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The Story of Kmart's Reorganization

John Fisher

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The Story of Kmart's Reorganization

Jon Fisher

Justin Wolbert

5/4/2011



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LIST OF ACTORS

- Board of Kmart's Directors:** The body ultimately responsible for filing bankruptcy, and writing the plan for reorganization.
- Creditors Committee:** Represented by Otterbourg, Steindler, Houston & Rosen, P.C. of NY. Co-Counsel is Winston & Strawn of Chicago IL. The committee's financial advisor is KMPG LLP. The committee was appointed January 31, 2002.
- Charles Conaway:** Kmart CEO 2000-2001.
- ESL Investments:** A hedge fund managed by Edward Lampert, who has been called the next Warren Buffett, which specializes in buying distressed organizations.
- Equity Committee:** Represented by Traub, Bonacquist & Fox, LLP of NY. Co-Counsel is Goldberg, Kohn, Bell, Black, Rosenbloom & Moritz, Ltd. of Chicago IL. The committee's advisor was Saybrook Restructuring Advisors. The committee was appointed on June 17, 2002.
- Financial Advisors:** Miller Buckfire Lewis & Co., LLC and Dresdner Kleinwort Wasserstein, Inc.
- Financial Institutions Committee:** Represented by Jones Day of Cleveland OH, Chicago IL, and Washington DC. The committee's advisor was FTI Consulting, Inc.
- Joseph Antonini:** Kmart CEO 1987-1995.
- Kmart:** As a whole, the company included the following entities: Kmart Corporation, Kmart Corporation of Illinois, Inc., Kmart of Indiana, Kmart of Pennsylvania LP, Kmart of North Carolina LLC, Kmart of Texas LP, Bluelight.com LLC, Big Beaver of Florida Development LLC, The Coolidge Group, n/k/a, TC Group 1 LLC, Kmart Michigian Property Services, L.L.C.,

Kmart Financing 1, Troy CMBS Property L.L.C., Big Beaver Development Corporation, Big Beaver of Guaynabo Development Corporation, Bluelight.com, Inc., Kmart Holdings Inc., Kmart of Amsterdam, NY Distribution Center, Inc., Kmart Stores of Indiana, Inc. f/k/a Kmart Logistics Services, Inc., Kmart of Michigan, Inc., Kmart Stores of TCNP, Inc., f/k/a Kmart Trading Services, Inc., Kmart Overseas Corporation, JAF, Inc., VTA, Inc., Big Beaver of Caguas Development Corporation II Big Beaver of Carolina Development Corporation, Kmart Pharmacies, Inc. Builders Square, Inc., and Sourcing & Technical Services Inc.

Kmart Creditor Trust:

The entity the plan implemented to oversee unsecured creditors' claims against Kmart.

Mark Schwartz:

Kmart President 2000-2001.

Plan investors:

ESL & Third Avenue Trust.

Restructuring Advisors:

Alix partners LLC.

Sebastian S. Kresge:

Founder of Kmart.

**Skadden, Arps, Slate,
Meagher &Flom:**

Counsel for Kmart.

John William Butler, Jr.

“Jack Butler co-leads Skadden’s global Corporate Restructuring practice, which works to provide innovative, practical legal solutions to clients involved in distressed company situations.... In December 2010, Mr. Butler was one of 10 lawyers profiled for delivering “creative solutions” to clients during the credit crisis in the *Financial Times*’ inaugural “U.S. Innovative Lawyers” report, where the firm ranked first nationwide for innovation and received top rankings in corporate restructuring, M&A and financial services.”¹

¹ <http://www.skadden.com/index.cfm?contentID=45&bioID=695>

J. Eric Ivester

“J. Eric Ivester represents clients in business reorganizations, acquisitions and divestitures. Mr. Ivester has represented debtors, creditors, investors, sellers, purchasers and other financial advisors in all stages of complex restructuring transactions, from Chapter 11 reorganizations to out-of-court negotiations, workouts and divestitures.”²

Mark A. McDermott

“Mark McDermott represents public and private corporations and their principal stakeholders in troubled company M&A, restructuring and financing transactions. He has represented corporations in out-of-court restructurings, prepackaged and prearranged Chapter 11 cases, and traditional Chapter 11 cases....Mr. McDermott recently was named one of America’s “Outstanding Young Restructuring Lawyers” by *Turnarounds & Workouts* magazine. He also was named to the *Euromoney and Legal Media Group’s 2009 Expert Guide to the World’s Leading Insolvency and Restructuring Lawyers*.”³

Judge Susan Pierson Sonderby:

The judge of the bankruptcy court. She earned her B.A. from the University of Illinois in 1969 and graduated with a J.D. from The John Marshall School of Law in 1973. She was originally appointed for a fourteen year term as a bankruptcy judge in the Northern District of Illinois in 1986. She was elevated to Chief Bankruptcy Judge in 1998 and re-appointed by the Seventh Circuit in 1999. Her current term expires in 2014.

Subsidiaries:

The 37 affiliated debtors who are owned by Kmart Corporation but are legally separate identities.

² <http://www.skadden.com/Index.cfm?contentID=45&bioID=704>

³ <http://www.skadden.com/Index.cfm?contentID=45&bioID=2197>

Unsecured Creditors' Committee: The body that represents all the unsecured creditors' claims.

KEY TERMS

Automatic Stay:	Provides legal protection to debtors. Found in Bankruptcy Code §362. In short, it bars most creditor actions to enforce prepetition obligations or debts owed by a debtor and allows the Debtor to continue to operate while reorganizing.
Bankruptcy Court:	The United States Bankruptcy Court for the Northern District of Illinois (Eastern Division).
Critical Vendors:	Vendors which Kmart regarded as essential to the success of the reorganization.
DIP Financing:	A loan provided to Kmart to support continued operations during the pendency of the bankruptcy case. Kmart received approximately \$2 billion dollars in DIP Financing.
Disclosure Statement:	A written statement by Kmart providing sufficient information to enable relevant investors to make informed decisions about the plan.
Effective Date:	The date that the plan of reorganization went into effect and the automatic stay is lifted.
New Holding Company:	A successor corporation created pursuant to the terms of the Plan of Reorganization. After the plan was approved, The New Holding Company changed its name back to “Kmart Holdings.”
New Operating Company	An intermediary company that houses upper-level management of the reorganized enterprise that will in turn own, directly or indirectly, various corporate and other entities that will own and operate the business of reorganized Kmart.
Petition Date:	January 22, 2002: the date Kmart filed its bankruptcy petition.

Plan of Reorganization:

The findings of fact and conclusions of law which detailed the future rights and obligations of the reorganized Kmart.

Chapter One

THE RISE OF KMART

Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1.
Warren Buffett

The American Dream is the belief that a person can go from dirt poor to filthy rich in a single lifetime. This dream is the aspiration of millions, but it is only realized by a select few. The stories of those who have lived the American Dream, such as the Rockefellers and Carnegies, have been passed down in hagiographic detail. A less known story is that of Sebastian S. Kresge, the founder of Kmart. In 1897 he started a five and ten cent store with



In 1957, S. S. Kresge leads his team around the swimming pool on his 26 acre estate. Co-author Jon Fisher's great-grandfather is the fifth person from the right.

an \$8,000 loan, and he incorporated S.S. Kresge on March 9, 1912. By 1924, he had a personal worth of \$5,000,000,000 in 2009 US dollars. Under the leadership of the company's president, Harry Cunningham, the first Kmart store was opened in 1962.⁴ Kmart's growth was explosive. For example, 271 Kmart stores were opened in 1976 alone.⁵

By the 1980's, Kmart was a retail giant, and the company was ready to use its financial power to support new ventures. In 1984, Kmart acquired Walden Book Company and Home Centers of America. In 1990, it purchased Sports Authority. In 1991, it became the

⁴ International Directory of Company Histories, Vol. 47. St. James Press, 2002.

⁵ *Id.*

controlling partner in OfficeMax when it acquired 91% of the company. In 1992, Kmart purchased Borders Books.⁶

By 1995, Kmart was the world's fifteenth largest corporation. The company's gross sales totaled \$34,313,000,000 and resulted in a profit of \$2,960,000,000.⁷ By early 2002, Kmart was nation's second largest discount retailer⁸ and the third largest general merchandise retailer.⁹ Kmart operated 2,114 stores, including 136 supercenters, with locations in each of the 50 United States, Puerto Rico, U. S. Virgin Islands, and Guam.¹⁰ Kmart's retail operations were located in 308 of the 324 metropolitan statistical areas in the nation. Kmart had relationships with more than 4,000 merchants worldwide and had more than 5,000 leases and subleases with 3,240 landlords and subtenants. Kmart had over 6,300 executory contracts and employed approximately 234,000 people on a payroll of 5 billion dollars in salaries and benefits.¹¹

Kmart's success was based on two main strengths: buying power and brand awareness.¹² First, the size of the company allowed it to buy goods cheaply and in bulk. For more than a decade, Kmart had over 30 billion in net sales and contracted with over 4,000

⁶ These acquisitions would later prove to be financial failures. See Chapter Two.

⁷ International Directory of Company Histories, Vol. 47. St. James Press, 2002.

⁸ Wal-Mart was the largest discount retailer.

⁹ Wal-Mart was first, and Target was second.

¹⁰ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 7, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL)

¹¹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 7, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL)

¹² International Directory of Company Histories, Vol. 47. St. James Press, 2002.

merchants. Kmart was able to acquire exclusive brand rights for national prominent goods such as: Martha Stewart Living, Jaclyn Smith, Kathy Ireland, Disney non-character apparel for infants and children, Joe Boxer, and Route 66.¹³ Second, Kmart's rapid expansion provided universal brand awareness. Over 95% of Americans lived within 15 miles of a Kmart. Further, Kmart had circulars that reached into over 70 homes and a steady flow of e-commerce on its company website.¹⁴ Sebastian Kresge's company was living the American Dream.

¹³ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 8 , In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II)

¹⁴ *Id* at 6.

Chapter Two

CIRCLING THE WAGONS: KMART BEGINS TO SLIP

"Think of Kmart as a sick uncle. He has been coughing and wheezing for years. Now he has to have major surgery. We hope he survives the knife. But he will never be what he once was. "
Tom Walsh, Free Press Columnist, January 2002.

Like all good things, Kmart's rise to power eventually came to an end. Kmart's demise was caused by three main factors. First, Kmart failed to develop a consistent company philosophy. Second, Kmart developed a corporate culture with low levels of management accountability and high levels of compensation. Third, Kmart was simply unable to compete with Wal-Mart. In particular, Wal-Mart bested Kmart with superior supply chain development and management, revenue, and product turnover.

A. Kmart is different from Wal-Mart and Target

One of Kmart's central problems was the lack of a coherent corporate philosophy. In the early 2000's, Kmart was awkwardly positioned between Target, which was known for reasonably priced style, and Wal-Mart, which was known for rock bottom prices. In an attempt to compete on a different plane, Kmart experimented with investments in other companies, such as Office Max, Walden Books, and Sports Authority.¹⁵ However, Kmart did not develop these assets, and soon abandoned its investments.¹⁶

B. Corporate Payments

At the same time that Kmart was struggling to find its identity, Kmart's corporate officers feasted on a tradition of expensive perks. For instance, Joseph Antonini, Kmart's

¹⁵ See Chapter 1.

¹⁶ *International Directory of Company Histories*, Vol. 47. St. James Press, 2002.

Chairman and CEO from 1987-1995, traveled luxuriously with the choice of five corporate jetseven as the fortunes of the company began to decline¹⁷ Further, Mr. Antionini complacently ignored technological advancements. For instance, he was proud that he never used an Automated Teller Machine, and he used an assistant to print his email. The corporation as a whole did not begin to use videoconferencing until the 2000's.¹⁸

By the time that Kmart filed for bankruptcy, corporate compensation was high. Charles Conaway, the Chairman and CEO of Kmart at the beginning of 2002, collected



Conaway's "temporary housing"

nearly \$23 million in compensation over the period of 11 months. Several months before Kmart filed for bankruptcy, he received a \$5 million retention loan.¹⁹ He lived in a 29-room mansion and billed Kmart \$523,000 in "temporary housing and living costs." His original contract provided him \$1.4

million in annual salary, \$6 million in up-front cash and stock bonuses, and a restricted stock award worth \$5.4 million.²⁰ Despite this approximately \$12 million in salary for one year

¹⁷ By comparison, Wal-Mart's only aircraft was a two-seat propeller aircraft that Sam Walton flew himself. While this is a limited snapshot of the men in charge at their respective companies, it illustrates the broad principal that Kmart was will to splurge into excess and Wal-Mart really believed in its "save more" philosophy. See Robert Dickie, *Financial Statement Analysis and Business Valuation for the Practical Lawyer* 158 (ABA 2002).

¹⁸ Marcia Turner, *Kmart's 10 Deadly Sins: How Incompetence Tainted An American Icon* 136 (John Wiley & Sons Inc. 2003).

¹⁹ Max Oritz, *Kmart's Road to Bankruptcy*, *The Detroit News*, Aug. 12, 2002.

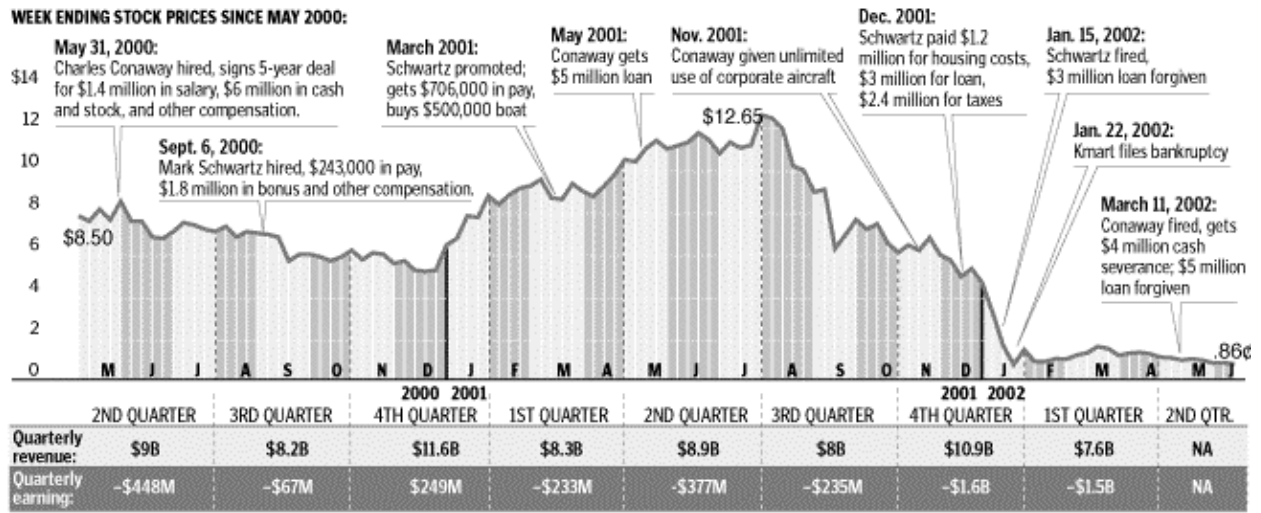
²⁰ By comparison, the previous CE Floyd Hall, earned approximately \$3 million in salary and bonuses in 1999.

worth of work, Conway was also promised an additional \$15 million in cash and stock payments to cover “foregone compensation” from his previous employer.

Mark Schwartz, the president of Kmart at the beginning of 2002, was also given enormous sums of money for driving the company to the brink of bankruptcy. Over 16 months, he made \$10.8 million, including \$4 million in retention bonuses and \$1.4 million in unspecified housing costs. As well, Kmart paid him \$2.4 million in 2001 to reimburse him for his income taxes.²¹ The payments made to Schwartz and Conway are summarized on the following chart.

Executives cash in as Kmart stock declines

Since May 2000, the Troy-based discount retailer has been rocked by financial problems as former executives Charles Conway and Mark Schwartz were given a combined \$34 million in compensation.



Despite receiving personal fortunes, Schwartz and Conway also added luxury to the lives of other company executives. They purchased two corporate jets to add to Kmart’s fleet and approved a program that awarded executives with Jaguars and Land Rovers as their company cars. Besides these company programs, the pair also authorized over \$20 million

²¹ Max Oritz, *Kmart's Road to Bankruptcy*, The Detroit News, Aug. 12, 2002.

in retention loans to 23 other Kmart executives ranging in amount from \$300,000 to \$3 million.²² Charles Conway stated at his first annual meeting that Kmart was going to “close the gap” on Target and Wal-Mart.²³

C. Kmart vs. Wal-Mart

Without a coherent, distinguishing corporate philosophy, Kmart was unable to compete with the rise of Wal-Mart during 1988, Kmart was larger than Wal-Mart and earned higher revenues: Wal-Mart had net income of \$627 million on \$16 billion in revenues, whereas Kmart had a net income of \$692 million on \$26 billion in revenue.²⁴ By 1994, however, Wal-Mart had earnings of \$2.3 billion and revenue of \$68 billion, while Kmart had a \$1 billion loss and revenues of \$28 billion.²⁵

Kmart’s demise at the hands of Wal-Mart was caused by three main weaknesses. First, Wal-Mart developed more effective supply chains. Second, Wal-Mart developed a higher revenue stream. Third, Wal-Mart experienced a much higher turnover of inventory.

i. Supply Chain

Wal-Mart’s central strength was its well-constructed supply chains. Wal-Mart had almost no supply storage areas because its vendor-managed inventory system made suppliers responsible for delivering product exactly when it was needed. Wal-Mart’s system was known as “just in time” inventory management.²⁶

²² Kmart’s road to bankruptcy Detroit News, Aug. 12, 2002. Bill Vlastic, Mark Truby, & David Shepardson

²³ “My commitment is within 720 days to get the business fixed structurally and culturally... we’re definitely on track.” 24 Robert Dickie, *Financial Statement Analysis and Business Valuation for the Practical Lawyer* 157 (ABA 2002).

²⁵ Id.

²⁶ Now in Bankruptcy, Kmart struggled with supply chain Steve Konicki, information week, Jan 28, 2002

In contrast, at Kmart it was not unusual for a supplier's sales representative to find shelves empty but products piled up in stockrooms. Even major brands such as Martha Stewart were not supplied properly.²⁷

As well, Kmart's management simply refused to utilize supply chain technology even as it was embraced by Wal-Mart. For instance, Kmart had a contract with i2 Technologies Inc. regarding logistics-monitoring and transportation-management software as well as a custom version of TradeMatrix supply-chain software. But after signing the contract, Kmart decided to write off the \$130 million dollar investment and not implement any changes until it reengineered its business structure.²⁸

ii. Revenue Stream & Overhead

In 1988, Kmart spent \$0.231 in overhead for every dollar earned, but Wal-Mart only spent \$0.163. Naturally, this allowed Wal-Mart to have lower prices and higher profits. In part because of lower pricing, Wal-Mart was able to outgrow Kmart.²⁹

From 1996 to 2002 Kmart's sales increased 14.2% and its sales per square foot increased 27.7% to \$235.³⁰ During 2002, however, Kmart was deep into the red and posted losses of \$3.2 billion. Part of the reason why Kmart's growth was insufficient to keep it in the black was the intense pressure it was facing from Wal-Mart. During the same 1996-2002 time period, Wal-Mart increased its sale per square foot by 30.9% from \$311 to \$407. At the

²⁷ Even Martha complained of distribution problems and the difficulty customers had locating her products. For such customers, she said, "If you are frustrated, keep looking."

²⁸ Steve Konicki, *Now In Bankruptcy, Kmart Struggled With Supply Chain*, Information Week, Jan. 28, 2002, at 13.

²⁹ Kmart was growing at 9% a year, while Wal-Mart was growing at 40% a year.

³⁰ Robert Dickie, *Financial Statement Analysis and Business Valuation for the Practical Lawyer* 163 (ABA 2002).

time Kmart filed for bankruptcy, Wal-Mart made \$172 per year more than Kmart per square foot of store.

From 1991 to 2002, Kmart increased its revenues from \$24.9 billion to \$36.2 billion, an increase of 45%,³¹ but Wal-Mart increased its revenues more than five-fold. As well, Wal-Mart was able to supply goods cheaper and faster than Kmart.³²

iii. Asset Turnover

The asset turnover of a store is the amount of sales revenue generated for every dollar's worth of assets. In general, discount retailers such as Wal-Mart and Kmart strive to have a high asset turnover. In 2002, Kmart had an asset turnover of 4.9.³³ In contrast, Wal-Mart's turnover was 6.6. Thus, in terms of volume increases and the ability to spread costs over more sales, Kmart was simply unable to compete with Wal-Mart.³⁴

In conclusion, it was evident to Kmart that the company was losing ground to Wal-Mart throughout the 90's and early 2000's. Unable to compete with Wal-Mart on prices, Kmart began to look into cutting its fixed costs. Kmart determined that, to remain competitive with Wal-Mart, fixed costs would have to be cut by \$347 million (9%). Despite the efforts of management, Kmart simply lacked the necessary logistics expertise, the sales volume, and the management commitment to achieve this kind of cut.³⁵ Even if Kmart

³¹ When adjusted for inflation, Kmart's increase in revenue was 11%.

³² *Id.*

³³ The rate Wal-Mart had in 1991.

³⁴ *Id.*

³⁵ Robert Dickie, *Financial Statement Analysis and Business Valuation for the Practical Lawyer* 164 (ABA 2002).

could make the necessary cuts, it still lacked the facilities needed to generate the necessary sales and could not afford to build new stores.³⁶

³⁶ *Id.* at 165

Chapter Three

BLUE LIGHT ALWAYS VS. EVERYDAY LOW PRICES

"It takes as much imagination to create debt as to create income."

Leonard Orr

In an effort to restore the fortunes of the company and find a way to compete with Wal-Mart, Kmart hired Charles Conaway as the new CEO.³⁷ Conaway decided that Kmart should return to its roots and become the nation's number one low-priced realtor. To implement this plan, Conaway decided to implement drastic price cuts in an attempt to lure customers from Wal-Mart. This decision had disastrous results.

To implement Conaway's new plan, Kmart began the "blue-light always" campaign.³⁸ The company planned to put 50,000 items on sale nationwide. This signaled a major change in retail strategy for Kmart.³⁹

The new program was not supported by Kmart's board or by their vendors. The board of directors did not approve of the program and wanted a trial-run before it began. Further, Kmart did not even consult with its suppliers to get their feedback or ask for their support.⁴⁰ Despite the lack of support, Conaway moved forward with the program.

³⁷ Conaway was the former president and COO of CVS, the second largest pharmacy chain in the United States. International Directory of Company Histories, Vol. 47. St. James Press, 2002.

³⁸ International Directory of Company Histories, Vol. 47. St. James Press, 2002.

³⁹ The traditional strategy was a promotion-driven business model where Kmart would offer numerous items highly discounted prices in the hopes when shoppers came in, they would buy other items.

⁴⁰ Marcia Turner, Kmart's 10 Deadly Sins: How Incompetence Tainted An American Icon 157 (John Wiley & Sons Inc. 2003).

This maneuver proved to be a critical mistake. Not only did Wal-Mart move quickly and ruthlessly to match or undercut Kmart's lowered prices, but Kmart also compounded its mistake by simultaneously cutting back its distribution of expensive advertising circulars. Customers, accustomed to receiving the advertising in the Sunday paper, simply stopped shopping. Same-store sales fell throughout the final months of 2001, including during the crucial holiday selling season.⁴¹

In short, Kmart could not match Wal-Mart on price, could not increase its sales enough to cover its costs, and could not cut its overhead enough break even.⁴² In 1991 Kmart had a market capitalization of \$8.6 billion. As of 2002, Kmart's market capitalization was reduced to a mere \$200 million, a destruction of 98% of its value.⁴³

⁴¹ Marcia Turner, *Kmart's 10 Deadly Sins: How Incompetence Tainted An American Icon* 157 (John Wiley & Sons Inc. 2003).

⁴²*Id.*

⁴³ *Id.*

Chapter Four

DEBT IS A FOUR LETTER WORD

“Buy what thou hast no Need of and ere long thou shalt sell thy Necessaries.”
Benjamin Franklin

Like a consumer who solves financial difficulties by signing up for a new credit card, Kmart soon found itself buried in debt obligations. Kmart entered into a three-year credit agreement⁴⁴ on December 6, 1999 that provided it with a revolving facility of \$1.1 billion.⁴⁵ On November 13, 2001, Kmart entered into a one year agreement with various lenders⁴⁶ that extended it \$400 million on a revolving credit basis.⁴⁷ In 2002, Kmart owed approximately \$2.1 billion in principal under unsecured indentures⁴⁸ to the Bank of New York. On November 1, 1994, Kmart was also a party to commercial development revenue refunding bond indentures⁴⁹ with an outstanding principal balance of \$1.8 million.

In the late 80's and early 90's, Kmart acquired several companies only to abandon them a few years later.⁵⁰ When Kmart later sold these companies, it did so at a loss and

⁴⁴ Held by Chase Securities Inc., JP Morgan Securities, The Chase Manhattan Bank, Bank of America, Bank Boston N.S. and Bank of New York.

⁴⁵ As of the petition date, Kmart owed the fund \$813 million. Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 10, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

⁴⁶ *Id.*

⁴⁷ By 2002, Kmart was indebted \$393 million to its lenders plus accrued interest and applicable costs, expenses, and fees. *Id.*

⁴⁸ An indenture is a written agreement between the issuer of a bond and the bondholders which specifies the interest rate, maturity date, and convertibility. In essence, an unsecured indentured is simply an unsecured bond.

⁴⁹ *Id.*

⁵⁰ These companies included The Sports Authority, Borders, and Office Max. See Chapter One.

remained obligated to the debt incurred in these leveraged acquisition transactions. As of early 2002, Kmart owed \$70 million in industrial revenue bonds and was indebted to lease agreements that had a present value of \$314 million.⁵¹

In sum, Kmart was heavily indebted on a three-year loan it received in 1999. When it became obvious that it could not meet its financial obligations, it acquired a new loan for a single year in the hopes of turning the corner and getting back into the black. After Kmart performed poorly in the 4th quarter of 2001, a critical quarter for retailers, it was boxed in. It could not afford to pay its loans, debt obligations, or its creditors.⁵²

⁵¹ Over the full life of the leases, the value would balloon out to \$519 million. *Id.*

⁵² The total debt to equity (D/E) ratio is a comparison between a company's combined long and short-term debt to shareholders' equity, or book value. The D/E ratio is 1.0 when debt equals equity, and high debt companies have higher D/E ratios than low debt companies. Kmart using the discount retailer's January 2001 fiscal year report, (\$8 share price), and again using its October 2001 quarterly report, (\$7). Kmart's January 2001 D/E of 0.5 put it only marginally into the high-debt category, its October D/E ratio was .8. *See* Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 8, *In re Kmart Corporation, et al.*, Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

Chapter Five

THE BEGINNING OF THE END

How did you go bankrupt? Gradually, then suddenly.
Ernest Hemingway

For Fiscal Year 2001, Kmart had gross sales of approximately 36 billion, administered 14.3 billion in assets and had outstanding liabilities of 10 billion dollars. However, declining sales had resulted in a liquidity crisis.⁵³ Furthermore, major vendors were beginning to halt shipments of goods.⁵⁴ On January 21, 2002, Fleming Companies, Kmart's sole grocery provider, sent the management of Kmart a letter stating that it would be halting all shipments to Kmart stores. Later that day, Kmart's board voted to file for relief under chapter 11 of the United States Bankruptcy Code.⁵⁵

Although Kmart's bankruptcy was likely inevitable, two factors probably contributed to Kmart's filing on January 22, 2002. First, Kmart had already begun talks with potential financiers. By late January, Kmart had secured promises for \$2 billion in post-petition financing.⁵⁶ Second, Kmart was facing increasing demands from its vendors. Declining sales had resulted in a liquidity crisis, and major vendors were beginning to halt shipments of

⁵³ 4th quarter sales were substantially lower than expected and Kmart did not have cash on hand to pay its obligations on its loans.

⁵⁴ Fleming wanted.

⁵⁵ Constance L. Hays, Big Grocery Supplier Files for Bankruptcy Protection (NYT, April 2, 2003). Fleming itself was forced to file for bankruptcy about a year later when Kmart cut off its distribution arrangement with Fleming. *Id.*

⁵⁶ *Id.*

goods.⁵⁷ On January 21, 2002, Fleming Companies, Kmart's sole grocery provider, sent the management of Kmart a letter stating that it would be halting all shipments to Kmart stores. Later that day, Kmart's board voted to file for relief under chapter 11 of the United States Bankruptcy Code.⁵⁸

⁵⁷ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 8 , In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

⁵⁸ Constance L. Hays, Big Grocery Supplier Files for Bankruptcy Protection (NYT, April 2, 2003). Fleming itself was forced to file for bankruptcy about a year later when Kmart cut off its distribution arrangement with Fleming. *Id.*

Chapter Six

BLACK FRIDAY

*You owe me ten shillings,
Say the bells of St. Helen's.
When will you pay me?
Say the bells of Old Bailey.
When I grow rich,
Say the bells of Shoreditch.
Pray when will that be?
Say the bells of Stephney.
I am sure I don't know,
Says the great bell at Bow...
Here comes a candle to light you to bed,
Here comes a chopper to cut off your head.
Nursery Rhyme*

The previous chapters have summarized the events that brought Kmart to the brink of bankruptcy in the beginning of 2002. Unable to find a solution to its financial difficulties, Kmart filed a voluntary petition for Chapter 11 bankruptcy on Friday, January 22, 2002 in the Northern District of Illinois. The case was assigned to Judge Susan Pierson Sonderby.⁵⁹

A. Kmart's Story

It is likely that Kmart was brought to the brink of bankruptcy by corporate mismanagement, the lack of a company philosophy, and a failed price war with Wal-Mart.⁶⁰ Unsurprisingly, this was not the story that Kmart presented to the bankruptcy court. According to Kmart, the company needed to file for bankruptcy protection in 2002 due to circumstances largely out of its control. Kmart asserted that Wal-Mart and Target had provided significant competition in the years leading up to the bankruptcy. Additionally, the

⁵⁹ See List of Characters.

⁶⁰ See Chapter Four.

company argued, the market forces were to blame, including “the evaporation of the surety bond market, and an erosion of supplier confidence, as well as intense competition in the discount retailing industry, unsuccessful sales and marketing initiatives, the continuing recession, and recent capital market volatility.”⁶¹

Despite the market limitations claimed by Kmart, the company was still an industry leader in discount retailing. Through reorganization, Kmart hoped to “improve [its] operating performance and to realize significant cost savings.”⁶² Kmart intended to use the restructuring process to bring its debt in line with its cash flow generating capability and competitors. Kmart felt that the reorganization “should create financial flexibility for future operating requirements and capital expenditures and improve liquidity.”⁶³

B. First Day Motions

Like all Chapter 11 bankruptcies, Kmart’s started with a flurry of activity. On the first day, Tuesday, January 22, 2002, Kmart filed twenty-three motions.⁶⁴ Many of these

⁶¹ Motion For Order (i) Authorizing the Debtors to Pay Petition Wages, Salaries, and Employee Benefits; (ii) Authorizing

the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and (iii) Directing All banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations, Filed Jan. 22, 2002.

⁶² *Id.*

⁶³ *Id.* The goals of reorganization listed in the first day motions are vague. There are at least two explanations for this: (1) the first day motion was badly written; (2) Kmart really didn’t any clear reorganization strategy beyond shedding debt through bankruptcy. The second option is more likely. See Chapter Thirteen.

⁶⁴ Kmart’s motions included: MOTION for an Order Authorizing the Debtors to Mail Initial Notices in Lieu Providing a Mailing Matrix Required under Local Rules; MOTION for an Order Granting Extension of Time to File Schedules and Statements; MOTION for an Order Pursuant to 11 U.S.C.102 and 105[a], Bankruptcy Rules 2002[m] and 9007, and Local Rules 101, 400, and 402 Establishing Omnibus Hearing Dates and Certain Notice, Case Management and Administrative Procedures; MOTION for an Administrative Order Pursuant to 11 U.S.C. 105[a] and 331 Establishing Procedures for Interim Compensation and Reimbursement of Expenses Professionals; MOTION for an Order Pursuant to 11 U.S.C. 105[a]327[a] and 331 Authorizing Retention of Professionals Utilized by Debtors in the Ordinary Course of Business; MOTION for an Order Pursuant to 11 U.S.C.105, 345 and 363 Authorizing [A] Continued Maintenance of Existing Bank Accounts, [B] Continued Use of Existing Cash Management System, [C] Continued use of Existing Business Forms, [D] Continuation of Intercompany Transactions with Non-Debtor Subsidiaries and Affiliates, and [E] Waiving Investment and Deposit Requirements; MOTION for an Order Pursuant to 11 U.S.C.105[a],365 and 507[a][6].

were ruled upon a mere three days later. This section will be divided into two parts. First, the traditional foundations for first day motions will be examined. Second, several of the typical first day motions filed by Kmart will be summarized.

i. Traditional Foundations for First Day Motions

Under the bankruptcy code, the general rule is that a debtor cannot pay the pre-petition claims of a creditor.⁶⁵ First day critical vendor and employee wage payment orders and the like evolved as exceptions to this rule. A typical first day motion in general allows

Authorizing Continuation of Certain Customer Practices; MOTION for Order Under 11 U.S.C. 365[a] Authorizing the Debtors to Assume Certain Services Agreement with Non-Executive Chairman; MOTION for Order [i] Authorizing the Debtors to Pay Pre-petition Wages, Salaries, and Employee Benefits,[ii] Authorizing the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and [iii] Directing All Banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations; MOTION for Order Under 11 U.S.C. 105[a]363[b][1] and 363[a] Authorizing Debtors to Implement a Key Employee Retention Plan; MOTION for Order Under 11 U.S.C. 265[a] Authorizing the Debtors to Assume Certain Employment Agreements with Senior Management Employees; MOTION for Entry of Order Pursuant to 11 U.S.C.105[a],366 503m and 507 of the Bankruptcy Code [1]Prohibiting Utilities from Alteringm, Refusing or Discounting Servcies on Account of Pre-petition Invoices and [11]Establishing Procedures for Determining Requests for Additional Assurance; MOTION for an Order Pursuant to 11 U.S.C. 105 Authorizing Payment of Pre-petition Claims of Consignment Vendors and Customer Service Providers and Approving Procedures Concerning Consigned Goods; MOTION for Order Under 11 U.S.C. 105[a] Authorizing the Payment of Pre-petition Claims of Certain Critical Trade Vendors; MOTION for an Order Pursuant to 11 U.S.C. 105[a],541,and 507[a][8] Authorizing the Debtors to Pay Pre-petition Sales, Use, Trust Fund and Other Taxes and Related Obligations; MOTION for an Order Pursuant to 11 U.S.C. 105[a] Authorizing Payment of Certain Pre-petition Shipping and Delivery Charges; MOTION for an Order Pursuant to 11 U.S.C. 363 and 546[g] Authorizing Debtors to Implement a Vendor Return Program and Granting Related Relief; MOTION for an Order Pursuant to 11 U.S.C. 105[a],503[b] and 546[b] Authorizing Payment of Contractors and Service Providers in Satisfaction of Liens; MOTION for Order Pursuant to 11 U.S.C.105[a]and 363 Authorizing Payment of Pre-petition Obligations Necessary to Obtain Imported Merchandise; MOTION Pursuant to 11 U.S.C. 105,362,503 and 546 for entry of Interim and Final Orders [1] Providing Administrative Expense Treatment for certain Holders of Valid Reclamation Claims and [11] Establishing Procedures for Resolutions and Payment of Reclamation Claims; MOTION for Entry of Interim and Final Orders [1] Providing Administrative Expense Treatment for Paca and Pasa Trust Claims Procedures and [11] Establishing Procedures for Resolutions and Payment of Paca and Pasa Claims; MOTION for an Order Pursuant to 11 U.S.C. 105[a] and 365[a] Authorizing [A] Rejection of Certain Unexplained Real Estate Leases and [B] Approving Procedures for Rejecting Other Unexpired Leases; and MOTION for Interim and Final Order Authorizing Debtors to Obtain Post-petition Financing Pursuant to 11 U.S.C.105,361,362,364[c][2] and 364[c][3]. *See* Docket Report.

⁶⁵ Brandi McCoy, *The Last Day for First Day Orders: Attacks on the Practice of Paying Pre-petition Claims of Certain "Critical Vendors"*, 3 DePaul Bus. & Com. L. J. 321, 323 (2005).

the debtor to avoid complying with one or more requirements of the bankruptcy code.⁶⁶ A significant sub-category of first day order are those that allow payments of prepetition claims immediately, without confirmation of a plan of reorganization, in the case of, for example, “critical” vendors and employees that largely fund their lives paycheck-to-paycheck.

The first debtors to propose first day orders were railroads under the prior Bankruptcy Act of 1898, which, as amended, remained the law until it was replaced by the Bankruptcy Code of 1978, effective 1979.⁶⁷ The railroads claimed that their successful reorganization was essential to the public interest, and so public policy justified the payment of some pre-petition claims to ensure that the employees, employers, and vendors associated with the railroad were supportive of the reorganization.⁶⁸ The practice of allowing these payments became known as the “Doctrine of Necessity,” and the bounds of the doctrine were not clearly defined. And perhaps clear definition was not necessary or desirable to those that championed the doctrine’s use and development. When the typical railroad organization case involved hundreds of millions of dollars, the distribution of a few thousand via first day orders was not a matter of much concern.⁶⁹

The use of first day orders spread swiftly to non-railroad cases. They claimed that the court should allow pre-petition claims because “the debtor relies on certain vendors for critical products and services, and unless the debtor is permitted to pay its pre-petition debts

⁶⁶ Brandi McCoy, *The Last Day for First Day Orders: Attacks on the Practice of Paying Pre-petition Claims of Certain “Critical Vendors”*, 3 *DePaul Bus. & Com. L. J.* 321, 323 (2005).

⁶⁷ Brandi McCoy, *The Last Day for First Day Orders: Attacks on the Practice of Paying Pre-petition Claims of Certain “Critical Vendors”*, 3 *DePaul Bus. & Com. L. J.* 321, 323 (2005).

⁶⁸ Brandi McCoy, *The Last Day for First Day Orders: Attacks on the Practice of Paying Pre-petition Claims of Certain “Critical Vendors”*, 3 *DePaul Bus. & Com. L. J.* 321, 323 (2005).

⁶⁹ See Douglas G. Baird, *Bankruptcy From Olympus*, 77 *U. Chi. L. Rev.* 977, (961) (2010).

to these essential vendors, they likely will stop supplying the debtor, and the debtor's chances of successfully reorganizing will be impaired.”⁷⁰ The practice spread and, eventually, first day orders were increasingly applied to all cases, irrespective of size, as a matter of course.⁷¹ Courts gradually interpreted the railroad “Doctrine of Necessity” to be incorporated by the Bankruptcy code through 11 U. S. C. §105(a), the “all writs” statute, which states in part that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”

First day orders became standard in bankruptcies, even as the size of the payments of pre-petition debts grew in size, and many judges granted them as a matter of course. Perhaps some judges granted the motions because they rarely meet with firm opposition as they are filed before the creditor's committee is formed. Further, “judges are unlikely to push back out of the fear of being ‘labeled ‘toxic judges’ and find themselves out of the business of hearing large Chapter 11 cases.”⁷² Regardless of the reason, first day orders became standard in bankruptcies, even as the size of the payments of pre-petition debts grew in size.⁷³

ii. Typical First Day Motions

It is in this context, in which first day orders were granted as a matter of course, that Kmart filed its first day motions. Kmart filed many motions, including a request to employ

⁷⁰ Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, Am. Bankr. Inst. J., 2003 ABIJNL LEXIS 100, at *9-*10.

⁷¹ See Douglas G. Baird, *Bankruptcy From Olympus*, 77 U. Chi. L. Rev. 977, (961) (2010).

⁷² See *id.* at 977.

⁷³ See *id.*

Skadden, Arps, Slate, Meagher & Flom⁷⁴ and PricewaterhouseCoopers,⁷⁵ permission to continue customer practices (such as honoring gift certificates and warranties),⁷⁶ permission to pay employee wages and benefits,⁷⁷ permission to pay the expenses of professionals,⁷⁸ and permission to pay pre-petition debts to certain “critical vendors.”⁷⁹ For the purposes of illustration, this paper will analyze (1) the motion to pay employee wages and benefits, (2) the motion to permission to pay the expenses of professionals, (3) the motion to obtain DIP financing, and (4) the motion to pay “critical vendors.” These motions were chosen either because they represented the typical first day motions raised by Kmart or because their outcome became particularly significant for later cases.

1. Motion for Order Authorizing Payment of Pre-Petition Employee Wages and Benefits

As one of their first day motions, Kmart moved the court to enter an order “authorizing the Debtors to (a) pay the various pre-petition claims of the Debtor’s employees and independent contractors...and (b) continue the Debtors’ various Employee

⁷⁴ Application for an Order Pursuant to 11 U.S.C. §§ 327(a) and 329 Authorizing the Employment and Retention of Skadden, Arps, Slate Meagher & Flom (Illinois) and Affiliated Law Practice Entities as Attorneys for the Debtors (Filed Jan. 22, 2002). See also, Cast of Characters.

⁷⁵ Application Pursuant to Fed. R. Bankr. P. 2014(a) For Order Under Section 327(a) of the Bankruptcy Code Authorizing the Employment and Retention of PricewaterhouseCoopers LLP as Financial Advisors to the Debtors (Filed Jan 22, 2002). See also, Cast of Characters.

⁷⁶ Motion for an Order Pursuant to 11 U.S.C. §§ 105(a), 365 and 507(a)(6) Authorizing Continuation of Certain Customer Practices (Filed Jan. 22, 2002).

⁷⁷ Motion For Order (i) Authorizing the Debtors to Pay Petition Wages, Salaries, and Employee Benefits; (ii) Authorizing the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and (iii) Directing All banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations, 7 (Filed Jan. 22, 2002).

⁷⁸ Motion for an Administrative Order Pursuant to 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Interim Compensation and Reimbursement of Expenses of Professionals, 11 (Filed Jan 22, 2002).

⁷⁹ Cite.

benefit plans and programs.”⁸⁰ The average monthly payroll for Kmart’s 242,000 employees was \$342.9 million. At the time of filing, approximately \$43.0 million remained due for salaried employees, and \$159.2 million was due to hourly employees.⁸¹

At the time of Kmart’s chapter 11 filing, Sections 507(a)(3) and 507(a)(4) of the Bankruptcy Code required that the priority claims of each employee would be limited to \$4,650 in pre-petition wages and benefits.⁸² Kmart estimated that 97% of its workforce met this category.⁸³ However, Kmart did not provide more than an estimate, stating that “it is difficult for the Debtors to know the exact amount due each Employee for the pre-petition period.”⁸⁴

To the degree that Kmart’s requests exceeded the statutory priority limits of the Bankruptcy Code, they still claimed that the payments were justified under section 105. ⁸⁵Kmart noted that “[n]umerous courts have used their section 105(a) powers under the ‘doctrine of necessity’ to authorize payment of a debtor-in-possession’s pre-petition

⁸⁰ Motion For Order (i) Authorizing the Debtors to Pay Petition Wages, Salaries, and Employee Benefits; (ii) Authorizing the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and (iii) Directing All banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations, 7 (Filed Jan. 22, 2002).

⁸¹ *Id.*

⁸² *Id.* at 28.

⁸³ *Id.* at 9.

⁸⁴ *Id.* at 28. This statement is confusing. Kmart is asking for money to pay its employees, but then it is claiming that it doesn’t know exactly how much it needs to pay. Once the court granted Kmart’s motion, it seems likely that Kmart calculated the exact amount necessary to pay each employee before cutting the check. It is not clear why Kmart did not perform this analysis for the court. Perhaps, Kmart just assumed that the motion would be summarily granted, and that any attempt to pinpoint exact numbers would be unnecessary.

⁸⁵ *Id.* at 30.

obligations where, as here, such payment is an essential element of the preservation of the debtor-in-possession's potential for rehabilitation.”⁸⁶

As with all of its first day motions, Kmart supported the motion to pay employee wages with an affidavit of Charles Conaway. Conaway's testimony is detailed, and it directly states all of the facts alleged in the motion.⁸⁷

An order was entered by the court approving the motion on January 25, 2002.⁸⁸

2. Motion for the Payment of Expenses of Professionals

Another typical first day motion is a request to establish procedures for the interim payment of professionals. Although reading the code literally would suggest that professionals would wait until the end of the case – or at least for 120 day periods – to seek approval of and receive payment of their fees and reimbursable expenses, professionals are actually allowed to collect interim fees, generally subject to a retainage arrangement, like one used in construction contracts, during the course of the bankruptcy.⁸⁹ As the lawyers in *Kmart* were likely to incur large amounts of fees and expenses and were unwilling to provide their services on credit, on the first day of the bankruptcy case they filed a motion requesting the permission to pay the professionals involved in the bankruptcy. The motion cited Section 331 of the Bankruptcy Code, which allows professionals to apply for relief every 120

⁸⁶ *Id.* at 31-32.

⁸⁷ *See*, Affidavit and Statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, 44 (filed Jan. 22, 2002).

⁸⁸ Order (i) Authorizing the Debtors to Pay Petition Wages, Salaries, and Employee Benefits; (ii) Authorizing the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and (iii) Directing All banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations (Filed Jan 25, 2002).

⁸⁹ Jonathan P. Friedland, Michael L. Bernstein, George W. Kuney, & John D. Ayer, *Chapter 11 – 101, The Nuts and Bolts of Chapter 11 Practice: a primer*, 246 (American Bankruptcy Institute, 2007).

days, or more often if the court permits. Kmart requested monthly payment of all professionals. Under Kmart's requested procedure, each professional would submit a detailed monthly statement of services rendered and expenses incurred. If there was no objection, Kmart would pay ninety-percent of the bill for fees with a ten percent holdback, and one hundred percent of disbursements for the month. Kmart proposed that these payments would be "subject to the Court's subsequent approval as part of the normal interim fee application process approximately every 120 days."⁹⁰

As legal support for its motion, Kmart noted that "[s]imilar procedures for compensating and reimbursing court-approved professionals have been established in other large chapter 11 cases.... Such procedures are needed to avoid professionals funding the reorganization case." Of course, Kmart also cited the talismanic Section 105, although it did not explore its relation to this request in any detail.⁹¹

The court entered an order approving this motion on January 25, 2002.⁹²

3. DIP Financing

Although the filing of the bankruptcy provided with some breathing room regarding pre-petition creditors, Kmart still needed to continue operations as usual if the reorganization was to succeed. Unsurprisingly, Kmart did not have enough cash on hand to

⁹⁰ Order (i) Authorizing the Debtors to Pay Petition Wages, Salaries, and Employee Benefits; (ii) Authorizing the Debtors to Continue the Maintenance of Employee Benefit Programs in the Ordinary Course; and (iii) Directing All banks to Honor Pre-petition Checks for Payment of Pre-petition Employee Obligations (Filed Jan 25, 2002).

⁹¹ Motion for an Administrative Order Pursuant to 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Interim Compensation and Reimbursement of Expenses of Professionals, 11 (Filed Jan 22, 2002). It is likely that Kmart thought that this motion would be summarily granted and that extensive support was not necessary. See footnote 55.

⁹² Interim Order Authorizing PricewaterhouseCoopers LLP as Financial Advisors for the Debtors and Debtors in Possession (Entered Jan. 25, 2002).

fund the completion of the restructuring process. Therefore, Kmart concluded that it was necessary to obtain a firm commitment for post-petition financing at the outset of its case.⁹³

Kmart requested permission to obtain post-petition financing from JPMorgan Chase Bank and a syndicate of financial institutions (the “Post-petition Lenders”) up to the amount of \$2 billion. Under section 364(c)(1), Kmart moved to grant the Post-petition Lenders: (1) superpriority claim status; (2) perfected first priority liens on all unencumbered pre-petition and post-petition property; and (3) perfected junior security interests and liens on all pre-petition and post-petition property subject to valid, perfected, and non-avoidable liens.⁹⁴

Kmart was not able to procure the required post-petition financing in the form of unsecured credit or unsecured debt with an administrative priority, primarily because of the large amount of funds required by Kmart during the course of the bankruptcy proceedings.⁹⁵ Therefore, Kmart determined “in their sound business judgment” that the best option was the following:

- JPM Chase Bank, Fleet Retail, CSFB and GCC committed to provide \$500 million each;
- Kmart agreed to pay the underwriting fees;

⁹³ Affidavit and Statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, filed Jan. 25 2002.

⁹⁴ Motion for Interim and Final Order Authorizing Debtors to Obtain Post-petition Financing Pursuant to 11. U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(2) and 364(c)(3) Scheduling Final Hearing Pursuant to Fed. R. Bankr. P. 4001(c) (filed Jan. 22, 2002). Kmart does not appear to support this statement with anything more than the affidavit of Conaway. See Affidavit and Statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, filed Jan. 25 2002.

⁹⁵ Motion for Interim and Final Order Authorizing Debtors to Obtain Post-petition Financing Pursuant to 11. U.S.C. §§ 105, 361, 362, 364(c)(1), 364(c)(2) and 364(c)(3) Scheduling Final Hearing Pursuant to Fed. R. Bankr. P. 4001(c) (filed Jan. 22, 2002). Kmart does not appear to support this statement with anything more than the affidavit of Conaway. See Affidavit and Statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, filed Jan. 25 2002.

- JPMorgan Chase and JPM Securities were entitled to change the structure, terms pricing, or amount of the DIP Credit Facility; and
- Until each initial lender under the DIP Credit Facility was reduced by assignment to no more than \$250 million (or greater if satisfactory to the lender), the aggregate usage of the DIP Credit Facility will be limited to \$1.75 billion.⁹⁶

Kmart's motion was granted on January 25, 2002. In the order, the court incorporated the credit agreement as requested by Kmart.⁹⁷

⁹⁶ Affidavit and Statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, filed Jan. 25 2002.

⁹⁷ Order Approving DIP Credit Agreement and Related Documents (Entered on the Docket Jan. 25, 2002).

Chapter Seven

BEST FRIENDS: KMART'S CRITICAL VENDOR MOTION

The hot, harsh sun beats down on the hundreds, perhaps thousands, waiting in the line snaked around a solitary well. Those who are fortunate will receive a cupful or two of relief; others will get nothing.

Suddenly, a small group of figures push their way to the front.

"We'll each take a gallon," their leader says.

"But that's not fair. There's only so much to go around," the well keeper replies.

"We don't care, We're critical vendors."⁹⁸

In this chapter, the motion to pay critical vendors will be examined in detail. Although Kmart's motion to pay critical vendors was originally granted by the court, the bankruptcy court's order was reversed on appeal by the district court. To the surprise of many, the district court's reversal was upheld on appeal to the Seventh Circuit. The details of the critical vendor motion are necessary to understand the importance of this reversal.

A. The Bankruptcy Court Decision

As one of its twenty-five first day motions, Kmart Corporation requested authorization for payment of pre-petition claims of certain "critical" trade vendors.⁹⁹ In the motion, Kmart requested the authorization to pay vendors that were "essential to the uninterrupted functioning of the Debtor's business operations."¹⁰⁰ The vendors listed in the motion were the grocery vendor Fleming Companies, the music vendor Handleman

⁹⁸ Joseph Gilday, "Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code, 11 Am. Bankr. Inst. L. Rev. 411, 413 (2003).

⁹⁹ Motion for Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Pre-petition Claims of Certain Critical Trade Vendors, 1 (Filed Jan 22, 2002).

¹⁰⁰ *Id.* at 7-8.

Company, egg and dairy vendors, and other vendors who supplied goods and services related to advertising.¹⁰¹ All told, Kmart owed these vendors a total of \$183.8 million.¹⁰²

Table 1: “Critical” Vendors¹⁰³

Vendor	Relationship to Kmart	Total Owed
Fleming	Fleming was a food distribution company that supplied substantially all of the food and consumable products in the Debtor’s stores. Food sales accounted for \$4.2 billion, or 11%, of Kmart’s yearly sales.	\$76 Million
Handleman	Handleman was Kmart’s sole music vendor. Music sales in Kmart accounted for \$500 million, or 1.5%, of Kmart’s yearly sales.	\$64 Million
Egg and Dairy Vendors	Kmart’s eggs and dairy were supplied by a network of small vendors. Egg and dairy sales accounted for approximately \$160 million, or 0.5%, of Kmart’s yearly sales.	\$6.8 Million
Advertising	Kmart depended upon many newspapers, ad production businesses, and commodity paper suppliers to supply weekly newspaper advertisements. Kmart estimated that advertising generated \$11 billion, or 30% of their yearly sales.	\$37 Million

¹⁰¹ *Id.* at 8.

¹⁰² *Id.* at 9-11.

¹⁰³ Motion for Order Under 11 U.S.C. § 105(a) Authorizing the Payment of Pre-petition Claims of Certain Critical Trade Vendors, 1 (Filed Jan 22, 2002).

What made the critical vendor motion extraordinary was the sweeping nature of its request for relief. Kmart requested authority “to pay all, a portion [of,] or none of the Critical Vendor Claims as determined by *Debtors in their sole discretion*.”¹⁰⁴ Kmart announced the intention to force the critical vendors to sign a trade agreement in exchange for the money, which would place limits on future claims and litigation. But Kmart requested the authority to make the payments even if no trade agreement could be reached if, “in their business judgment, that failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors’ business operations.”¹⁰⁵ Further, if the critical vendor declined to comply with the trade agreement, Kmart sought:

authority, *in their discretion and without further order of the court*, (a) to declare that any Trade Agreement between the Debtors and such Critical Vendor is terminated (if applicable), and (b) to declare that provisional payments made to Critical Vendors on account of Critical Vendor Claims be deemed to have been in payment of then-outstanding post-petition claims of such vendors without further order of the Court or action by any person or entity.¹⁰⁶

Further, if Kmart chose to terminate the trade agreement, they sought the authority to force the return of any payments made to the critical vendors.¹⁰⁷

The authority cited by Kmart for their requests was Section 105(a) of the Bankruptcy Code, which provides that “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”¹⁰⁸ Kmart noted that

¹⁰⁴ *Id.* at 11 (emphasis added).

¹⁰⁵ *Id.* at 13.

¹⁰⁶ *Id.* at 14 (emphasis added).

¹⁰⁷ *Id.*

several courts had used this provision to justify the “‘necessity of payment’ doctrine to authorize payment of a debtor’s pre-petition obligations where, as here, such payment is necessary to effectuate the ‘paramount purpose’ of chapter 11 reorganization, which is to prevent the debtor from going in to liquidation and to preserve the debtor’s potential for rehabilitation.”¹⁰⁹

However, Kmart’s motion to pay critical vendors was opposed by Capital Factors (“Capital”). Capital was a factoring agent, purchasing accounts receivable and assuming the collection responsibilities, for some of Kmart’s apparel suppliers. Capital held unsecured claims of about \$20 million. Capital was not listed as a “critical vendor” by Kmart, and so the payment of the “critical vendors” shrunk the amount of cash that would be available to satisfy Capital’s claims when it came time to do so under a confirmed plan of reorganization or otherwise.¹¹⁰

Four days after the first day motion to allow payment to critical trade vendors, the bankruptcy judge signed an order granting the requested relief. Kmart was “authorized, but not directed, in the reasonable exercise of their business judgment, to pay all, a portion or none of the pre-petition claims” of the critical vendors.¹¹¹ Further, Kmart was given authorization to enter into trade agreements with the critical vendors in exchange for payment.¹¹² However, if Kmart used “diligent efforts” to get the critical vendors to sign the

¹⁰⁸ *Id.* at 17.

¹⁰⁹ *Id.* at 18.

¹¹⁰ *Capital Factors, Inc. v. Kmart Corporation*, 291 Bankr.Rep. 818, 820 (N.D. Ill. 2003).

¹¹¹ Order Under U.S.C. § 105(a) Authorizing the Payment of Pre-petition Claims of Certain Critical Trade Vendors,² (Jan 26, 2002).

trade agreements, they could pay the vendors without an agreement if the “failure to pay the Critical Vendor Claim is likely to result in irreparable harm to the Debtors’ business operations.”¹¹³ In sum, every major request Kmart presented in the motion was granted.

B. Critical Reservations?

Although the court did eventually overrule the objections of Capital, it expressed some reservations regarding Kmart’s motion:

Motions to pay critical trade creditors always present difficult questions for courts. We’re seeing more and more of them, and our problem is that we have to stretch to find some authority to do them. However, I, after hearing this testimony and reading the affidavit [of Charles C. Conaway, Kmart’s Chief Executive Officer], am convinced that Fleming, Handleman and the egg and dairy vendors...as well as the advertising concerns, are necessary to keep this business going as a going concern.¹¹⁴

The reservations expressed by the court are significant for two related reasons. First, the court’s order allowing the payment of critical vendors was eventually reversed. In particular, the order was reversed specifically because there was no legal support for the grant of the motion. Even the bankruptcy court recognized that the legal support for the motion was thin, and that it needed “to stretch” to find in favor of Kmart. Second, the statement by the court exemplifies the attitude, so common among bankruptcy judges, to approve first day motions without deeply questioning their legal support, even when they know it is thin.¹¹⁵ Perhaps the judge was afraid to question a debtor such as Kmart out of fear that other large companies would choose other forums if the courts of the Northern District of Illinois were

¹¹² *Id.* at 4.

¹¹³ *Id.*

¹¹⁴ *Id.* (citing App. to Appellee’s Brief).

¹¹⁵ See Douglas G. Baird, *Bankruptcy From Olympus*, 77 U. Chi. L. Rev. 977, (963) (2010).

viewed as hostile to critical vendor motions and other aggressive reorganization techniques that are accepted in jurisdictions that might be described as “accommodating.” In any case, the *Kmart* judge appeared content to go along with the common practice of the time. So long as there was a sufficient showing that the vendors listed by Kmart were “critical,” the court apparently felt that it was unnecessary to look beyond section 105(a) for legal support.

When the bankruptcy court granted Kmart’s “critical vendor” orders, one commentator viewed it as just one decision among many confirming the practice. In June 2002, Bruce Nathan examined various decisions regarding critical vendors in “Critical Vendors: Elevating the Low-Priority Unsecured Claims of Pre-Petition Trade Creditors.” Nathan recognized that courts often allowed general unsecured claims to be given higher priority if the creditors were deemed to be “critical.” As part of his analysis, he noted that Kmart obtained orders authorizing extensive payments to several “critical” vendors. These payments were cited as part of a larger trend in which “low-priority, pre-petition general unsecured claims can be converted to higher-priority administrative claims arising from post-petition credit sales to the debtor.”¹¹⁶

Later developments, such as the motion’s eventual reversal by the District Court, are examined in Chapter Nine.

¹¹⁶ See Bruce S. Nathan, *Critical Vendors: Elevating the Low-Priority Unsecured Claims of Pre-Petition Trade Creditors*, 21 Am. Bankr. Inst. J. 14, 14 (2002). However, the author did note that *In re Co.ServeL.L.C.*, 273 B.R. 487 (Bankr. N.D. Tex. 2002), held that a critical vendor payment (1) must be indispensable to the debtor’s business, (2) non-payment of the claim risks probable harm, and (3) there is no practical or legal alternative to payment of the claim. *Id.* at 33.

Chapter Eight

IN THE BELLY OF THE BEAST

*There is only one class in the community that thinks more about money than the rich, and that is the poor.
The poor can think of nothing else.*

Oscar Wilde

After the flurry of first day motions, the parties in Kmart's chapter 11 case created a veritable blizzard of filings. One month into the bankruptcy, 937 items had been entered on to the docket (approximately 40 per day). By six months, the docket grew to over 5000 items, and after one year the docket totaled over 8000 documents.¹¹⁷

An examination of all of these documents is beyond the scope of this paper. However, two topics are of particular importance. First, this chapter examines Kmart's treatment of unexpired pre-petition leases. Kmart used the bankruptcy code to shed unprofitable store operations. Trimming excess costs was crucial to Kmart's survival and eventual reorganization. Second, this chapter examines Kmart's treatment of JDA Software. Companies are often granted administrative priority for post-petition claims under the theory that this will encourage them to cooperate with the debtor. As JDA Software discovered, however, the grant of administrative priority is not automatic. Even if a company provides post-petition services, a debtor may avoid granting priority to its unless the company can prove that its services benefited the estate.

A. Unexpired Leases

Before filing for bankruptcy, Kmart was a party to about 2,000 real property leases, mostly for retail outlets. The day after filing for bankruptcy, Kmart filed a motion for

¹¹⁷ Docket Report.

permission to reject approximately 365, or approximately 18%, of its unexpired pre-petition real estate leases.¹¹⁸ Even after the rejection of so many leases, the claims of landlords under the remaining, assumed leases comprised the largest claim against the estate.¹¹⁹

As a support for its motion, Kmart made several claims. First, Kmart claimed that “Debtors have determined that rejecting the Real Property Leases as of the Rejection Date for each Real Property Lease is in the best interests of the Debtors’ estates, creditors and other parties in interest.¹²⁰ Second, Kmart claimed that they, in conjunction with their real estate advisors, had evaluated the possibility of assigning the leases and determined that they do not have “any marketable value beneficial to the Debtors’ estates.” Third, Kmart noted that the retention of the leases would involve the payment of real estate taxes, utilities, insurance and other related charges. The payment of these expenses would not bring any benefit to the estate. Fourth, Kmart noted that the costs associated with the leases were substantial and “constitute an unnecessary drain” on its resources. Fifth, the savings resulting from rejecting the leases would favorably affect Kmart’s cash flow. Finally, “no person has expressed any interest in purchasing or taking an assignment of the Real Property Leases.”¹²¹

¹¹⁸ Motion for an Order Pursuant to 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 23, 2002).

¹¹⁹ See chart on page 65.

¹²⁰ Kmart does not appear to support this claim with any hard facts or financial analysis. As well, they note that they are not finished with their review and evaluation of the unexpired leases.

¹²¹ Motion for an Order Pursuant to 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 23, 2002)

As with other motions filed during the first days of bankruptcy, the factual support proposed for the motion was in the form of an affidavit of Conaway.¹²² The wording of the motion largely tracked the language of Conaway's affidavit, or visa-versa.¹²³

Through the motion, Kmart sought two types of relief. First, Kmart sought the ability to reject outright certain leases, which they listed on Schedule A. Second, Kmart sought permission to reject some or all of the leases on Schedule B, and they specifically sought permission to retain some of the leases on Schedule B without seeking further permission from the bankruptcy court.¹²⁴

Sections 105 and 365(a) were proposed by Kmart as the legal support for the motion. Kmart noted that: (1) generally the assumption or rejection of leases was subject to review under the business judgment standard, (2) this standard is satisfied if the debtor determines the action will benefit the estate, and (3) that courts show great deference to a debtor's decision to reject. Further, Kmart noted that the lessors would have ample opportunity to object to this motion, so they would not be prejudiced.¹²⁵

A few days later, the court granted all of Kmart's requests.¹²⁶ Although several leasees objected to Kmart's motion, their objections were overruled.¹²⁷ A Notice of

¹²² Motion for an Order Pursuant to 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 23, 2002)

¹²³ Affidavit and statement of Charles C. Conaway in Support of Chapter 11 Petitions and First Day Orders, 93 (filed Jan. 25, 2002).

¹²⁴ Motion for an Order Pursuant to 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 23, 2002)

¹²⁵ Motion for an Order Pursuant to 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 23, 2002)

¹²⁶ Order Under 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases (filed Jan. 25, 2002).

Rejection to be sent to the affected lessors, a copy of which was filed with Kmart's original motion, was filed on February 19, 2002.¹²⁸

B. JDA Software, Post-petition Services, and Administrative Priority

This section will be divided into two parts. First, Kmart's use of section 503(b) throughout its bankruptcy work is briefly summarized to show how the court granted administrative priority to companies performing post-petition work. Second, JDA's failed request for administrative priority is examined in detail.

i. Kmart's General Use of Section 503(b)

Section 503(b) of the bankruptcy code deals with the "allowance of administrative expenses." In particular, section 503(b) provides that "the actual, necessary costs and expenses of preserving the estate" are to be treated as an administrative expense. The statute specifically lists "wages, salaries, and commissions," but it does not specify any other form of expenses.¹²⁹ However, cases have held that any post-petition expenses incurred by the estate will qualify if they are necessary and benefit the estate. This is true even if the expenses do not benefit creditors.¹³⁰ The court is not permitted approve a plan of reorganization that does not provide for the payment of administrative expenses, unless the holder of the claim agrees otherwise.¹³¹

¹²⁷ See, for example, Order Under 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases, Bank of New York (filed Feb. 15, 2002) and Order Under 11 U.S.C. §§ 105(a) and 365(a) Authorizing (A) Rejection of Certain Unexpired Real Property Leases and (B) Approving Procedures for Rejecting Other Unexpired Leases, Menard Inc. (filed Feb. 15, 2002).

¹²⁸ Notice of Rejection (filed Feb. 19, 2002).

¹²⁹ See 11 U.S.C. 503(b).

¹³⁰ See *Reading Co. v. Brown*, 391 U.S. 471 (1968); *In re Klein Sleep Products, Inc.*, 78 F.3d 18 (2d.Cir. 1996).

¹³¹ 11 U.S.C. § 1129(a)(9)(A).

Throughout the course of the bankruptcy, Kmart was granted permission to treat the claims of many post-petition vendors as administrative claims. For instance, these claims covered such items as purchase orders issued pre-petition but satisfied post-petition by the delivery of goods and services;¹³² post-petition obligations relating to license bonds issued by Hartford;¹³³ and expenses incurred by Kmart stores that were closed down during bankruptcy.¹³⁴

i. JDA Software’s Post-petition Claims

As JDA Software (“JDA”) discovered, however, Section 503(b) does not provide a blanket protection to vendors who perform post-petition services to the debtor. Rather, the services performed must result in a real benefit to the debtor. For the purposes of Section 503(b), potential or future benefits are not sufficient to provide administrative priority.

a. JDA’s Pre-Petition Work for Kmart

Kmart began a business relationship with JDA on June 22, 2001, exactly seven months before Kmart declared bankruptcy. Under the contracts signed by Kmart, JDA agreed to make modifications to software for Kmart’s “Caribbean Project” (“Services Agreement”).¹³⁵ As well, JDA agreed to provide “telephone and e-mail support, updates, and program temporary fixes” starting March 1, 2002 (“Support Agreement”). On the day that

¹³² ORDER in accordance with section 503[b][1][A] of Bankruptcy Code, the Debtors are authorized to treat purchase orders issued pre-petition but satisfied post-petition by the delivery of goods, merchandise or other services as post-petition administrative expenses (filed 2/13/2002).

¹³³ STIPULATION AND ORDER to lift stay to terminate certain surety bond's of Hartford (filed 3/6/2002).

¹³⁴ Among many others, see Agreed Order Resolving Lease Rejection and Administrative Claims for Kmart Store No 9453 (Signed on Oct. 26, 2004).

¹³⁵ In this project, Kmart planned on opening a store in Trinidad “and subsequent stores of an unspecified number in the Caribbean region.”

Kmart filed bankruptcy, JDA was owed in excess of \$1. 2 million for services rendered to Kmart. However, JDA had not completed all the services originally requested by Kmart. ¹³⁶

b. JDA's Post-Petition Work for Kmart

Soon after Kmart filed for bankruptcy, representatives of the company reassured JDA that it would be paid in full for all post-petition work. Eric Haskel, the international CFO of Kmart, and Steven Hunter, the Divisional Vice President of Kmart's Information Systems Application Department, "represented that Kmart would ensure that JDA 'be made whole' for all services rendered by JDA prior to the Filing Date. " As well, Haskel promised that Kmart would pay for all post-Bankruptcy Filing services rendered by JDA within thirty 30 days of invoice "even if I have to write the check myself."¹³⁷

Armed with a promise from the international CFO,¹³⁸ JDA continued to provide work with Kmart under the terms of the Services Agreement under on a "time and materials basis." It appears that all work completed performed by JDA was satisfactory, and one Kmart employee noted that JDA's "team was the first to not only bring a solid understanding of the system process, but an even better understanding of the business environment."¹³⁹ Eventually, JDA provided a total of \$291,597.07 of post-petition services to Kmart.¹⁴⁰

¹³⁶ Stipulation of Agreed Facts With Respect to Administrative Expense Claim Filed by JDA Software, Inc. (Filed Feb. 10, 2003).

¹³⁷ Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed July 30, 2002).

¹³⁸ The significance of Haskel's statement is downplayed in the Stipulation of Agreed Facts: "JDA representatives were told by at least one Kmart representative that work performed post-petition would be compensated as an administrative expense under Section 503." *See* Stipulation of Agreed Facts With Respect to Administrative Expense Claim Filed by JDA Software, Inc. (Filed Feb. 10, 2003).

¹³⁹ Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed July 30, 2002).

At the beginning of February, JDA requested payment for the work it had completed since the petition date.¹⁴¹ A few days later, Kmart informed JDA that “the opening of a Caribbean store was being delayed, and, as a result, JDA’s services were no longer needed.”¹⁴² JDA moved for all of its post-petition work to be recognized as administrative expenses.¹⁴³

c. Law Regarding Administrative Expenses in the Seventh Circuit

In the Seventh Circuit, courts have provided priority treatment for administrative expenses under section 503 “to encourage creditors to deal with the debtor in possession and thereby support the reorganization effort.” Section 503(b) states in part that “[a]fter notice and a hearing, there shall be allowed administrative expenses...including, - the actual, necessary costs of preserving the estate.” In granting administrative priority to claims under section 503, the Seventh Circuit uses the two-pronged *Jartran* test. First, the claims must arise “out of a transaction with the debtor in possession.” Second, the transaction must be “beneficial to the operation of the debtor in possession’s business.”¹⁴⁴

d. JDA’s Argues That It Provided a Benefit to Kmart

JDA argued that the post-petition services that it provided to Kmart were beneficial. First, they noted the fact that the international CFO specifically promised that the services

¹⁴⁰ Stipulation of Agreed Facts With Respect to Administrative Expense Claim Filed by JDA Software, Inc. (Filed Feb. 10, 2003).

¹⁴¹ Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed July 30, 2002).

¹⁴² Stipulation of Agreed Facts With Respect to Administrative Expense Claim Filed by JDA Software, Inc. (Filed Feb. 10, 2003).

¹⁴³ Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed July 30, 2002).

¹⁴⁴ *In re Kmart*, 293 B.R. 905, 909 (2003).

would be treated as administrative expenses. In reliance upon this promise, “JDA personnel attended numerous meetings, provided status reports and other consulting functions all in furtherance of the Caribbean Project and benefiting the Debtor’s business as a whole.”¹⁴⁵ In particular, JDA focused on the fact that Kmart requested the post-petition services. JDA warned that if their claims were not granted administrative status, the result “would allow the debtor to require performance under its executor contracts while it considers its options, as Kmart did, and then decide after the fact whether it wants to pay for those services. Such a result is wholly inequitable and inconsistent with the policies underlying the Bankruptcy Code. . . .” Further, the entire purpose of 503 would be frustrated, as vendors would refuse to do business under circumstances that might result in unpaid or underpaid claims.¹⁴⁶

e. Kmart Argues That It Was Not Provided With a Benefit

Kmart admitted that JDA’s claims arose out of a transaction with Kmart, but argued that Kmart was not provided with any benefit from JDA’s work. Specifically, Kmart noted that the use of the words “necessary and “actual” in section 503(b) were held by the Seventh Circuit to exclude merely potential benefits and to ensure that the estate is actually benefitted. Although the software developed by JDA might have been partially delivered to Kmart, Kmart never used any of the software developed by JDA and deleted all copies of the software from its computers. As well, Kmart noted that JDA could not prove that Kmart had ever used the software.

¹⁴⁵ Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed July 30, 2002).

¹⁴⁶ Response of JDA Software, Inc. To Debtors’ Motion for Summary Judgment With Incorporated Memorandum of Law Against the Motion for Administrative Expense Claim Filed by JDA Software, Inc. (Filed Feb. 24 2003).

f. The Bankruptcy Court Rules in Favor of Kmart

The bankruptcy court ruled in favor of Kmart. The court found that JDA collapsed the two-pronged test *Jartran* test and essentially ignored the “benefit” prong. Although JDA admittedly was induced by Kmart to continue work post-petition, this merely confirms that JDA entered into a transaction with Kmart. “Whether the estate benefitted from such a transaction, however, is a separate inquiry altogether, and one engaged in only after concluding that the creditor entered into a transaction with the debtor in possession. Put another way, post-petition performance alone does not automatically translate into a benefit to the estate, even if there was inducement on the part of the debtor.” The mere presence of a potential benefit is too speculative to count as an “actual” or “necessary” cost of the estate under 503(b).

Chapter Nine

SOMETIMES A PARENT HAS TO SAY NO

Next to doing the right thing, the most important thing is to let people know you are doing the right thing.
John D. Rockefeller

On April 10, 2003, about one month before Kmart was scheduled to exit bankruptcy, District Judge Grady heard oral argument an appeal on Kmart's critical vendor motion. The appellant was Capital Factors - a vendor who had unsuccessfully requested status as a "critical vendor." Judge Grady reversed the order authorizing payment of the critical vendors and concluded that neither § 105(a) nor a "doctrine of necessity" supported the orders."¹⁴⁷ This chapter will examine the district court's decision and briefly review the critical commentary written soon after the decision.

A. Bankruptcy Court Decision

The central issue raised by Capital Factors was "whether there was a sufficient evidentiary basis for the bankruptcy court to allow payment of [the critical vendor] claims."¹⁴⁸ As noted above, § 105 allows a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the bankruptcy code.¹⁴⁹ Although Kmart did not specifically refer to the "doctrine of necessity," the court found that its claim that the payments were "necessary," "integral" and had a "good business justification" made it apparent that Kmart had relied upon the doctrine. Further, if the

¹⁴⁷ *Capital Factors, Inc. v. Kmart. Corp.*, 291 Bankr. Rep. 818, 825 (N.D. Ill. 2003).

¹⁴⁸ *Id.* at 821.

¹⁴⁹ 11. U.S.C. § 105(a).

“doctrine of necessity” was not codified in the bankruptcy rules, it must be applied via § 105.¹⁵⁰

Significantly, precedent from the Seventh Circuit stated that § 105 only allowed a court to “enforce the provisions of the Code, not to add on to the Code” as sees fit. Further, the Code does not provide priority “based on the ‘critical’ or ‘integral’ status of a creditor.” Therefore, the bankruptcy court in Kmart “altered the priority scheme set forth in the Bankruptcy Code.”¹⁵¹ Although the district court acknowledged that there was a split among the courts regarding the proper application of § 105, the district court could not:

ignore the Bankruptcy code’s statutory scheme of priority in favor of “equity,” especially in light of the Seventh Circuit’s admonition that “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be. ”¹⁵²

As well, although the “doctrine of necessity was “well-intended” and even “beneficial,” its application in this case simply was not authorized by the Bankruptcy Code. “Congress has not elected to codify the doctrine of necessity or otherwise permit pre-plan payment of pre-petition unsecured claims.” Therefore, the bankruptcy court did not have either the statutory or the equitable power to “authorize the pre-plan payment of pre-petition unsecured claims.”¹⁵³ As a consequence, the “critical vendor” orders were reversed.¹⁵⁴

¹⁵⁰*Id.* at 822.

¹⁵¹*Id.*

¹⁵²*Id.*

¹⁵³*Id.* at 823.

¹⁵⁴*Id.* at 825.

B. Critical Commentary

The reversal of the bankruptcy court was immediately recognized as an important and potentially influential decision. In 2003, two members of Skadden, Arps, Slate Meagher & Flom¹⁵⁵ published a paper entitled “First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendor, Dip Financing and Cash Management Issues).”¹⁵⁶ The paper noted that motions to pay pre-petition claims of critical vendors were commonly justified when vendors might refuse to cooperate with the company’s reorganizational efforts and when the vendor is particularly essential to the operations of the business. However, the authors recognized that the traditional views of critical vendors were rejected by the district court in *Kmart*. The paper predicted several possible effects of the *Kmart* decision. First, the authors posited that the decision may work to the benefit of debtors as they will no longer be inundated with requests from vendors to be placed on the “critical vendor list.” Second, the decision may call into doubt many traditional first day motions justified by the doctrine of necessity such as the payment of pre-petition wages and salaries.¹⁵⁷

Andrew Currie and Sean McCann also noted the potentially wide ranging effect of the *Kmart* reversal. Before *Kmart*, courts “typically” allowed payments to critical vendors. However, they stated that the reversal of critical vendor payments raised “serious concerns about the continued viability of the doctrine of necessity.” They predicted several changes if the decision was upheld by the Seventh Circuit. First, venue choices would be influenced as

¹⁵⁵ SkaddenArps represented Kmart in the bankruptcy.

¹⁵⁶ See Jay M. Goffman& Grenville R. Day, *First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendor, Dip Financing and Cash Management Issues)*, 12 J. Bankr. L &Prac.59, 69-70, 73-75 ((2003).

¹⁵⁷ See Jay M. Goffman& Grenville R. Day, *First Day Motions and Orders in Large Chapter 11 Cases: (Critical Vendor, Dip Financing and Cash Management Issues)*, 12 J. Bankr. L &Prac.59, 69-70, 73-75 ((2003).

payments to critical vendors would no longer be available in the Seventh Circuit. Second, other circuits might elect to follow the Seventh Circuit's example, which would erode the confidence with which debtors typically approach first day motions. Third, vendors that would typically have been critical would now be treated like every other creditor. Fourth, the decision would likely slow down the trend of permitting the estate to make substantial payments in the first few days of the case, before most creditors were up to speed, and prior to the formation of the creditors' committee.¹⁵⁸

Thomas J. Salerno¹⁵⁹ noted that critical vendor motions had become "standard procedure," so much so that "most firms that do a substantial amount of debtor work have emergency motions (along with accompanying affidavits) on their word processors, ready to go." Salerno offered several criticisms of Kmart's handling of the appeal. First, in the context of Kmart, Critical Factor's claim of \$20 million was small. Kmart should have settled with Critical Factor before an appeal became necessary. In essence, Salerno was asserting that Kmart and Skadden, Arps should have engineered matters so that the critical vendor motion evaded review by an Article III District Court that might take a less expansive view of a bankruptcy court's section 105 powers than had the *Kmart* bankruptcy court. Second, several legal grounds could have been asserted by Kmart to support the critical vendor motion, but they were not. Most notably, Salerno speculated that the bankruptcy court may have been able to base its grant of critical vendor status upon the

¹⁵⁸ See Andrew J. Currie & Sean McCann, *Hold on to Those Payments, Critical Vendors: Capital Factors v. Kmart*, 22 Am. Bankr.

Inst. J. 1 (Jun. 2003).

¹⁵⁹ It should be noted that Salerno is presenting the case strictly from the perspective of debtor's counsel. For instance, the paper begins "Who would have thunk it? Just when practitioners get bankruptcy judges properly trained, some appellate court steps in and messes it all up." Thomas J. Salerno, "*The Mouse that Roared*" Or "*Hell Hath no Fury Like a Critical Vendor Scorned*," 22 Am. Bankr. Inst. J. 28, 28 (Jun. 2003).

requirement that the vendors agreed to extend post-petition, debtor-in-possession financing pursuant to Code § 364(b). Finally, Salerno noted that one of the effects of the decision might include Chicago's loss of "its recently acquired, coveted place as the haven for big cases."¹⁶⁰

¹⁶⁰ Thomas J. Salerno, "*The Mouse that Roared*" Or "*Hell Hath no Fury Like a Critical Vendor Scorned*," 22 Am. Bankr. Inst. J. 28 (Jun. 2003).

Chapter Ten

ALONG COMES A SPIDER

The way to become rich is to put all your eggs in one basket and then watch that basket.
Andrew Carnegie

In the months after Kmart filed for bankruptcy, the stock of the company plummeted. Some commentators even expressed doubt as to whether Kmart would be able to emerge from bankruptcy at all.¹⁶¹ In the best case scenario, Kmart's creditors would be forced to wait a long time before they got any money, and the amount that they would receive was uncertain. In this time of uncertainty, ESL saw an extraordinary financial opportunity.

A. Evaluating the financials

As noted in Chapter 4, ESL is a “vulture” hedge fund that specialized in buying up distressed companies.¹⁶² By 2002, ESL's CEO, Edward Lampert, already owned some of Kmart's debt, and in the months following Kmart's bankruptcy he began to examine the possibility of buying even larger amounts of Kmart's defaulted bonds.¹⁶³ The risks were great as the financials of Kmart were in shambles.¹⁶⁴

¹⁶¹ Sherri Day, *Kmart Faces Hurdle on Plan To Exit Bankruptcy Soon*, N.Y. Times, Apr. 15, 2003.

¹⁶² A vulture fund is a private equity or hedge fund that invests in debt issued by an entity that is considered to be very weak or dying, or whose debt is in imminent default.

¹⁶³ Amounts are uncertain because the debt market is private.

¹⁶⁴ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at App. D, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL)

	2001	2000	1999
Sales	\$36,151	\$37,028	\$35,925
Cost of sales	29,853	29,732	28,161
Gross margin	6,298	7,296	7,764
Selling, general and administrative expenses	7,588	7,366	6,569
Equity income (loss) in unconsolidated subsidiaries	0	(13)	44
Restructuring, impairment and other charges	1,091	0	0
Continuing (loss) income before interest, reorganization items, taxes and dividends on convertible preferred securities	(2,381)	(83)	1,239
Interest expense, net	344	287	280
Reorganization items	(183)	0	0
(Benefit from) provision for income taxes	0	(148)	315
Dividends on convertible preferred securities, net of income tax	70	46	50
Net (loss) income from continuing operations	(\$ 2,612)	(\$ 268)	\$ 594
Discontinued operations, net	166	0	(230)
Net (loss) income	(\$ 2,446)	(\$ 268)	\$ 364
<i>BASIC EARNINGS (LOSS) PER COMMON SHARE</i>			
Net (loss) income from continuing operations	(\$ 5.29)	(\$ 0.53)	\$ 1.21
Discontinued operations	0.34	0.00	(0.47)
Net (loss) income	(\$ 4.95)	(\$ 0.53)	\$ 0.74
<i>DILUTED EARNINGS (LOSS) PER COMMON SHARE</i>			
Net (loss) income from continuing operations	(\$ 5.29)	(\$ 0.53)	\$ 1.15
Discontinued operations	0.34	0.00	(0.41)
Net (loss) income	(\$ 4.95)	(\$ 0.53)	\$ 0.74
Basic weighted average shares (millions)	494.1	482.8	491.7
Diluted weighted average shares (millions)	494.1	482.8	561.7

Consolidated Balance Sheets in millions of \$	2001	2000
TOTAL ASSETS:	1,245	401
Cash and cash equivalents	5,796	6,350
Merchandise inventories	800	925
Total current assets	7,841	7,676
Property and equipment, net	6,093	6,522
Other assets and deferred charges	249	617
Total assets	14,183	14,815

TOTAL LIABILITIES & EQUITY:		
Long-term debt due within one year	0	68
Accounts payable	89	2,190
Accrued payroll and other liabilities	420	1,691
Taxes other than income taxes	143	187
Total current liabilities	652	4,136
Long-term debt and notes payable	330	2,084
Capital lease obligations	857	943
Other long-term liabilities	132	883
Total liabilities not subject to compromise	1,971	8,046
Liabilities subject to compromise	8,093	0
Company obligated mandatorily redeemable convertible	889	887
Common stock- share outstanding: 494 million-2001: 506	503	487
Capital in excess of par value	1,695	1,578
Retained earnings	1,032	3,817
Total liabilities and equity	14,183	14,815

Data as of January 20, 2002 and January 31, 2001. As of fiscal year 2001, Kmart had a net operating loss (NOL) carry forward of \$369 million and total deferred assets of \$1,369 million. By Fiscal year end 2002, these amounts had increased to \$1,143 million and \$2,466 million, respectively. In both years, Kmart recovered a full valuation allowance against these assets to reflect the uncertainty of its future earnings.

An intriguing question is what did ESL see that no other investor saw in Kmart's financials?

Even with a new management team, there was no guarantee that Kmart could find a way to compete in a market dominated by Wal-Mart and Target.

	Wal-Mart	Kmart	Target
Total division sales (\$millions)	\$157,121	\$ 30,762	\$ 36,917
Total stores (year-end)	2,875	1,514	1,147
Total square footage (000's)	388,685	139,000	140,255
Average sales per square foot	\$ 422	\$ 212	\$ 278
Same store sales growth (year-to-year):			
2001			
Q1	3.5%	1.7%	2.8%
Q2	5.6%	1.0%	3.4%
Q3	6.7%	(1.5%)	3.0%
Q4	7.2%	2.1%	6.2%
2002			
Q1	8.6%	(8.8%)	6.8%
Q2	7.1%	(11.0%)	4.4%
Q3	4.2%	(7.6%)	1.0%
Q4	3.3%	(9.8%)	(1.1%)

If anything, Kmart was losing ground on its two largest competitors. However, Lampert identified Kmart's one indisputable asset: below-market leases. ESL believed that even if Kmart itself could not be salvaged, the company would still be valuable in liquidation because of its real estate holdings.¹⁶⁵ Although Kmart owned some of its big-box retail locations, most of the stores were on long-term leases. At the time of bankruptcy, these

¹⁶⁵ David Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm* 478 (Kellogg School of Management ed., Academic Press 2010).

leases were considerably below market rate, and they would be valuable even in the event that Kmart had to sell leases to other business.¹⁶⁶ Officially, ESL stated that it intended to maintain Kmart as a retailer and that the company would be profitable by 2007.

B. Taking the plunge

Once Lampert determined that Kmart was worth the investment, his company moved swiftly to become Kmart's majority creditor. During the spring of 2002, ESL began quietly accumulating Kmart's defaulted bonds.¹⁶⁷ By the summer of 2002, ESL had accumulated more than \$1 billion of the company's defaulted debt.¹⁶⁸ By September 2002, ESL had a voice in the restructuring project through a seat on the financial institutions committee.

It did not take long for Lampert to begin asserting his newfound influence over Kmart's bankruptcy. In particular, Lampert wanted to speed up the bankruptcy process.¹⁶⁹ In early November of 2002, Lampert met with Kmart's Chairman and CEO, Jim Adamson, to emphasize the importance of Kmart's early emergence from bankruptcy. Lampert pressed Mr. Adamson to file a plan of reorganization by Thanksgiving.¹⁷⁰ When the

¹⁶⁶ When Wall Street analysts implied that Lampert only wanted to take control of Kmart merely in order to sell the leases, he responded that "no retailer should aspire to have its real estate be worth more than its operating business." Of course, Lampert never claimed to be a retailer.

¹⁶⁷ Trading in distressed debt often occurs through private, unpublished transactions, so the exact timing and size of Lampert's trades are unknown.

¹⁶⁸ Although it is hard to pinpoint dates, the amount is consistent with a timeline created by UBS investment bank.

¹⁶⁹ On July 24, 2002, the Bankruptcy Court extended the Debtors' exclusive period through February 28, 2003 and the solicitation period to April 22, 2003. Because the Debtors' required more time still, the court entered an order on February 25, 2003 that extended the filing period and solicitation period to June 30, 2003 and August 31, 2003, respectively.

¹⁷⁰ ESL lacked experience both in bankruptcy proceedings and in the running of businesses with the majority-control of a company's stock.

company did not meet this deadline, Lampert's attorney successfully demanded Adamson's resignation.¹⁷¹ Julian Day was appointed the new CEO of Kmart in January 2003, and the process of reorganization began moving at a rapid pace.

C. Proposing a plan

Throughout early 2003, ESL continued to buy Kmart debt in private negotiated transactions.¹⁷² Kmart's creditors, both banks and bond investors, made it clear to ESL that they would prefer to end their involvement with Kmart rather than taking stock in the New Holding Company.¹⁷³

¹⁷¹ David Stowell, *An Introduction to Investment Banks, Hedge Funds, and Private Equity: The New Paradigm* 478 (Kellogg School of Management ed., Academic Press 2010).

¹⁷² The amount acquired during this time is unknown.

¹⁷³ They probably believed Kmart could not be a viable company for the reasons mentioned in Chapter 5.

Chapter Eleven

CRACKING THE BANK

The ladder of success is best climbed by stepping on the rungs of opportunity.

Ayn Rand

Because of the complexity of the plan, only selected individual issues will be addressed in the proceeding five chapters. The discussion will begin with the financial condition of Kmart followed by the class structure under the plan. An analysis of Kmart's business reasons will be addressed followed by a liquidity analysis. Finally, what occurred on the Effective Date will be analyzed.¹⁷⁴

The previous chapter analyzed the reasons why ESL believed that Kmart was worth the risk of investing in based on its current and historic financial statements. This chapter analyzes the value of Kmart to determine how much that investment should be.¹⁷⁵ The

¹⁷⁴ The following chapters are based on the Disclosure Statement. The Disclosure Statement contains Kmart's history, business properties and operations, projections for those operations, risk factors associated with the business, a plan, a summary and analysis of the plan, and the financial statements related to the plan. Under section 1125(b) of the bankruptcy code, a vote to accept or reject the plan cannot be solicited from a claimholder or interest holder unless a Disclosure Statement has been approved by the bankruptcy court as containing the necessary adequate information. Adequate information is defined in 11 U.S.C. 1125(a) as: (1) information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information; and (2) "investor typical of holders of claims or interests of the relevant class" means investor having— (A) a claim or interest of the relevant class; (B) such a relationship with the debtor as the holders of other claims or interests of such class generally have; and (C) such ability to obtain such information from sources other than the disclosure required by this section as holders of claims or interests in such class generally have.

¹⁷⁵ Based on economic and market conditions as they existed and could be evaluated as of January 13, 2003.

Financial Advisors for the purposes of the Plan, estimated that the value of the reorganized Kmart in a hypothetical Chapter 11 reorganization, was between \$2,250 million to \$3,000 million. The equity value of reorganized Kmart was estimated to range from \$753 million to \$1,503 million.¹⁷⁶

Valuation Data (\$ in millions except per-share data)

	Low	Median	High
Aggregate firm value	\$2, 250	\$2, 625	\$3, 000
Aggregate equity value	\$753	\$1, 128	\$1, 503
Shares outstanding	86.24	86.24	86.24
Equity value per share	\$8.74	\$13.08	\$17.43

In arriving at the reorganized Kmart value, the Financial Advisors performed three types of analysis.

First, Kmart was analyzed according to a comparable public company analysis. Under this analysis, a subject company is valued by comparing it to publically held companies in

¹⁷⁶ In arriving at these estimates, the Financial Advisors relied on a series of projections regarding the future performance of Kmart, performance of the industry, and general business and economic conditions beyond the control of Kmart including: (1) Net Sales for 2003 as compared to 2002 were projected to decrease by 17.5% due to the closure of 283 stores. Net sales were expected to increase .7% in 2004, 5.3% in 2005, 5.5% in 2006 and 5.9% in 2007, (2) gross margins from 18% in 21.5% in 2007 because of improved promotional productivity, favorable product mix and marked improvement due to increased import purchases, (3) administrative expenses to remain at 20% from 2002 and 2003 as lower depreciation expense generated by fresh start accounting adjustments is offset by the effects of store closings and the resulting lower sales base (4) income taxes will be substantially offset by its unused net loss carry forwards against Kmart's cancellation of debt income on the effective date.

reasonably similar lines of business.¹⁷⁷The analytical work performed includes a comparing the enterprise value (market value of equity plus debt and minus excess cash) of Kmart to similar companies.

Second, Kmart was analyzed through the discounted cash flow method. The discounted cash flow method related the value of Kmart to the present value of any expected future cash flows to be generated by Kmart. The discounted cash flow method is a forward-looking approach that discounts the expected future cash flows by a theoretical or observed discount rate. For purposes of the valuation analysis, a discount rate between 20% and 25% was used.¹⁷⁸

Third, Kmart was analyzed through a comparable acquisition analysis. The comparable acquisition analysis entails calculating multiples of revenues, earnings and book value based on prices paid (including debt assumed and equity purchased) in announced mergers and acquisitions involving companies similar to Kmart. These multiples were then applied, to the projected financials of Kmart to determine an implied range of enterprise and equity values. The financial advisors (1) reviewed certain historical financial information of Kmart for recent years and interim periods, (2) reviewed the projections and the assumptions underlying them, (3) reviewed certain internal financial and operating data of Kmart, (4) met with certain members of management to discuss Kmart's operations and future projects (including the operational changes contemplated by the business plan, (5)

¹⁷⁷ The comparable public companies were chosen based on their similarity to the subject company's business, presence in the market and size. The price that an investor is willing to pay in the public market for each company's publicly traded securities represents that company's current and future prospects as well as the rate of return required on investment.

¹⁷⁸ This analysis reflected a number factors including: (1) business execution risk; (2) the nature and derivation of the projections set forth in the Business Plan; and (3) the cost of equity for comparable companies.

reviewed publicly available financial data and (6) considered certain economic and industry information relevant to Kmart's operating business and conducted such other analysis as the Financial Advisors deemed appropriate.¹⁷⁹

¹⁷⁹ The Financial Advisors did not make an independent valuation or appraisal of the assets or liabilities of Kmart, and no such independent valuation or appraisal was provided to the Financial Advisors in connection with the valuation analysis.

Chapter Twelve

A TIME TO STAND: KMART PROPOSES A PLAN

Defeat is not the worst of failures. Not to have tried is the true failure.

George Edward Woodberry

The purpose of a Chapter 11 plan is to allow the debtor to exit Chapter 11. Lingering in Chapter 11 erodes the confidence of vendors in Kmart, creates enormous stress in employees personal lives, diminishes the financial condition of the company, and dims the prospect for a successful reorganization. The terms of the plan are based primarily on the company's ability to realize the goals of its business plan, and extensive negotiations with creditors. However, a central tenant of the Bankruptcy Code is equality of distribution among similarly situated creditors which means classes have to be created fairly and creditors are due their fair share.

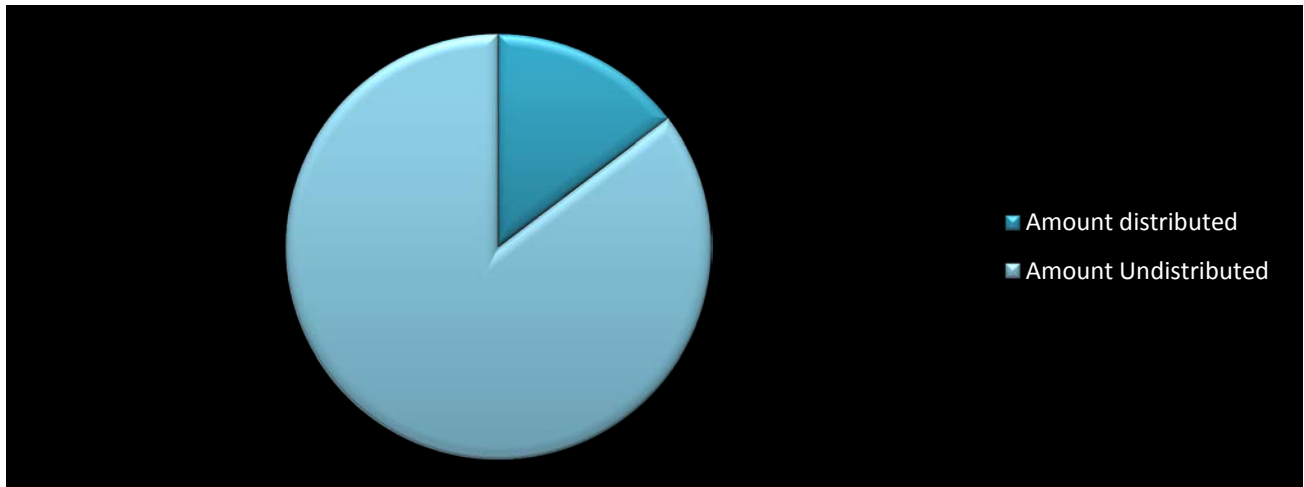
Pursuant to section 1122 of the bankruptcy code, the plan contained five types of unclassified claims, Administrative claims¹⁸⁰, Priority Tax claims¹⁸¹, PBGC claims, Workers' Compensation claims, and Consignment claims. In addition, the plan classified claims and interests into twelve classes into which creditor claims will be funneled into to determine how much money they would receive.¹⁸² According to the plan, it was anticipated that all of

¹⁸⁰ An administrative claim is a claim for payment of an administrative expense of a kind specified in §503(b) of the bankruptcy code and entitled to priority pursuant to §507(a)(1) of the bankruptcy code.

¹⁸¹ Priority tax claims will be entitled to full satisfaction. The debtors estimate that priority tax lien will total \$190 million.

the unclassified claims would be paid in full; however the classified claims would be paid only a percentage described in Appendix A.¹⁸³

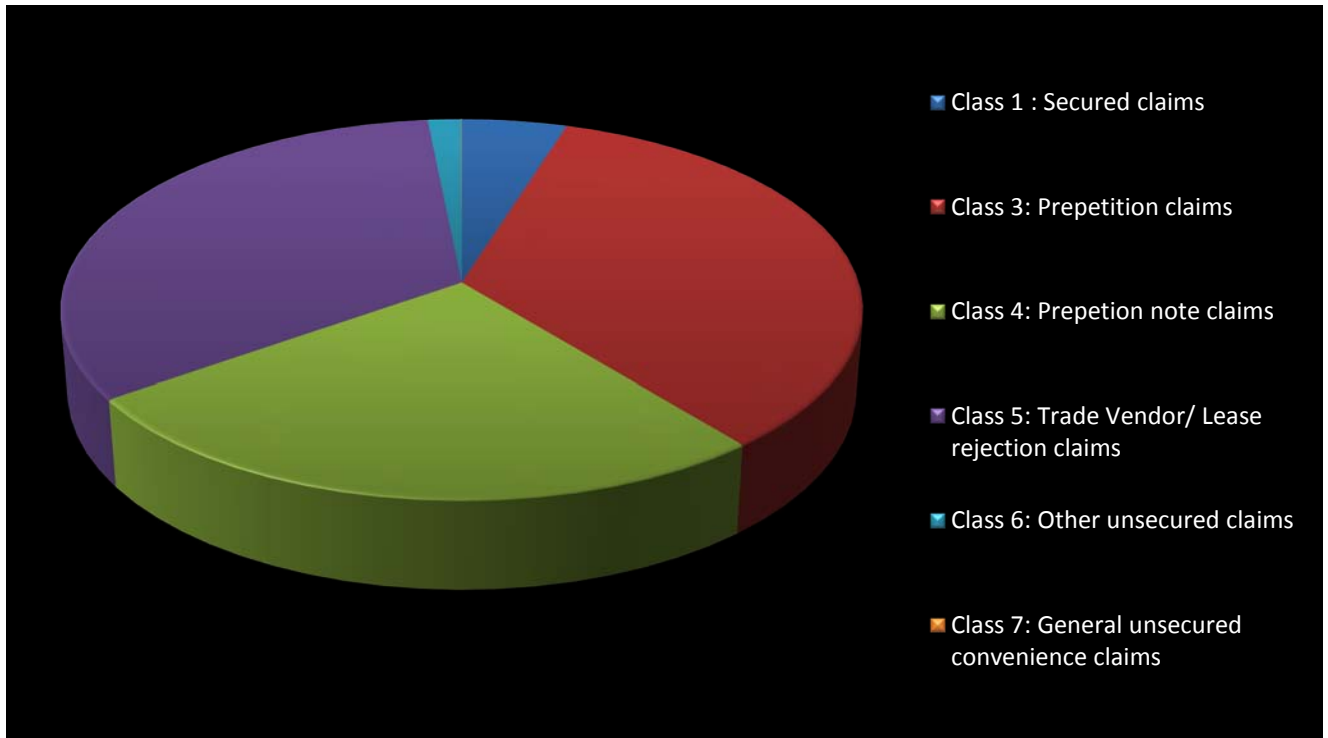
Of the total claims asserted against the Debtors only about 14% will be paid. This below graphic illustrates the amount distributed.



The dark blue part shows the actual amount of money of the total paid to creditors. The amount paid out is not divided evenly among the classes. The graphic below illustrates how payments are made among the classes that receive payment under the plan.

¹⁸² Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 78 , In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL)

¹⁸³ Appendix A



The distributions reflect extensive negotiations among the entities involved in the case based on their respective positions.

Chapter Thirteen

A NEW WAY FORWARD: THE BUSINESS PLAN

A good plan is like a road map: it shows the final destination and usually the best way to get there.

Stanley Judd

As part of its plan of reorganization, Kmart proposed an analysis of how it planned to achieve success in the future. First, Kmart proposed to change store policies to save meet customer expectations and keep expenses down. Second, Kmart outlined its market strategy for the next five years.

A. Better Store Policies

The primary strategy of the Debtors for a successful reorganization is to “rationalize” and “optimize” the company’s store and lease portfolio.¹⁸⁴ Kmart plans to reduce its stores by 600 to 1,514. The stores that will be closed will be based on historical and projected operating results, current and future competition, real estate value, store age, size, capital spending requirements and other similar factors.¹⁸⁵

Only a month before Kmart planned to exit bankruptcy, their overall strategic position remained unclear. “They haven't articulated a strategy,” said Walter K. Levy, the managing director for retail trends and positioning at Kurt Salmon Associates. “All they've done is have a series of tactics. They still haven't defined why the customer should shop

¹⁸⁴ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 61, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II)

¹⁸⁵ Id.

there rather than Wal-Mart or Target. That really is the bottom line." The company also was criticized for hiring inexperienced chief merchandising and chief store operations officers. "That's one of the reasons their same-store sales continue to trend downward," said Burt Flickinger III, a managing partner of the Strategic Resource Group. "Target and Wal-Mart have at least stabilized during this recession."¹⁸⁶

Kmart's response to these complaints in the media were less than persuasive. Kmart declared it will continue with its promotional campaign and rely on the exclusive brands that were unable to keep it afloat prior to the Petition Date.¹⁸⁷ Kmart claimed the difference it will successful now because it has (1) improved inventory control, (2) better store appearances, (3) a new "top seller" program, (4) "store of the future" campaign, and; (5) a better marketing plan.

Before entering bankruptcy, Kmart worked for years to improve inventory control. There was little reason to assume that Kmart would develop a successful supply chain management when there was still not a CIO¹⁸⁸ and the turnover at that position had been constant for the past six years. Additionally, the development of a system is expensive and Kmart simply could not afford to implement a program.¹⁸⁹ Finally, even if Kmart was able to revamp its inventory control, it would still be starting far behind Target and Wal-Mart.¹⁹⁰

¹⁸⁶ Sherri Day, *Kmart Faces Hurdle on Plan To Exit Bankruptcy Soon*, N.Y. Times, Apr. 15, 2003.

¹⁸⁷ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 62, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II.)

¹⁸⁸ Chief information officer

¹⁸⁹ Steve Konicki, *Now In Bankruptcy, Kmart Struggled With Supply Chain*, Information Week, Jan. 28, 2002, at 13.

¹⁹⁰ Id.

As well, improving store appearance was a goal for Kmart even in the 1980's. Kmart planned to become a smaller "store of the neighborhood" with more local control; test a "store of the future" with wider aisles; improve lighting, fixtures, and layout to help improve the shopping experience; and expand their use of exclusive brands. Besides being expensive to implement, none of these improvements significantly differentiated Kmart from Wal-Mart or Target.¹⁹¹

The top seller program¹⁹² was been moderately successful in the test market of Chicago - sales rose by 10%.¹⁹³ The program allows local managers greater flexibility and control over purchasing and stocking, and the program helped alleviate some supply chain concerns. The program was duplicated in Detroit, but the results were not sustainable. The new program was expanded to all stores in July 2002.¹⁹⁴

The plans for the "store of the future" were to make the stores brighter, cleaner, easier to navigate, and to put top selling merchandise closer to the entrance way. It remained unclear what role supercenters would have in the reorganized Kmart and how the new initiatives would affect them.¹⁹⁵

¹⁹¹ Stan Pohmer, *The Kmart Saga Re-visited*, Greenhouse Product News, Mar. 2003, at 3.

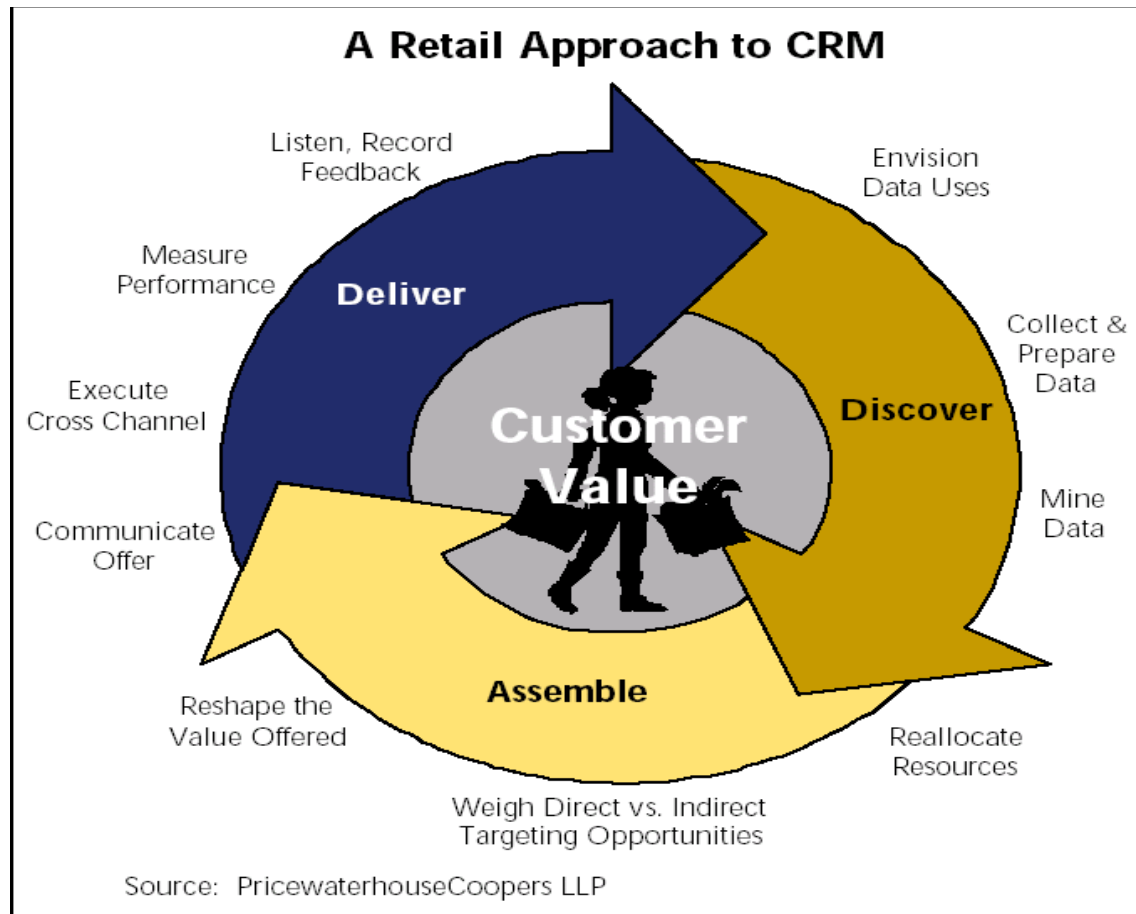
¹⁹² Focuses on improving sales and in-stock positions for each store's 300 top selling items.

¹⁹³ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 63, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II.)

¹⁹⁴ Id.

¹⁹⁵ Debbie Howell, *Supercenters key to Kmart's survival plan: New executive focused on execution*, DSN Retailing Today, Oct. 7, 2002, at 1.

Finally, the new marketing plan was to use a new customer relationship management (CRM) plan to target minorities.¹⁹⁶



The CRM plan was to listen to customers, and when they want to buy a product, actually have the product in the store. In short, do what Wal-Mart has been doing for years. The second part of the plan is to target minorities who made up 32% of Kmart's shoppers.¹⁹⁷ While it is true that this segment is the fastest growing in the United States and has a buying

¹⁹⁶ At the time, Kmart performed significantly better than Wal-Mart or Target in regards to minority sales.

¹⁹⁷ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 63, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II)

power of \$1.2 trillion dollars, the best sales that Kmart experienced with this group was in urban clusters where Wal-Mart and Target did not have a strong presence.¹⁹⁸ It was unknown how much of the market share Kmart could capture of this demographic when forced to compete with another national retailer.

In sum, Kmart's strategy for survival was to become more like Wal-Mart. But this was troubling because direct competition with Wal-Mart is what drove Kmart into bankruptcy.¹⁹⁹ At the time of Kmart's reorganization, Wal-Mart was already implementing many of the strategies outlined by Kmart, and Wal-Mart had been doing this for decades. ²⁰⁰Walter Levy's question of "why should shoppers shop at Kmart instead of Wal-Mart or Target?" has largely been unaddressed.

B. Market Factors for Success

Kmart articulated a five year plan that details how Kmart will return to profitability by 2007.²⁰¹ 2003 would be a transition year and would see the implementation of the store policies examined above. In 2004, Kmart planned to continue its recovery and have a \$1.3 billion dollar surplus by 2007. The company planned to record \$30.2 billion in sales in 2007, up from \$25.6 billion in 2003.

¹⁹⁸ Id.

¹⁹⁹ See Chapter 2.

²⁰⁰ See Chapter 2.

²⁰¹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 64, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

	2004	2005	2006	2007
Net sales	\$25,614	\$26,981	\$28,478	\$30,170
Cost of sales, buying and occupancy	20,423	21,308	22,407	23,669
Gross margin	\$ 5,191	\$ 5,673	\$ 6,071	\$ 6,501
Selling, general and administrative expenses	4,814	5,066	5,258	5,409
Earnings before interest and income taxes	377	607	813	1,092
Interest expense, net	86	73	61	51
Earnings before income taxes	\$ 291	\$ 534	\$ 752	\$ 1,041
Income taxes	110	202	287	397
Net earnings	\$ 181	\$ 332	\$ 465	\$ 644
Depreciation and amortization	47	93	142	192
EBITDA	\$ 424	\$ 700	\$ 955	\$ 1,284
Year/year same store sales growth	3.8%	4.5%	4.3%	4.0%

Source: Disclosure Statement.

There are numerous assumptions that are made under this analysis. Further, the factors are often difficult to predict because they are polycentric. The considerations involve the return of customers after bankruptcy, the stabilization of vendor relations, the approval of a plan, and the success of a number of new initiatives. Despite these complexities Kmart still believed it would be profitable in the coming years as evidenced by its projected cash flows:

	2004	2005	2006	2007
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net (loss) income	\$181	\$332	\$465	\$ 644
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Depreciation and amortization	47	93	142	192
Equity income in unconsolidated subsidiaries	(47)	(48)	(49)	(50)
Dividends received from Meldisco	46	47	48	49
Change in operating assets and liabilities				
Inventories	52	71	15	38
Accounts payable	331	148	65	114
Deferred income taxes and taxes payable	110	202	287	271
Other assets	82	(24)	(27)	(31)
Other liabilities	(205)	(184)	(144)	(190)
Net cash provided by continuing operations	\$597	\$637	\$802	\$1,037
CASH FLOWS FROM INVESTING ACTIVITIES:				
Capital expenditures	(\$450)	(\$500)	(\$550)	(\$ 600)
Net cash used for investing activities	(\$450)	(\$500)	(\$550)	(\$ 600)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Payments on debt, net	(\$ 95)	(\$ 19)	\$ 0	\$ 0
Payments on capital lease obligations	(52)	(52)	(52)	(52)
Net cash provided by (used for) financing activities	(\$147)	(\$ 71)	(\$ 52)	(\$ 52)
Net change in cash and cash equivalents	\$ 0	\$ 66	\$200	\$ 385
Cash and cash equivalents, beginning of year	\$300	\$300	\$366	\$ 566
Cash and cash equivalents, end of year	\$300	\$366	\$566	\$ 951

Apart from these assumptions, there were tangible business reasons to believe Kmart would be successful. As a result of chapter 11 protections, Kmart was able to shed much of its burdensome real estate and lease portfolio.²⁰² This has reduced the average tent per square foot from approximately \$4.40 to \$3.99. Additionally, 600 of the stores that were closed were low-volume store ²⁰³ allowing Kmart greater “rationalization” and “optimization.”²⁰⁴ The proposed budget (taking into account the aforementioned cuts) allows normalized maintenance to all remaining stores through fiscal 2007. The budget also allows for opening 70 new stores, and approximately \$175 million per year in other operating improvement projects.²⁰⁵

A second business reason for success was the shift away from pantry vendors and instead to rely on self-distributing these products. Kmart rejected its supply contract with Fleming, a grocery vendor that previously was deemed “critical.” The self-distributing was expected to occur by middle of March 2003 and would increase utilization of Kmart’s existing distribution centers by approximately 115 million cartons annually and reduce excess capacity by 89%. Also, this method should increase sales by \$450 million through

²⁰² Kmart has eliminated more than 950 real estate leases, including 340 pertaining to dark stores; it has renegotiated over 80 real property leases resulting in over \$12 million in annual rent concessions; and has closed or identified 29% of its lease stores for closing, representing 49% of its lease obligations on a gross basis.

²⁰³ Stores with annual sales less than \$12 million.

²⁰⁴ Store closing are expected to increase average sales per store, projected average earnings before interest, taxes, depreciation, amortization per store, and average return on invested capital.

²⁰⁵ Such as pharmacies, one-hour photo labs, and information technology upgrades.

2006 and cement relationships with individual food and consumable vendors while allowing Kmart control over vendor allowances processes.²⁰⁶

Finally, Kmart assumed the contracts of its exclusive vendors, enabling the company to offer unique merchandise and allowing it to pursue a targeted campaign along these brands.²⁰⁷

²⁰⁶ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at App. D, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

²⁰⁷ Martha Stewart, Route 66, Kathy Ireland, Thalia, Joe Boxer, Curtis Matches, Jaclyn Smith, 123 Sesame Street, Disney.

Chapter Fourteen

NO TIME TO QUIT: LITIGATION ROADBLOCKS

If I owe you a pound, I have a problem; but if I owe you a million, the problem is yours.
John Maynard Keynes

The committee of unsecured creditors threatened to prevent confirmation of the plan by starting four types of litigation.

i. Fraudulent Transfers

First, the committee of unsecured creditors threatened extended litigation over various transfers made by Kmart over the two years preceding the bankruptcy. Section 548 of the bankruptcy code provides that the trustee may avoid certain transfers of property made within two years of the petition date.²⁰⁸ From 1998 to 2000, Kmart transferred assets to various subsidiaries. Specifically, Kmart transferred to each subsidiary the assets constituting the business operations located in the respective states of each Kmart subsidiary. These assets included real estate and inventory comprising the retail stores and certain distribution centers. In exchange for the transfer of these assets, Kmart became the owner of all the equity of the subsidiaries. Thus, as of the Petition Date, the subsidiaries owned approximately 20% of the Debtor's aggregate real estate and inventory.

²⁰⁸ See 11 U.S.C. § 548. Two types of transfers are avoidable. First, transfers of property are avoidable if they were made with the “actual intent to hinder, delay, or defraud” any present or future creditor. Second, transfers of property are avoidable if the debtor received “less than a reasonably equivalent value,” and was insolvent, had unreasonably small capital, intended to incur un-repayable debts, or made the transfer to a business insider under an employment contract.

²⁰⁸ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 70, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

Further, in October 2000, Kmart of Michigan, Inc. (“KMI”) became the owner of substantially all the trademarks, service marks, and trade names used in the Kmart business, including the name “Kmart,” the big red K logo, “Super K” and similar marks. KMI licensed the marks in exchange for royalty fees at a contract rate of approximately 1% of such entities gross revenue. These fees averaged revenue of \$75 million a quarter.²⁰⁹ When Kmart paid KMI’s royalty fee, KMI immediately loaned it back to Kmart. As of the petition date, KMI had an intercompany claim against Kmart in the amount of \$316 million.²¹⁰

ii. The Committee Requests Substantive Consolidation

Second, the unsecured creditors committee also threatened to litigate whether the various Kmart subsidiaries should be “substantively consolidated.” They argued that the separate entities of Kmart should be disregarded pursuant to an “alter ego” and “piercing of the corporate veil” theories.²¹¹ This would result in a pooling of their assets for the benefit of all creditors and not just the pre-petition lenders.

The legal standing for this argument is derived from Section 105(a) of the bankruptcy code. This section provides that the court may issue orders “necessary” to carry out the

²⁰⁹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 70, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

²¹⁰ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 70, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

²¹¹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 70, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

provisions of the bankruptcy code.²¹² There are no statutorily prescribed standards dealing with when substantive consolidation is allowed.

The two factors courts usually rely on in determining the allowance of substantive consolidation are (1) whether the creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit and (2) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.²¹³

In Kmart's case, the unsecured creditors argued that Kmart met the test for the first factor. Kmart, through its corporate department, provided services to all Kmart entities.²¹⁴ As a collective whole, the pre-petition lenders held most of the pre-petition, impaired, unsecured claims against the Kmart of subsidiaries. The unsecured creditors asserted that they were entitled to substantially all the value in Kmart's subsidiaries. As a result, they argued that the other creditors of Kmart, including trade vendors and other unsecured creditors, should not be distributed any value from the Kmart of subsidiaries until the pre-petition lenders were paid in full.²¹⁵

On the other hand, Kmart argued that the creditors did not deal with the Kmart entities as a single economic unit. Rather, the pre-petition lenders obtained separate

²¹² 11 U.S.C. §105, A second well can be drawn from section 1123(a)(5)(C).

²¹³ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 71 , In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL)

²¹⁴ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 72 , In re Kmart Corporation, et al., Ch. 11 Case No.02-02474 (BRL) (Bankr. N.D.IL). These services included accounting and bookkeeping, treasury, legal, tax, informational systems, administrative, real estate management, store planning, construction and design, human resources administration, "back office" corporate services and shared a centralized cash management system. Id.

²¹⁵ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 72 , In re Kmart Corporation, et al., Ch. 11 Case No.02-02474 (BRL) (Bankr. N.D.IL).

subsidiaries guarantees from each Kmart subsidiary. Further, the separate entities had their own real estate, executory contracts, and inventory.²¹⁶

On the second prong of the test, the unsecured creditors committee argued that historically Kmart filed consolidated financial statements. Moreover, Kmart's corporate department provided service to all Kmart entities including accounting, bookkeeping, treasury, legal, tax, information systems, administrative, real estate management, store planning, construction and design, human resource administration, and similar "back office" corporate services. The entities also share a centralized cash management system.

On the flip side, Kmart could have argued that not all creditors dealt with the Kmart entities as a single economic unit—prepetition lenders obtained separate subsidiary guarantees from each subsidiary. Furthermore, each subsidiary has separate real estate leases and executory contracts, and each owns its own real estate and inventory. Alternatively, Kmart could argue that substantive consolidation was not in the best interest of all creditors, eliminating it as an option.²¹⁷

iii. Preference Claims

As a general matter, a "preference" under the bankruptcy code is a payment made by a debtor to a creditor within the 90 days prior to the petition date if the payment is on account of a pre-existing debt owed by the debtor to the creditor. Kmart made over \$1

²¹⁶ Id. In fact, the pre-petition lenders could argue that substantive consolidation would harm them. The pre-petition lenders would have only one claim against the consolidated pool of assets, and their anticipated recovery on that single claim would be diluted by claims of all other unsecured creditors. Because some pre-petition lenders would receive less for their claims due to substantive consolidation, Kmart argued that consolidation was not in the best interests of all creditors.

²¹⁷ This is because if the entities were substantively consolidated, the subsidiary guarantees would be eliminated, and the prepetition lenders' asserted priority entitlement to the subsidiaries would be lost. Furthermore, the claims would be diluted by the claims of all other unsecured creditors.

billion preference payment to Fleming, \$422 million on taxes; over \$410 million in real estate payments, \$8.3 million in intercompany loans among affiliates; \$2.2 billion in payments to pre-petition lenders on loan pay downs; \$106 million in interest on pre-petition notes \$248 million to Kmart's joint venture partners; and \$108 million in employee benefit payments (not including payroll).²¹⁸

As a general matter, if creditor provides a debtor with “new value” after the creditor has received a payment from the debtor and the new value remains unpaid as of the petition date, it can be deducted from the amount of the new value from the previous preferential transfer. Similarly, payments are made by a debtor on account of goods and services acquired in the “ordinary course” of business; they may be exempt from recovery by a debtor under the preference statutes.²¹⁹

Kmart identified all transfers made by them to all persons within the 90-day preference period. Based on this analysis, approximately \$6 billion in preferential payments could be subject to recovery under the bankruptcy code.²²⁰ Of the \$6 billion in claims, approximately \$1.86 could be classified as “new value.” Additionally, \$2.18 billion could be classified under the “ordinary course” umbrella. The remaining \$2 billion fall outside both categories.

Asserting the “ordinary course” defense requires an intensive fact-based analysis that is polycentric and involves nebulous facts. Because of this, the defense and successful claim is

²¹⁸ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 103, In re Kmart Corporation, et al., Ch. 11 Case No.02-02474 (BRL) (Bankr. N.D.IL).

²¹⁹ Id.

²²⁰ This amount does not include preferential amounts made to trade vendors and service providers.

highly uncertain, very risky, and expensive to litigate. There is also the possibility that the Debtors were insolvent at the time of alleged preferential payments were made.

After applying the estimated costs of litigation, and the risks involved in such litigation, the Debtors estimate that the potential recovery would range from \$240 million and \$405 million.²²¹

iv. Trust Claims

The bankruptcy code permits a court to appoint a trustee under section 1104(a) of the bankruptcy code.²²² The UST must move for the appointment of a trustee if there are reasonable grounds to suspect that parties have participated in fraud or dishonest conduct.²²³ Also, the appointment of a trustee can be appointed on “request of a party in interest.”²²⁴ In the *Kmart* case, a trustee was appointed by the court to investigate the mismanagement and fraud committed by the company’s senior management.²²⁵

²²¹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 104 , In re Kmart Corporation, et al., Ch. 11 Case No.02-02474 (BRL) (Bankr. N.D.II).

²²² Appointment may be “for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor” or “if such appointment is in the best interests of creditors, any equity security holders, and other interest of the estate” or if grounds exist to convert or dismiss the case under §1112, but the court determines that the appointment of the trustee or examiner is in the best interests of creditors and the estate.

²²³ 11 U.S.C. §1104(e).

²²⁴ “If the court does order the appointment of a trustee under this section, then any time before the confirmation of a plan, on request of a party in interest or the United States Trustee, and after notice and a hearing, the court shall order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonest, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management of the debtor if (1) such appointment is in the interests of the creditors, any equity security holders, and other interests of the estate; or (2) the debtor’s fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000.” 11. U.S.C. §1104(c).

²²⁵ The members accused of fraud were fired and no longer employed by Kmart when the investigations were taking place.

The Debtors admitted that evidence indicates that the estates have claims against former officers on grounds that they were grossly derelict in performing their duties to the company, its associates, vendors, and investors, for claims such as breach of fiduciary duties of due care, loyalty and candor, gross negligence, and certain bankruptcy-related causes of action.²²⁶ In addition, management also breached contract and conducted misconduct against certain third party vendors who purported to provide consulting services to Kmart.²²⁷ Finally, there are numerous allegations issued against Charles Conway directly.²²⁸

²²⁶ For example, in summer 2001, a senior executive directed initiatives that resulted in the excessive purchase of inventory without sufficient analysis and oversight, and without appropriate consultation with the merchant community or Kmart's treasury officials in the amount of \$850 million.

²²⁷ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 44, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.II).

²²⁸ The complaints filed in the United States District Court for the Eastern District of Michigan alleged that Mr. Conway made material misstatements or omission during the alleged class period that inflated the trading prices of Kmart's common stock and seek, damages under section 10b-5 of the Securities and Exchange Act of 1934 and section 410 of the Michigan uniform Securities Act. Kmart is not a defendant in this litigation.

Chapter Fifteen

BEST INTERESTS: KMART'S LIQUIDATION ANALYSIS

Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks.
Warren Buffett

Under Section 1129(a)(7) of the bankruptcy code, Kmart was required to prove that the reorganization was in the best interests of the creditors. Kmart needed to show three things: (1) the total value of the outstanding claims against Kmart; (2) the value of these claims if Kmart was liquidated; (3) the value of the claims if Kmart was reorganized. The purpose of the liquidation analysis is to provide information in order that the bankruptcy court may determine that the plan of reorganization is in the best interests of all classes of creditors and equity interest holders impaired by the plan.²²⁹

i. Outstanding claims

The last date for setting claims against the Debtors' was July, 31 2002. After this date, the debtors had a total of 44,935 claims filed against them asserting claims in the total face amount of \$75.2 billion. However, Alix Partners determined that many of these "claims" were invalid or duplicates.²³⁰

²²⁹ The "best interest test" requires that a bankruptcy court find that the plan provides to each member of each impaired class a recovery that has a value at least equal to the value of the distribution each member would receive if Kmart were liquidated under Chapter 7.

²³⁰ PBGC claims (the government agency that affords certain guarantees of pension plan liabilities) had claims of almost \$41 billion that would not be realized because the Debtors intended to continue paying their pension obligations. Furthermore, Alix Partners determined that there were \$12.4 billion in duplicate claims.

Vehicle of recovery	\$ in millions
No plan or liquidation	\$ 75, 200, 000, 000
Plan	\$ 8, 000, 000, 000
Liquidation	\$ 18, 000, 000, 000

ii. Value in liquidation

The liquidation value to unsecured creditors is not a simple matter of determine the aggregate value of the assets. The pie is first reduced by the secured creditors to the extent of the value of their collateral, including the value of goods delivered on consignment to the extent this interest is perfected followed by the costs and expenses of liquidation, including administrative expenses and costs of both the chapter 7 and chapter 11 cases.²³¹

In a hypothetical Chapter 7 liquidation of Kmart, Alix Partners estimated that the total value of the unsecured claims would range from \$11.7 billion to \$18.2 billion.²³² For purposes of the analysis, Alix Partners assumed that liquidation would require three phases and would take place over 18 months. Phase 1 would comprise a three-month period during which inventories would be sold in a going-out-of-business sale conducted by a third party.

²³¹ Costs include the compensation of a trustee as well as of counsel and other professionals retained by the trustee, asset disposition expenses, all unpaid expenses incurred by the debtor in its bankruptcy case that are allowed in the chapter 7 case, litigation costs, and claims arising from the operation of the debtor during the pendency of the bankruptcy case. Second, the liquidation itself would trigger certain priority payments that would otherwise be due in the ordinary course of business. Finally, the liquidation would trigger the rejection of a large number of executory contracts and unexpired leases and thereby create a significantly higher number of unsecured claims. However, holders of rights of letter of credit beneficiaries are generally not affected by liquidation.

²³² The difference in amounts will be discussed in the liquidation section. Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 105 , In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

By the end of this sale, substantially all store, distribution center, and field associates would be terminated. Phase 2 would comprise the next six month period and would sell off Kmart's real estate. Further, most of the company's non-real estate fixed assets would be marketed. Additionally, headquarter operations would "wind down." Phase 3 would comprise a nine month period after the real estate sale during which any remaining litigation would be pursued, final tax returns filed, bankruptcy reports and schedules filed and remaining assets disposed.

The value of Kmart in liquidation fluctuates mainly because of two factors. First, in the event of liquidation, the aggregate amount of unsecured claims will increase significantly (as reflected in the high range estimate), and such claims will be subordinated to priority claims that will be created.²³³ Secondly, the assets in liquidation are sold at a forced sale and therefore are sold at a deep discount.

iii. Value under plan

The value of Kmart under the plan is approximately \$3 billion dollars.²³⁴ The members of each impaired class would receive at least as much under the plan as they would in liquidation in a hypothetical Chapter 7 liquidation. Creditors and interest-holders would receive a better recovery through the distributions contemplated by the plan because the continued operations of Kmart as a going concern, would allow for the realization of more value for Kmart's assets and reduce claims against the estate.²³⁵

²³³ For example, employees would file claims for wages, pensions, and other benefits, some of which will be entitled to priority. Further, landlords would likely file large claims for both unsecured and priority amounts. The resulting increase in both general unsecured and priority claims would decrease percentage recoveries to unsecured creditors of Kmart.

²³⁴ See chapter 11 for a detailed discussion of the valuation.

²³⁵ The assets the estate holds can be valued at their fair market value rather than a discounted rate because of the forced liquidating sale.

Chapter Sixteen

NEW HORIZONS: APPROVAL OF THE PLAN

Four steps to achievement: Plan purposefully. Prepare prayerfully. Proceed positively. Pursue persistently.

William Arthur Ward

A. The Plan Proposal

Kmart proposed a global settlement of their claims, embodied by the plan that affords distributions to their constituencies commensurate with the risks of their litigation positions. Under section 1123(b)(3)(A) of the bankruptcy code and rule 9019 of the bankruptcy rules, a settlement, such as the plan, should be approved if it represents a reasonable compromise that is in the collective best interests of all constituencies in light of risks of continued litigation. The settlement need not afford the best possible recovery to any particular constituency, but instead need only represent a recovery that falls within a reasonable range of litigation possibilities. The necessary creditors and debtors believed the plan to meet those standards.

B. Voting

Claimholders and interest holders in each impaired class are entitled to vote in their respective classes as a class to accept or reject the Plan. Classes 1, 2, and 3 are unimpaired by the plan. Therefore, under section 1126(f) of the bankruptcy code, they are conclusively presumed to have accepted the plan. Because all debtors are proponents of the plan, class 8 and 12 are deemed to have accepted the plan. The remaining classes (4, 5, 6, 7, 9, 10, 11, and 12) are impaired. Accordingly, under section 1126(c) of the bankruptcy code, except as

provided in 1126(e), an impaired class has accepted the Plan if the Plan is accepted by the holders of at least two-thirds in dollar amount and more than one-half in number of the allowed claims of such class that have timely and properly voted to accept or reject the plan.²³⁶ Section 1126(d) states that an impaired class of interest has accepted the plan if it is accepted by at least two-thirds in amount of the allowed interest of such class that have timely and properly voted to accept or reject the plan.

Section 1129(b) of the Bankruptcy Code provides that a plan can be confirmed even if it has not been accepted by all impaired classes as long as at least one impaired class of claims has accepted it. The court can confirm the plan, at the request of Kmart, notwithstanding the plan's deemed rejection by impaired classes so long as it "does not discriminate unfairly" and is "fair²³⁷ and equitable"²³⁸ to each impaired class that has not accepted the plan.²³⁹ The votes of holders of subordinated securities claims and interests in Kmart are not being solicited. Therefore, they are deemed to have rejected the plan pursuant to section 1126(g) of the Bankruptcy Code. On April 11, 2003, Kmart filed the voting report certifying the method and result of the ballot tabulation for each voting

²³⁶ 11 U.S.C. 1129(e).

²³⁷ A plan is fair and equitable as to a class of secured claims that rejects the plan if the plan provides (1) that the holder of claims included in rejecting class retain the liens securing those claims, and (2) that each holder of a claim of such class receives on account of that claim deferred cash payments totaling at least the allowed amount of that claim, as of the effective date.

²³⁸ A plan is fair and equitable as to a class of unsecured claims that rejects the plan if the plan provides (1) for each holder of a claim included in the rejecting class to receive or retain on account of that claim property that has a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (2) that the holder of any claim or interest that is junior to the claims of such rejecting class will not receive or retain on account of such junior claim or interest any property at all.

²³⁹ A plan does not discriminate unfairly within the meaning of the Bankruptcy Code if a dissenting class is treated equally with respect to other classes of equal rank.

class.²⁴⁰ Accordingly, Kmart passed plan pursuant to section 1129(b) of the Bankruptcy Code on April 23, 2003.

C. Effective Date

On the effective date the plan goes into effect thus triggering several important events.

i. Contributions

On the effective date, the Plan Investors will pay Kmart in cash pursuant to the terms and conditions in the investment agreement.

ii. Post-effective date financing

On the effective date, Kmart will enter into the exit financing facility agreement in order to repay the DIP facility claims, make payments required on the effective date, and conduct their post-reorganization operations. Exit financing is of paramount importance to any reorganizing plan because every business must have necessary funds to operate. Kmart, along with their investment banker and financial advisor, Miller Buckfire Lewis, solicited commitments of \$2 billion dollars in exit financing upon terms acceptable to the creditors. After extensive negotiations, the Debtors agreed to the exit lenders proposal. On January 14, 2003, the Debtors filed a motion requesting authority to accept the commitment letter and to pay expenses in connection therewith. On January 28, 2003, the Bankruptcy Court entered an order granting the requested relief. The authorization of the letter and associated expenses are administrative claims.

²⁴⁰ The only rejecting classes were the deemed rejected classes.

iii. Trust preservation

Pursuant to section 1123(b)(3) of the bankruptcy code, Kmart will retain and may enforce any retained actions pending on the effective date, except those specifically excluded by the plan.

iv. Executory contracts and unexpired leases

Unless provided for in article 8.1(c) of the plan, each executory contract and unexpired lease is deemed automatically assumed in accordance with sections 365 and 1123 of the bankruptcy code.²⁴¹

v. New existence

Perhaps most importantly, Kmart will take all steps necessary to form New Holding Company and New Operating Company pursuant to their respective certificates of incorporation and by-laws.²⁴² Secondly, contribute and transfer all assets of Kmart, other than qualified real estate and trust assets to entities contemplated by the restructuring transactions. Finally, issue all of the New Operating Company common stock to New Holding Company.²⁴³

²⁴¹ Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 68, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

²⁴² Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession at 109, In re Kmart Corporation, et al., Ch. 11 Case No. 02-02474 (BRL) (Bankr. N.D.IL).

²⁴³ The articles of incorporation and bylaws of New Holding Company will authorize (a) five-hundred million (500,000,000) shares of New Holding Company Common Stock, \$0.01 par value per share; (b) authorize twenty million (20,000,000) shares of New Holding Company preferred stock for future issuance upon terms designated by the board of directors of the New Holding Company; (c) provide, pursuant to §1123(a)(6) of the bankruptcy code, provisions prohibiting the issuance of non-voting equity stock for two years from the effective date, and provisions setting forth voting power among classes of equity securities possessing voting power.

Chapter Seventeen

FAIRY TALES: KMART FROM 2003-2010

If you want a happy ending, that depends, of course, on where you stop your story.
Orson Welles

Senior management of Kmart lived the life of rock stars and divas. They had gated estates, yachts, company jets, and saw their perks, bonuses, and loans increase while their company reported loss to the tune of \$3.9 billion dollars in a mere five quarters.²⁴⁴ The life of excess in the lives of rock stars is something that may be strived for in a capitalist society, but when it corporate America gets in the act, there are real tangible losses. Over 70,000 workers lost their jobs and millions of stock-holders lost their retirement plans because the actions of Kmart.²⁴⁵ To understand the effect of the *Kmart* case, the management, average Joes, and the Kmart Corporation will be explored.

A. Executive management

As expected, within 50 days of the Petition date, the debtors replaced almost all members of senior management.²⁴⁶ In their wake, several new members were appointed in their place.²⁴⁷ Further, the newly appointed board did not crack down on financial payments

²⁴⁴ Max Oritz, *Kmart's Road to Bankruptcy*, The Detroit News, Aug. 12, 2002.

²⁴⁵ Karen Dybis, *Kmart's woes trickle down: Suppliers, malls and even retailer's hometown suffer along with laid-off workers*, The Detroit News, Feb. 24, 2003.

²⁴⁶ Charles Conway (CEO), Mark Schwartz (President), John McDonald (EVP, CFO), David Rots (CAO) were all separated from their employment with Kmart by March 11, 2002.

²⁴⁷ James Adamson became (CEO), Ronald Hutchison was named chief restructuring officer, Albert Koch was appointed (CFO), Edward Stenger was named (treasurer), Julian Day was named (president and COO), Michael Macik became (EVP of HR), William Underwood was appointed (EVP of sourcing & global operations).

to ex-executives. It seems that the board operated under the “good-old-boys” framework and awarded their former colleges’ golden parachutes despite the rampant allegations of fraud, deceit, and corruption. The chart below illustrates the payments made.²⁴⁸

Kmart payouts

Kmart's annual report includes new details about severance packages for top executives who departed as the chain's financial woes worsened:

Name	Title	Termination Date	Severance Agreement	Forgiven Loans
Charles Conaway	former CEO	3/11/02	\$4 million	\$5 million
David Rots	former Ex. VP	3/25/02	\$43,400/month*	\$2.5 million
Anthony D'Onofrio	former Ex. VP	3/25/02	\$38,000/month*	\$2.5 million
Mark Schwartz	former President	1/15/02	\$0	\$3 million
Jeffrey Boyer	former Ex. VP	11/0/01	\$1.3 million	\$0

* Severance payments now ceased

Source: Securities and Exchange Commission filings

It is significant to note the funds given out were latter limited not by the company, but by court decree.²⁴⁹

B. Average Joes

At the time of the Petition Date, Kmart had over 519 million outstanding shares of stock that would soon become worth nothing.²⁵⁰ The stock had already lost over 86% of its value since the start of the year and was trading at a 38 year low.²⁵¹ The bankruptcy also has a devastating effect on employees of Kmart. A manager at a Texas store told the *Free Press* that the company announcement “was devastating, just devastating. It’s just that you’re never ready.” Employees, he said, were hurt, angry and afraid, “all those emotions that

²⁴⁸ Max Oritz, *Kmart's Road to Bankruptcy*, The Detroit News, Aug. 12, 2002.

²⁴⁹ Kmart would have given the executives their negotiated benefits. Only when forced by the creditors were the payments retracted. Max Oritz, *Kmart's Road to Bankruptcy*, The Detroit News, Aug. 12, 2002.

²⁵⁰ Karen Dybis, *Kmart Plan Guts Investors*, The Detroit News, Jan. 19, 2003.

²⁵¹ Rebecca Byrne, Meet the Street: Bankruptcy Not Expected to KO Kmart, The Street, Jan. 23, 2002.

come with uncertainty.”²⁵² By the time Kmart had finished reorganizing, more than 60,000 employees had lost their jobs and 600 stores were closed.²⁵³ The holders of common stock received no distributions under the plan.

The consequences of a bankruptcy not only affect Kmart directly, but the thousands of business, municipalities, and employees that depended on Kmart to bring in sales. A retail consultant said a significant number of former Kmart store locations will remain vacant for significant periods of time. The resulting decline in shoppers will devastate many small businesses, and cause strip centers to fold. "Kmart is well-defined as a wrecking crew, and my position is the wreckage will continue."²⁵⁴ For example, Penske Auto Centers cut more than 4,000 employees in April alone because of Kmart's bankruptcy.²⁵⁵ Despite debts to the private sector, Kmart also left behind bills to be passed on to municipalities that will be doubly hit on the bankruptcy, first because of not receiving the taxes they are owed, and second in the loss revenue from employees and business operations. For example, the city of Troy MI, was owed \$213,000 in taxes according to city records that remain unpaid.²⁵⁶

²⁵² Id.

²⁵³ Stan Pohmer, *The Kmart Saga Re-visited*, Greenhouse Product News, Mar. 2003, at 3.

²⁵⁴ Karen Dybis, Kmart's woes trickle down: Suppliers, malls and even retailer's hometown suffer along with laid-off workers, *The Detroit News*, Feb. 24, 2003.

²⁵⁵ Id.

²⁵⁶ Id.

C. The end of Kmart

In November 2004, Kmart Holdings bought Sears Roebuck for \$11 billion dollars and merged the companies to create Sears Holdings.²⁵⁷ Sears Holding is the third largest general merchandise retail company in the United States. The company was formed in 2005 by the merger of Sears Roebuck (Sears) and Kmart Holdings. The merger was coordinated by Edward Lampert, the current Chairman, whom now holds over 54% of the shares outstanding through his hedge fund ESL Investments.²⁵⁸ The idea behind the merger of Kmart and Sears was to combine the strengths of companies, the reputation for quality and service of Sears, and the low prices of Kmart. The company generated \$44 billion in sales in 2009.²⁵⁹ Despite the high volume of sales, profits have not followed. The recession that followed the 2007-08 housing collapse has not been kind to the new company as its sales decreased 5.1% in 2009 and the company's net income fell from \$1.5 billion in 2006 to a mere \$253 million in 2009.²⁶⁰ The "Kmart" division of Sears Holdings contributed only 35.7% in sales to Sears Holdings in 2009.

It appears that Kmart's assets were not properly valued in the reorganization. Analysts from Deutsche bank conducted an independent analysis and concluded that the real estate was substantially undervalued.²⁶¹ Because of the bankruptcy process, Kmart had an

²⁵⁷ 2011 Reorgs Database\Documents Database\News Articles\Sears Holding current.docxWiki Analysis, <http://www.wikinest.com>.

²⁵⁸ Parija Bhatnagar, The Kmart-Sears Deal, CNN, Nov. 17, 2004.

²⁵⁹ 2011 Reorgs Database\Documents Database\News Articles\Sears Holding current.docxWiki Analysis, <http://www.wikinest.com>.

²⁶⁰ Id.

²⁶¹[who] Concluded that the stock could be valued as high as \$152.95 a share.

average rent of \$2.03 per square foot per store while other comparable retailer's average was \$10.07.²⁶² Because of the severity of this undervaluation, Kmart sold off its stores piece by piece thereby receiving maximum value for them.²⁶³ The Deutsche bank report noted that the department stores were "the mother lode of real estate value." As late of July 2004, it was still unsure if Kmart would liquidate or try to turn itself around.²⁶⁴ For example, in June 2004, Kmart sold 78 of its stores to Sears and Home Depot for \$965 million.²⁶⁵

According to its most recent financial statements, Sears Holding is doing well and is profitable.²⁶⁶

²⁶² Id.

²⁶³ 2011 Reorgs Database\Documents Database\News Articles\Sears Holding current.docxWiki Analysis, <http://www.wikinvest.com>.

²⁶⁴ Stan Pohmer, The Kmart Saga Re-visited, *Lawn & Garden Retailer* March 2003 Volume: 2 Number: 3.

²⁶⁵ Kmart stock soars with release of analyst report.

²⁶⁶ The company had net-income during the fourth quarter of \$474 million and a yearly net-income of \$133 million in 2010. 2011 Reorgs Database\Documents Database\News Articles\SHLD discussion of KMART.docx.

Chapter Eighteen

THE HAND OF JUSTICE: THE SEVENTH CIRCUIT AFFIRMS

If you have ten thousand regulations you destroy all respect for the law.
Winston Churchill

On January 22, 2004, the Seventh Circuit heard arguments on Kmart’s critical vendor motion. The court upheld the order of District Judge Grady, holding that the “critical” vendors should not have been paid in full for pre-petition claims.²⁶⁷

A. Seventh Circuit Opinion

The court noted that, out of approximately 4,330 vendors, Kmart decided that 2,330 of these were “critical.” The critical vendors were paid in full for Kmart’s pre-petition debt. The other 2,000 vendors, along with 43,000 additional creditors, “eventually received about 10¢ on the dollar, mostly in stock of the reorganized Kmart.”²⁶⁸

Kmart first argued that by the time Judge Grady reversed the order authorizing payment, it was too late and the money could not be refunded. However, the Seventh Circuit noted that “[r]eversing preferential transfers is an ordinary feature of bankruptcy practice, often continuing under a confirmed plan of reorganization.” Although debt incurred through a DIP financing order is not reversible under the bankruptcy code, “[n]othing comparable anywhere in the Code covers payments made to pre-existing, unsecured creditors, whether or not the debtor calls them ‘critical.’”²⁶⁹

²⁶⁷ *In re Kmart*, 359 F.3d 866, 874 (7th Cir., 2004).

²⁶⁸ *Id.* at 869.

Next, Kmart argued that it relied to its detriment on the original order. The court held that, although the “critical vendors” continued selling goods and services to Kmart in exchange for the payment of pre-petition debts, this was not “*detrimental* reliance.” They were paid in full for all of the post-petition goods and services that they provided to Kmart – and so the court found that, although perhaps there was some kind of reliance on the order, there was no detriment to the vendors.²⁷⁰

The Seventh Circuit then turned its attention to the asserted authority for the payment – Section 105(a). “Section 105(a) allows a bankruptcy court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of” the Code.” However, the Seventh Circuit held that this section does not give the bankruptcy court the authority to override the rules of bankruptcy, but rather only to implement them. Although the “doctrine of necessity” is found in some very old cases, the court found that it “is just a fancy name for a power to depart from the Code.” Further, the cases where the doctrine originated, which were decided in the late 1800’s, predate the first general effort to codify the rules of bankruptcy. The court dismissed this old caselaw, noting that “[o]lder doctrines may survive as glosses on ambiguous language enacted in 1978 or later, but not as freestanding entitlements to trump the text.”²⁷¹

Regardless of ancient doctrines or any possible interpretation of the code, the Seventh Circuit found that the critical vendor order was unsound on its face. The premise

²⁶⁹ Id.

²⁷⁰ Id. at 869.

²⁷¹ Id. at 871.

of the original order was “the belief that vendors not paid for prior deliveries will refuse to make new ones.”²⁷² The court noted:

For the premise to hold true, however, it is necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation – a demonstration never attempted in this proceeding – but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors. 273

B. Critical Commentary

Rather than providing clarity, the Seventh Circuit’s decision resulted in further confusion regarding the viability of “critical vendor” orders. In April 2004, H. Bradley Staggs wrote in the *American Bankruptcy Institute Journal* that the Seventh Circuit’s decision in *Kmart* created “further uncertainty as to a bankruptcy court’s authority to enter a critical-vendor order.” Although the court shut the door to any attempt to use § 105(a) or the doctrine of necessity, the court noted in dicta that § 363(b)(1) might provide authorization if (1) the “critical” vendors would cease providing goods to the debtor without payment, and (2) the entry of the critical-vendor order is in the best interests of the estate. Staggs notes that adherence to these requirements might require the debtor, in the first few days of its bankruptcy, to “present a liquidation analysis to the bankruptcy court that would reflect a lower percentage recovery for pre-petition creditors (including non-critical vendors) as compared to the recovery such creditors would receive under a theoretical chapter 11 plan

²⁷² Id. at 872.

²⁷³ Id. at 873.

that may eventually be confirmed after the debtor makes payments to critical vendors.” It is unlikely, he claimed, that a debtor would be able to make this showing. As well, the comments by the court regarding § 363(b)(1) are just dicta. A vendor relying upon a court’s grant of critical vendor status under § 363(b)(1) would have no guarantee that the payment would not be subject to subsequent avoidance.²⁷⁴

A few months later, in June 2004, commentators were more hopeful for the resurrection of the critical vendor doctrine. A paper entitled “Down, But Not Out: The Status of Critical-Vendor Payments Post-Kmart” noted that the Seventh Circuit’s dicta had already been used to “authorize the full payment of at least one debtor’s pre-petition wage obligations.”²⁷⁵ The paper predicted the following effects of the decision: First, debtors would be limited to only the most critical vendors, and they would need to meet the high burden of proof of showing that each vendor “has, in fact, threatened to stop supplying goods unless paid its pre-petition obligations.” Further, “debtors seeking critical vendor orders should consider providing their non-critical vendors with notice of their critical vendor motions” to prevent any allegation of insufficient notice. Despite these limitations, the paper expressed the opinion that the critical vendor doctrine was not “killed” by the Seventh Circuit: “this decision merely adds a new metaphorical ‘wrinkle’ to a ‘crumpled’ doctrine.”²⁷⁶

²⁷⁴ H. Bradley Staggs, *Critical-Vendor Orders: Has the Seventh Circuit Put Such Orders on the Critical List?*, 23 Am. Bankr. Inst. J. 16 (Apr., 2004).

²⁷⁵ See *In re Jays Foods L.L.C.*, Final Order Under 11 U.S.C. §§363(b) & 507(a) (authorizing (1) the payment of pre-petition employee obligations and the continuation of employee benefit plans and programs post-petition, and (2) directing all banks to honor pre-petition checks for payment of employee obligations).

²⁷⁶ James H.M. Sprayregen, James A. Stempel, et al., *Down But Not Out: The Status of Critical-Vendor Payments Post-Kmart*, 23 A. Bank. Inst. J. 26 (June 2004).

Chapter Nineteen

FORTUNE COOKIES

Your best teacher is your last mistake.

Ralph Nader

A. Ride the Waves

Chapter 11 bankruptcies often place all the parties involved on unstable footing. The Debtor needs to avoid getting pushed over by demands from creditor, creditors need to compromise to maximize the value of the estate, and the legal system attempts to establish just remedies. Just like in surfing, a debtor has to find a big wave and ride it out to the end. The surfer has to have skill, knowledge, and speed to make it until the end or otherwise face a wipeout.

Kmart did not know how it would compete with Wal-Mart or Target but knew that it could survive by focusing on its premium brands. Kmart's plan was to exit bankruptcy as soon as possible and become a thinner company by cutting stores and employees. As long as the company does not get pushed over and keeps going, it should be ok.

B. Have a good publicist

A company usually enters chapter 11 because they have made some mistakes along the way. When talking in front of a judge or creditors it is important to focus on what the company did right and how they plan to do better in the future. Kmart did not state that its board had no control over its CEO and COO, or had no plan to compete with Wal-Mart, and Target. Instead it focused on acknowledging isolated incidents of bad judgment and

suggested ways to avoid the situation in the future. Kmart presented itself as a wiser company who learned from its mistakes to the creditors, judge, and public.

C. Don't make assumptions

As noted above, JDA was denied an administrative claim even though it performed post-petition services requested by Kmart. The teaching of this ruling is that vendors cannot assume that post-petition work completed for debtors will receive administrative status. “Depending on the circumstances, a cautious vendor might want to proceed on the assumption that administrative claim status will not be available.”²⁷⁷

A vendor in this situation has several options. First, they may “request a payment method such as payment in advance or payment upon delivery or seek to secure the debtor’s payment obligations through a letter of credit.” For instance, “JDA could have insisted that Kmart post a deposit with JDA or arrange for the issuance of a letter of credit in favor of JDA or a guarantee of payment from a credit-worthy third party.”²⁷⁸ Second, a vendor may force the debtor to assume the pre-petition contract before performing any work. This would protect the defendant from being left with a “a low-priority pre-petition general unsecured claim for its damages from the debtor’s rejection or cancellation of the contract.”²⁷⁹ Regardless of the structure of the post-petition transaction, a creditor should be careful, as a transfer might be viewed as an unauthorized transfer of property subject to

²⁷⁷ Joseph Cioffi, *Protections For Vendors in a Customer’s Bankruptcy May Not Be As Expected*, The Metropolitan Corporate Counsel, June 2004.

²⁷⁸ Bruce S. Nathan, *Trade Creditors Beware: Providing Post-Petition Goods and Services to a Chapter 11 Debtor Under a Pre-Petition Contract Without Protection Can Be Toxic to Collectibility*, Business Credit, September 2003.

²⁷⁹ Bruce S. Nathan, *Trade Creditors Beware: Providing Post-Petition Goods and Services to a Chapter 11 Debtor Under a Pre-Petition Contract Without Protection Can Be Toxic to Collectibility*, Business Credit, September 2003.

avoidance under 11 U.S.C. §549. In any case, it might be wise for a vendor to seek explicit permission from the bankruptcy court before performing any services post-petition.²⁸⁰

D. Know your jurisdiction: *Kmart's* effect on the critical vendor motion

Although some commentators predicted an end to the critical vendor doctrine, these dire predictions have not come to pass. Mark A. McDermott,²⁸¹ one of the lawyers who represented Kmart, noted in late 2006 that predictions of a possible end to the doctrine were “overdrawn.” “In fact, the *Kmart* decision is the only court of appeals ruling that clearly delineates, albeit in dictum, the circumstances under which payments may be made to pre-petition creditors outside the context of a plan.” At the end of 2006, the positions of the Circuit Courts with regard to critical vendor orders were as follows:

- First Circuit – no published decisions;
- Second Circuit – debtors may honor pre-petition obligations outside the context of a plan if necessary to the reorganization;²⁸²
- Third Circuit – debtors may honor pre-petition obligations outside the context of a plan if necessary to the reorganization;²⁸³
- Fourth Circuit – court of appeals held that § 105(a) affords no authority for a debtor to pay pre-petition claims prior to plan confirmation;²⁸⁴

²⁸⁰ Joseph Cioffi, *Protections For Vendors in a Customer's Bankruptcy May Not Be As Expected*, The Metropolitan Corporate Counsel, June 2004.

²⁸¹ See Cast of Characters. McDermott, among others, filed Kmart's critical vendor motion, and may not be an unbiased source of information on this topic.

²⁸² *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) (granting priority status to supply creditors where services or goods were necessary to ensure continued operation of hotel).

²⁸³ *In re Lehigh & New Eng. Ry. Co.*, 657 F.2d 570, 581 (3d Cir. 1981) (authorizing payment to creditors under “necessity of payment” doctrine where payment “is in the interest of all parties ... [and] will facilitate the continued operation of the railroad”).

- Fifth Circuit – court of appeals has weakened the use of § 105(a) for the payment of pre-petition claims, but the lower courts have authorized payment under §§105(a), 362(A), 363(b), 1107, and 1108;²⁸⁵
- Sixth Circuit – pre-plan payments may be made under § 105(a) and the “necessity of payment” rule;²⁸⁶
- Seventh Circuit – Kmart controls;
- Eight Circuit – pre-plan payments may be made under the Code;²⁸⁷
- Ninth Circuit – conflicting rulings;²⁸⁸
- Tenth Circuit – no published decisions; and
- Eleventh Circuit - § 105(a) may not be used to alter the priority scheme, but some lower court decisions conflict.²⁸⁹

²⁸⁴ See *In re NVR L.P.*, 147 B.R. 126, 128 (Bankr. E.D. Va. 1992) (declaring pre-petition payment could be justified if in the best interests of both debtor and creditors); but see *In re FCX, Inc.*, 60 B.R. 405, 410 (Bankr. E.D.N.C. 1986) (reversing decision authorizing pre-petition payment because it would subordinate remaining unsecured creditors' claims absent requisite inequitable conduct on part of creditors).

²⁸⁵ See *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt., Inc.)*, 4 F.3d 1329, 1334 (5th Cir. 1993) (observing Bankruptcy Code did not give bankruptcy courts authority to debtor to use post-petition funds to satisfy pre-petition claims); but see *In re CEI Roofing, Inc.*, 315 B.R. 50, 61 (Bankr. N.D. Tex. 2004) (permitting pre-petition payment of wage claims to necessary employees under section 105 and section 507(a)(3) and (4));

²⁸⁶ See *In re Quality Interiors, Inc.*, 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991) (“A general practice has developed ... where bankruptcy courts permit the payment of certain pre-petition claims, pursuant to 11 U.S.C. § 105, where the debtor will be unable to reorganize without such payment.”).

²⁸⁷ See *In re Payless Cashways, Inc.*, 268 B.R. 543, 544-45, 547 (Bankr. W.D. Mo. 2001) (citing section 364(b) of Bankruptcy Code as basis for approving debtor's lending transactions in addition to authorizing debtor to pay its critical lumber vendors' prepetition claims).

²⁸⁸ See *Burchinal v. Cent. Wash. Bank (In re Adams Apple, Inc.)*, 829 F.2d 1484, 1490 (9th Cir. 1987) (noting that goal of debtor rehabilitation may warrant overriding Code's general policy of equality of creditor treatment, thereby justifying payment of “pre-petition wages to key employees” and “debts to providers of unique and irreplaceable supplies”); but see *B&W Enters., Inc. v. Goodman Oil Co. (In re B&W Enters., Inc.)*, 713 F.2d 534, 537 (9th Cir. 1983) (rejecting notion that pre-petition critical vendors could be paid pursuant to necessity of payment rule).

²⁸⁹ *Shapiro v. Saybrook Mfg. Co., Inc. (In re Saybrook Mfg. Co., Inc.)*, 963 F.2d 1490, 1496 (11th Cir. 1992) (stating cross collateralization is inconsistent with priority scheme of Bankruptcy Code).

Even in the presence of favorable caselaw, however, debtors may face difficult standards if they want to request the payment of “critical vendors” in their first day motions. Debtors generally must affirmatively prove that there are “no realistic alternatives to payment of the claims and that absent payment, the estate’s value will be seriously and substantially jeopardized. The possibility of favorable trade terms will not, by itself, satisfy this standard.”²⁹⁰ However, the Bankruptcy Code may provide some support for payment of pre-petition claims. The act provides that “any claim for the value of goods received by a debtor in the ordinary course of business within twenty days *prior* to commencement of its case will be entitled to administrative expense priority status, rather than just general unsecured status.” This may allow debtors who want to pay pre-petition vendor claims an opportunity to do so if they pertain to goods delivered twenty days before the case commenced.²⁹¹

²⁹⁰ Mark A. McDermott, *Critical Vendor and Related Orders: Kmart and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 14 Am. Bankr. Inst. L. Rev. 409 (Winter 2006).

²⁹¹ *Id.*