

Kmart's Road to Bankruptcy

Nests feathered as Kmart failed. FBI makes probe of execs a top priority; grand jury meets

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The Detroit News

August 12th, 2002

(PFD File)



Max Ortiz / The Detroit News

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

During his time at Kmart, Schwartz owned homes in Michigan, New York and Arkansas. He spent \$100,000 on an indoor pool and other renovations at his 10-acre Oakland Township estate. He bought a \$500,000 Bayliner motor yacht -- christened "I Am Blessed" -- and \$240,000 worth of land in South Dakota, where he now lives, according to deeds, building permits and boat registrations.

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

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

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

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

Federal officials told The News that as many as 200 subpoenas could be issued in their probe, which could last another six months. James Adamson, the outside director who replaced Conaway as chairman and CEO earlier this year, has promised cooperation with investigators.

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

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

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

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

He signed a lucrative contract in May 2000, complete with a \$1.4 million annual salary, \$6 million in up-front cash and stock bonuses, and a restricted stock award worth \$5.4 million at the time. By comparison, Kmart's previous CEO, Floyd Hall, earned about \$3 million in salary, bonus and other compensation in 1999.

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

Just 12 months later, Conaway demanded a new deal. On May 15, 2001, Conaway stepped onto the stage of the Detroit Opera House for his first annual meeting as Kmart CEO. Blue and red lights flashed and employees waved pom-poms as Conaway pledged to "close the gap" on rival discounters Wal-Mart and Target.

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

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

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

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

Moreover, with Kmart's shares plunging, Conaway's stock-laden long-term compensation package was withering. Despite Conaway's upbeat address to shareholders, Kmart was losing more money than investors knew. While it reported combined losses of \$120 million in the first two quarters, the figure would prove to be much higher when Kmart restated its financial results this past May.

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

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

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

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

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

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



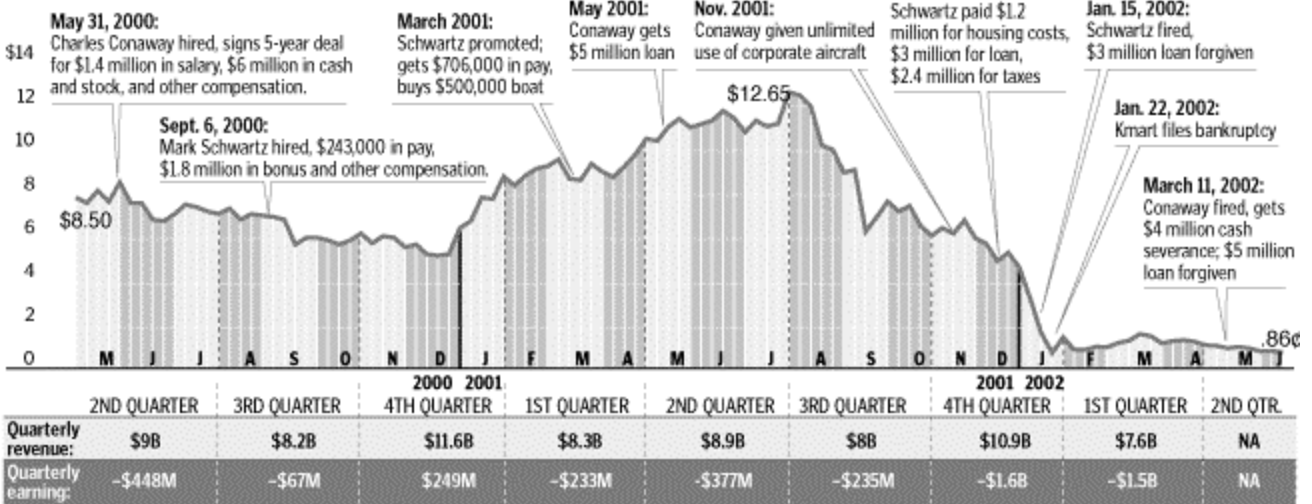
Charles V. Tines / The Detroit News

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

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 Conaway and Mark Schwartz were given a combined \$34 million in compensation.

WEEK ENDING STOCK PRICES SINCE MAY 2000:



Source: Detroit News research

The Detroit News

Corporate odd couple

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

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

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

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

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

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

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

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

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

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

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

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

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

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

When Conaway got his \$5 million loan, Schwartz pressed for a forgivable loan of his own. Schwartz' own restricted stock package was tanking. In August of 2001, Conaway approached Kmart's board to expand the loans to Schwartz and other officers.

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

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

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

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

A letter from Conaway accompanied the loan deals.

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

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

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

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

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

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

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

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

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

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

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

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

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

Sweetheart exec deals cost Kmart millions

Annual report reveals details of packages that sparked outrage

By Karen Talaski
The Detroit News
May 13, 2002

Kmart Corp. identified two former executives whose severance payments it suspended and disclosed that it awarded a third ex-manager a severance deal worth roughly \$1.3 million after just six months of employment.

In its annual report, the Troy-based discount retailer said it has stopped monthly severance payments of \$43,000 to former Executive Vice-President David Rots and \$38,000 to former Executive Vice-President Anthony D'Onofrio. Kmart previously indicated it halted some severance payments, but the company didn't identify the recipients.

Jeffrey Boyer, Kmart's former chief financial officer, received bonuses and other incentives worth \$1.3 million when his employment was terminated last November.

Controversy and outrage among investors, creditors and Kmart workers have centered on the compensation of former executives and so-called "retention loans" that were advanced to executives even as Kmart was on the verge of becoming the largest retail bankruptcy in history.

As part of its reorganization, Kmart has marked 283 stores for closure and said 22,000 employees would be laid off without termination pay. Kmart expects to complete these closures next month.

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

Details about the compensation and severance packages of Kmart's top executives were disclosed as part of the company's 10-K report with the Securities & Exchange Commission, which was filed this week.

In its report, Kmart outlined deals with its seven highest-paid executives. The company didn't identify other executives affected by several rounds of terminations as Kmart's new management cleans house.

Two other executives -- John Owen and David Montoya -- previously disclosed that Kmart had suspended their severance payments. On May 9, the two men filed a motion requesting their monthly payments be resumed. That motion is set for a May 29 hearing in federal bankruptcy court.

Although the \$9 million in severance payments and retention loans given former Chief Executive Officer Charles C. Conaway were well-publicized, the company's latest SEC filings offer the first look at what Kmart's other executives received as the company's house of cards caved in.

Rots, Kmart's former chief administrative officer, received an annual salary of \$520,834 and \$38,278 in personal use of the company's planes. Rots also got a \$2.5 million retention loan and \$422,185 in tax reimbursements.

D'Onofrio, former executive vice-president for supply chain operations, received an annual salary of \$456,864. He also received a \$2.5-million retention loan and \$505,722 in tax reimbursements.

Former chief financial officer Boyer received a salary of \$284,091 for the six months he served in the position. He did not receive a retention loan because he left the company before the bonus package was offered.

Mark S. Schwartz, the retailer's former president and chief operating officer, was paid a salary of \$706,250 last year. In December, Kmart gave Schwartz -- who left Kmart a week before the retailer's Jan.

22 bankruptcy filing -- a \$3-million "retention loan" and reimbursed him for \$1.2 million in housing and temporary living costs.

These tax reimbursements, or "gross-up" allowances, are typically negotiated as part of a severance agreement, but they are not the industry standard, said Carol Bowie, director of governance research services for the Investor Responsibility Research Center in Washington, D.C.

"The company's interest is having the executive leave in a manner that will result in the least amount of problems," Bowie said. "The executive is interested in receiving as much compensation as possible from the company because they don't know when they're going to get their next job.

"Obviously, from a shareholder's point of view, it's not a very productive use of a company's assets, but some companies see it as a part of doing business," Bowie added.

Kmart's failure grew out of ineffectual retailing strategies, questionable accounting practices and a cash shortage during its key fourth quarter. The discount chain's tumble has been exacerbated by a crisis of confidence in American business set off by the Enron Corp. collapse.

The retailer's accounting methods are drawing considerable scrutiny. Since January, Kmart and the SEC have conducted concurrent investigations into a number of areas, including the way Kmart records what is called vendor allowances. These are payments made to Kmart by suppliers for preferential treatment, such as better shelf space and the like.

The FBI also is investigating Kmart's finances as part of a review by the U.S. Attorney's Office for the Eastern District of Michigan.

Kmart has not filed a proxy statement and does not plan at this time to hold an annual meeting, said spokesman Jack Ferry.

Two of the seven executives whose pay is detailed in the annual filing are still employed at Kmart.

Merchandising Executive Vice-President Cecil Kearse received an annual salary of \$495,500 and a \$2.5-million loan. Randy Allen, Kmart's chief diversity officer and executive vice-president of strategic initiative, received an annual salary \$515,000.