed to have little control over Conaway and his second-in-command, Mark Schwartz.

Corporate odd couple

They were an odd, mismatched pair. With his stylish suits, tousled hair and toothy smile, Conaway exuded charisma in a corporation desperate for leadership. Schwartz, however, came across more like a blitzing linebacker.

A stocky, volatile Texan, Schwartz, then 41, was hired in September 2000 as Kmart's executive vice president of store operations. Less than six months later, he took over as president and chief operating officer.

The circumstances of Schwartz's hiring have become a key focus of Kmart's internal stewardship review. While Schwartz was billed as a retail dynamo who made his reputation as an executive with Wal-Mart, his career has been studded with failure.

His three previous companies — the Arkansas real-estate firm MPG Enterprises Inc., the Hechinger home-improvement retail chain in Maryland, and New York-based Big V Supermarkets — all crashed in bankruptcy.

According to a former high-ranking Kmart executive, Conaway knew of Schwartz's problem-plagued past, including a $1.1 million debt that he owed to Wal-Mart, his former employer. But sources close to Kmart's board said directors were not fully informed of Schwartz's background.

Despite three corporate bankruptcies in his recent past, Schwartz still cut a sweet deal when he joined Kmart. His initial salary was $243,000, but he received a $1.8 million bonus, 75,000 shares of restricted stock upon his hiring, and a $1 million retention bonus just three months later. With his promotion to president, Kmart boosted his annual salary to $706,000.

In a June interview with The News, Schwartz was asked why he joined Kmart. "Because of the contract," he said. "The money."

Schwartz also ran up $1.4 million in housing costs that were reimbursed by Kmart. The expenses tripled what Conaway spent even though Conaway's Oakland Township home cost more than twice as much as Schwartz's $1.45 million estate.

During his Kmart tenure,

Schwartz also maintained homes in Goshen, N.Y., and Bentonville, Ark., renovated his Michigan home twice, and bought the yacht at the 2001 Detroit Boat Show.

Those expenditures, as well as $108,000 in personal use of Kmart planes, are under scrutiny by the FBI, a federal official told The News.

Schwartz was a feared figure at Kmart, given to profane tirades in management meetings and on store visits. On one occasion, he threatened to shave the head of Cecil Kearse, a senior merchandising executive with meticulously groomed blond hair, if certain performance targets weren't met, according to current and former executives.

Afterward, computer-generated photos of a bald Kearse began appearing on walls throughout Kmart offices.

"Schwartz would tear people up and walk over them," said Tim Olson, a former store manager in Oklahoma who lost his job in June. "He was clearly out for himself."

By the late summer of 2001, Kmart employees sensed a rivalry brewing between Conaway and Schwartz. At Friday management meetings, chairs on the stage were rearranged in an effort to keep Schwartz from dominating the sessions.

When Conaway got his $5 million loan, Schwartz pressed for a forgivable loan of his own. Schwartz' own restricted stock package was tanking.

In August of 2001, Conaway approached Kmart's board to expand the loan program to Schwartz and other officers.

It was a critical period. The BlueLight Always program turned chaotic. Store managers struggled to maintain adequate inventory levels. The price cuts drained cash from a company already awash in red ink. Vendors complained of late payments.

Yet throughout the fall of 2001 Conaway lobbied the board for a retention loan program that would cover dozens of executives. Some of the execs, brought in from Wal-Mart by Schwartz, had been with Kmart only a few months. In November, amid plunging sales and a dismal start to the holiday selling season, Kmart's board approved a broad, conceptual executive loan program to be administered by Conaway and human resources chief David Rots.

Within days, on Dec. 3, the cash started flowing.

One after another, 20 executives received loans ranging from $300,000 to the $3 million given to Schwartz. Kmart would also paid him an additional $2.4 million to cover his taxes in 2001.

A letter from Conaway accompanied the loan deals received by each exec.

"We have many more obstacles to overcome," Conaway wrote, "before we have succeeded in creating the greatest turnaround in retail history."

But by then, Kmart was in a free fall. On Dec. 21, its stock sunk to a 20-year low of $5 a share. Moody's Investors Service slashed Kmart's debt rating to junk-bond status, and Prudential Securities analyst Wayne Hood issued a report suggesting bankruptcy as a real possibility for Kmart.

Adamson said outside directors had "no idea" that bankruptcy was a possibility until Hood issued his report. Incredibly, the directors could not even find Conaway, who was on vacation at the time.

On Jan. 14, the Kmart board convened for a tense, two-day meeting. At the end, Schwartz was fired. He walked away with his $3-million retention loan.

A week later, Conaway cut a last deal, or so he thought. Stripped of his chairman's title — which was given to Adamson — Conaway negotiated a $6.5-million lump-sum payout if he was "terminated" within 18 months. The following day, Kmart filed for Chapter 11 bankruptcy.

Less than two months later, Conaway was out. His last employment contract was rejected by the bankruptcy court. He left with a cash severance of $4 million — and, in final negotiations, Kmart forgave his $5-million retention loan.

Kmart's creditors and shareholders vehemently protested the final payouts to Conaway and Schwartz, and the money isn't necessarily gone for good.

"The court has broad powers to recover money paid out in the months leading to bankruptcy," said Michael Sirkin, a compensation expert with the New York law firm Proskauer Rose LLP.

Conaway has kept a low profile since his firing. Security guards watch over his gated estate, which reportedly is up for sale for $5.8 million.

Schwartz, for his part, is running his convenience store business in the rural Black Hills of South Dakota and said he wants a more modest lifestyle.

"Just look at our house in Detroit compared to our house here," he said. "It looks like Sanford and Son."

He said he plans to leave his troubles at Kmart far behind.

Title to his property in South Dakota, court records show, was transferred on May 20 to his wife's name.

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