UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF MICHIGAN

SECURITIES AND EXCHANGE COMMISSION	:	**Jury Trial Demanded**
Plaintiff,	:	
v.	:	**CIVIL ACTION NO.**
CHARLES C. CONAWAY and JOHN T. MCDONALD, JR.,	:	
Defendants.	:	

COMPLAINT

Plaintiff Securities and Exchange Commission ("SEC" or "Commission"), for its Complaint against defendants Charles C. Conaway ("Conaway") and John T. McDonald, Jr. ("McDonald"), (collectively the "Defendants"), alleges as follows:

SUMMARY OF ALLEGATIONS

1. This civil fraud case involves material misrepresentations and omissions by Conaway and McDonald about the financial condition of Kmart Corporation ("Kmart" or "Company") in the months preceding the Company's bankruptcy. Conaway was Kmart's Chairman and Chief Executive Officer ("CEO"), and McDonald was Treasurer and Chief Financial Officer ("CFO").

2. Defendants failed to disclose that Kmart had made an extraordinary and reckless over purchase of inventory. Instead of candidly admitting the fact of the ill-advised overbuy and the significant impact it had on the Company's liquidity, Conaway and McDonald dealt

with Kmart's liquidity problem by secretly slowing down payments owed vendors. Defendants then lied about why vendors were not being paid on time and misrepresented the impact that Kmart's liquidity problems had on the Company's relationship with its vendors, many of whom stopped shipping product to Kmart.

3. Conaway and McDonald are responsible for materially false and misleading disclosure about such matters in the Management's Discussion and Analysis ("MD&A") section of Kmart's Form 10-Q for the quarter and nine months ended October 31, 2001 ("Form 10-Q(3)") and in a conference call with analysts and investors on November 27, 2001 ("Conference Call").

4. By engaging in such conduct, Conaway and McDonald (i) directly or indirectly violated the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder; (ii) aided and abetted violations of Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 13a-13, and 12b-20 thereunder by Kmart; and (iii) demonstrated their substantial unfitness to serve as officers or directors of a publicly-traded company pursuant to Section 21(d) of the Exchange Act.

JURISDICTION AND VENUE

5. This Court has jurisdiction over this action pursuant to Sections 21(e) and 27 of the Exchange Act, [15 U.S.C. §§78u(e) and 78aa].

6. Defendants, directly and indirectly, have made use of the means and instrumentalities of interstate commerce, or of the mails, or the facilities of a national securities exchange in connection with the transactions, acts, practices and courses of business alleged herein.

7. Venue is proper because many of the transactions, acts, practices and courses of business alleged in this Complaint occurred in the Eastern District of Michigan, including, among other things, the preparation of the Form 10-Q(3) and the Conference Call.

DEFENDANTS

8. Conaway was Kmart's Chairman of the Board and CEO from May 31, 2000, until his termination on March 11, 2002. Conaway resides in Michigan.

9. McDonald was Kmart's Vice President and Treasurer from September 6, 2000, through November 9, 2001. From November 9, 2001, until his termination on March 11, 2002, McDonald was Kmart's CFO. McDonald is licensed as a Certified Public accountant by the Commonwealth of Massachusetts. McDonald resides in West Virginia.

THE COMPANY

10. Kmart is a Michigan corporation headquartered in Troy, Michigan. The Company is a large discount and general merchandise retailer. Its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange until December 19, 2002, when trading was suspended.

11. On January 22, 2002, Kmart filed a petition under the Federal Bankruptcy Code seeking reorganization relief. Before filing for relief under the Federal Bankruptcy Code, Kmart operated approximately 2,100 stores nationwide, employed approximately 250,000 people and had annual sales of approximately $37 billion.

INVENTORY OVERBUY

12. Each year beginning in late September and peaking in late October Kmart made inventory purchases to stock its shelves for the Holiday Season. These inventory purchases required Kmart to borrow heavily against its $1.565 billion credit facility ("Credit Facility").

The inventory purchases were timed to enable Kmart to pay its suppliers and banks according to terms with Holiday Season sales proceeds. Although there was variation among vendors, Kmart's terms with its suppliers generally required payment within thirty to sixty days. Historically, the time around Thanksgiving and Christmas ("Holiday Season") was Kmart's highest sales period. In a typical year, Kmart's reliance on its Credit Facility would peak near the end of October or beginning of November, before Holiday Season sales enabled the Company to begin paying down its bank debt.

13. In the summer of 2001, Kmart's Chief Operating Officer ("COO"), newly promoted to that position by Conaway, made an extraordinary purchase of inventory in the approximate amount of $850 million ("Inventory Overbuy"). The Inventory Overbuy was made without the approval or knowledge of other senior managers of the Company. It was extraordinary not just because of its size, but also because of its timing, which was at least one and a half months before the historical Holiday Season inventory build.

14. In mid-August, 2001, Defendants and other members of senior management, referred to as the Executive Leadership Team ("ELT"), became aware of the Inventory Overbuy. Initially, they believed the size of the Inventory Overbuy was in the range of $400 million, and would not discover until after Labor Day that it was more than double that amount. Even at the lower amount of $400 million, these members of senior management, including Defendants, were seriously concerned that the Inventory Overbuy would cause Kmart to exceed the available balance on the Credit Facility.

15. Defendants and other members of senior management identified a series of action steps to address the apparent $400 million liquidity problem caused by the Inventory Overbuy. These included plans to lower capital expenditures by $168 million, to consummate

real estate sale-leaseback transactions valued at $200 million, and to accelerate the collection of vendor allowances in the third quarter by $300 million. Allowances were provided by vendors for advertising, special displays, price protections, exclusivity and similar product related considerations. In a normal year, Kmart did not collect the majority of its allowances until the end of Kmart's fourth quarter in January.

16. By early September, Defendants and other members of senior management knew that the Inventory Overbuy was actually $850 million, more than double the original estimate. They also learned that the vendor allowance collections effort would fall far short of the projected $300 million, and that the actual collection might be approximately $50 million. In time, the capital expenditures effort was ineffective, and the sale-leaseback transaction fell through entirely.

PROJECT SID

17. By Labor Day, Defendants and other members of senior management realized that the action steps initially identified would not alleviate the liquidity problem caused by the Inventory Overbuy, which Conaway characterized as "reckless" and "unilateral." At this time, Defendants considered, approved and authorized the implementation of a plan to unilaterally extend the terms of payment to Kmart's suppliers. This plan was known among senior managers as Project SID, which was an acronym for "slow-it-down." Under Project SID, Kmart's Assistant Treasurer, who was responsible for its day-to-day implementation, would select the vendor invoices to be paid and not paid. Kmart's extension of payment terms beyond usual terms was not discussed in advance with suppliers nor approved by them. As a consequence, Project SID created serious business relationship issues between Kmart and its vendor community.

18. Defendants instructed the Kmart employees responsible for managing Project SID to maintain a minimum total borrowing "cushion" on the Credit Facility of at least $100 million. By the end of September 2001, Kmart owed its primary banks approximately $1.185 billion, leaving a liquidity cushion of approximately $380 million. In addition, Kmart had withheld approximately $163 million from its suppliers through Project SID.

19. In September and October 2001, Conaway convened a series of meetings attended by McDonald and other members of Kmart's ELT. The purpose of these meetings was to track accounts payable and available cash, address specific problems with vendors caused by Project SID, and review operations issues related to Kmart's liquidity. At these meetings, Defendants and the other members of Kmart's ELT received cash flow analyses that showed Kmart's available cash with and without SID. By the end of the quarter ended October 31, 2001 ("third quarter"), Defendants knew that Kmart had insufficient liquidity to pay its bills on time.

20. A significant number of vendors stopped shipping product to Kmart as of late October/early November 2001. These included major suppliers such as Black and Decker, 3M, Newell Rubbermaid, Gillette, LEGO, and Samsung, among others.

21. On October 27, 2001, McDonald's predecessor as Kmart's CFO warned Conaway in an email of the seriousness of the Company's "cash crunch" and the "nearly $800 million in past due invoices," over half of which was attributable to Project SID.

22. As of October 31, 2001, the last day of the third quarter, Kmart had $267 million available on its Credit Facility and $570 million in past due invoices with its suppliers as a result of Project SID. Stated differently, if Project SID withholdings are factored into Kmart's liquidity calculation, Kmart's cash position was negative $300 million.

23. On November 8, 2001, McDonald's predecessor as Kmart's CFO met with Conaway in person and briefed him at length on the significant financial problems facing the Company. Kmart's CFO recommended to Conaway that the Company may need to plan for a bankruptcy filing and that senior management discuss the liquidity crisis and Project SID at an upcoming meeting of the Board of Directors. The next day, November 9, 2001, Conaway terminated Kmart's CFO and appointed McDonald to that position.

24. As of November 27, 2001, a significant number of vendors were still not shipping product to Kmart. These included such major household names as Newell Rubbermaid, Anchor Hocking, Samsung, Wilson Sporting Goods, LEGO, 3M, Coleman, American Tourister, and AC Delco. Some Kmart stores were out of such staple products as vitamins, cigarettes, light bulbs, books and magazines.

eLMO COVER STORY

25. At the same time Project SID was being implemented, Kmart was converting its inventory and payables software to better track "hard" and "soft" goods, its two general categories of product. This conversion was known as Project eLMO.

26. Defendants constructed a cover story to mask Project SID that attributed Kmart's failure to pay its bills on time to glitches in implementing software changes associated with Project eLMO. Defendants instructed Kmart employees to tell suppliers who complained that Project eLMO was the reason for their past due invoices. In fact, as Defendants knew, Project eLMO had nothing to do with vendors not being paid on time.

27. In response to a direct question from an analyst during the Conference Call (more fully detailed at paragraphs 35 - 39 of this Complaint), Defendants attributed Kmart's failure to pay its vendors on time to Project eLMO. Defendants knew at all relevant times that

Kmart's past due invoices were the result of Project SID and that Project eLMO was not the cause.

FALSE AND MISLEADING MD&A

28. Defendants were required to provide the investing public, including Kmart's shareholders, with complete and accurate MD&A disclosure in the Form 10-Q(3). The purpose of MD&A is to give investors an opportunity to look at the Company through the eyes of management. Defendants deprived Kmart's shareholders of that opportunity in at least three respects.

29. First, Kmart was required to discuss in the MD&A section of Kmart's Form 10-Q(3) material changes in the financial condition of the Company from the end of the preceding fiscal year to October 31, 2001, as well as material changes in financial condition from the third quarter of the preceding year. Where the interim financial statements reveal material changes from period to period in one or more significant line items, Kmart was obligated to describe the causes for the changes if they had not already been disclosed. Kmart failed to adequately describe in the MD&A section of the Form 10-Q(3) the causes for material changes in accounts payable and merchandise inventory Kmart experienced during the third quarter.

30. As reported in the Form 10-Q(3), Kmart experienced an increase in accounts payable of $1,180 million or 56% between fiscal year ended January 31, 2001 ($2,093 million) and the third quarter ended October 31, 2001 ($3,273 million). Kmart experienced an increase in accounts payable of $718 million or 28% from the third quarter ended October 25, 2000 ($2,555 million) to the end of the third quarter ended October 31, 2001 ($3,273 million). There is no description of the causes for those material changes in accounts payable in the MD&A section. The MD&A fails to disclose that at least $570 million of that change was past due and

attributable to Project SID. By not describing Project SID in the MD&A section, Kmart provided incomplete and inaccurate disclosure in the Form 10-Q(3) because it did not describe a significant cause for the material change in accounts payable.

31. As also reported in the Form 10-Q(3), Kmart experienced a change in merchandise inventory of $1,906 million or 30% between fiscal year ended January 31, 2001 ($6,412 million) and the third quarter ended October 31, 2001 ($8,318 million). Kmart experienced a change in inventory levels of $440 million or 6% from the third quarter ended October 25, 2000 ($7,878 million) to the end of the third quarter ended October 31, 2001 ($8,318 million). The MD&A section describes the causes for those material changes as follows: "[i]nventory increased . . . due to seasonal inventory fluctuations and actions taken to improve our overall in-stock position." That description fails to inform the reader that a significant cause for those material changes was the COO's $850 million Inventory Overbuy, which Conaway characterized as "reckless" and "unilateral." By not including this information in the MD&A section, Kmart provided incomplete and inaccurate disclosure in the Form 10-Q(3) because it did not describe a significant cause for the material change in inventory.

32. Second, Kmart was required to identify in the MD&A section of the Form 10-Q any known trends or any known demands, commitments, events or uncertainties that will result in or that were reasonably likely to result in the Company's liquidity increasing or decreasing in any material way. Where material deficiencies were identified, Kmart was obligated to indicate the course of action that the Company had taken or proposed to take to remedy the deficiency, and also to identify and separately describe internal and external sources of liquidity. As of October 31, 2001, Kmart had effectively withheld approximately $570 million from its vendors without their consent via Project SID. The vendor borrowing constituted a material deficiency

at quarter end that should have been identified in the MD&A, and Project SID was a source of liquidity that should have been identified and separately described.

33. Third, the MD&A section also states that "[o]ur primary sources of working capital are cash flows from operations and borrowings under our credit facilities." This was misleading because hundreds of millions of dollars in "working capital" were attributable to Project SID during the third quarter.

34. McDonald was well aware of these problems when he signed Kmart's Form 10-Q(3) on or about November 27, 2001. Conaway led the management team that created and responded to the liquidity crisis and then concealed the problem from the public. As a result, Defendants knew, or were reckless in not knowing, that the MD&A section of the Form 10-Q(3) was false and misleading when it was filed with the Commission on November 27, 2001.

CONFERENCE CALL

35. Conaway and McDonald also made a number of materially false and misleading statements to investors and analysts in the Conference Call on November 27, 2001.

36. During the Conference Call, McDonald stated that Project eLMO "did have some issues along the way." Conaway then sought to "eliminate any misinformation that's clearly been circling in the marketplace." Conaway explained that, "We've clearly caused some systems issues, as John [McDonald] mentioned. During our accounts payable conversion, certain invoices involved in the integration were dropped and [this] has clearly caused some confusion." These statements were false and misleading. Project eLMO did not cause invoices to be "dropped." Payments were deliberately withheld through Project SID.

37. When asked by an analyst about Kmart's problems with vendors, Conaway responded in part, "there was a lot of noise from a small group of suppliers." This was false

and misleading. In truth, a substantial number of vendors had stopped shipping product to Kmart stores including such major suppliers as Black and Decker, Newell Rubbermaid, Gillette, LEGO and Samsung.

38. McDonald added, “we’re fully caught up at this point.” This was false. Kmart still owed approximately $365 million in undisclosed vendor borrowing as the result of Project SID as of November 30, 2001.

39. Defendants knew, or were reckless in not knowing, that these statements to investors and analysts were false and misleading. McDonald knew that the statement “we’re fully caught up at this point” was false, in part, because the Assistant Treasurer had told McDonald shortly before the Conference Call that the company would not be “fully caught up” until early December.

KMART’S BANKRUPTCY

40. Kmart utilized Holiday Season sales proceeds to pay down its Project SID borrowing in early December 2001. Kmart’s bank borrowing under its Credit Facility rose to unprecedented levels as a result. This caused Kmart’s banks to begin preparing debtor-in-possession petitions under the Federal Bankruptcy Code. Historically, Kmart had paid off its entire bank debt by calendar year end, but at the end of December 2001, Kmart’s bank debt on its Credit Facility was approximately $970 million. To make matters worse, Kmart was unable to collect from its vendors hundreds of millions of dollars worth of allowances arguably due and owing in January 2001, which further exacerbated Kmart’s deteriorating liquidity situation. On January 22, 2002, Kmart filed a petition under Chapter 11 of the Federal Bankruptcy Code.

41. On the eve of bankruptcy, January 15, 2002, McDonald received a $1.75 million cash payment from Kmart. This supplemented a similar $750,000 payment McDonald had

received on December 3, 2001. Conaway received approximately $20 million in compensation from Kmart for 20 months service.

FIRST CLAIM FOR RELIEF

(Violations of the Antifraud Provisions of the Exchange Act)

42. The Commission incorporates paragraphs 1 through 41 with the same force and effect as if set out here.

43. In the manner described in paragraphs 1 through 42, Conaway and McDonald, in connection with the purchase or sale of securities, knowingly or recklessly, by the use of means or instrumentalities of interstate commerce or of the mails, directly or indirectly (a) employed devices, schemes or artifices to defraud; (b) made untrue statements of material facts or omissions of material facts necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or (c) engaged in transactions, practices or courses of business which operated or would operate as a fraud or deceit upon persons in violation of Section 10(b) of the Exchange Act [15 U.S.C § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder.

44. Conaway and McDonald are likely to continue to violate these antifraud provisions of the Exchange Act unless enjoined.

SECOND CLAIM FOR RELIEF

(Aiding and Abetting Violations of the Antifraud Provisions of the Exchange Act)

45. The Commission hereby incorporates paragraphs 1 through 44 with the same force and effect as if set out here.

46. In the manner described in paragraphs 1 through 45, Kmart violated Section 10(b) [15 U.S.C § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder by filing with the Commission a Form 10-Q(3) containing materially false and misleading MD&A and Conaway and McDonald aided and abetted Kmart, pursuant to Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)], because they had a general awareness that their roles were part of an overall activity that was improper, and knowingly and substantially assisted the violation.

47. Conaway and McDonald are likely to continue to aid and abet violations of these antifraud provisions of the Exchange Act unless enjoined.

THIRD CLAIM FOR RELIEF

(Violations of the Reporting and MD&A Provisions of the Exchange Act)

48. The Commission hereby incorporates paragraphs 1 through 47 with the same force and effect as if set out here.

49. In the manner described in paragraphs 1 through 48, Kmart violated Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-13 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-13] by filing with the Commission a Form 10-Q(3) containing materially false and misleading MD&A, and Conaway and McDonald aided and abetted Kmart, pursuant to Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)], because they had a general awareness that their roles were part of an overall activity that was improper, and knowingly and substantially assisted the violation.

50. Conaway and McDonald are likely to continue to aid and abet violations of these reporting and MD&A provisions of the Exchange Act unless enjoined.

PRAYER FOR RELIEF

WHEREFORE, the Commission respectfully requests that this Court enter a judgment:

(a) permanently enjoining defendants Conway and McDonald, and their agents, servants, employees, attorneys, and those in active concert or participation with them, who receive actual notice by personal service or otherwise, from (i) violating Section 10(b) of the Exchange Act [15 U.S.C § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder; and (ii) aiding and abetting violations of Sections 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-13 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-13];

(b) ordering defendants Conaway and McDonald to disgorge all ill-gotten gains from the conduct alleged herein, with prejudgment interest;

(c) ordering defendants Conaway and McDonald to pay civil money penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)];

(d) permanently barring defendants Conaway and McDonald from serving as an officer or director of a publicly traded company pursuant to Section 21(d) of the Exchange Act [15 U.S.C. § 78u(d)]; and

(e) granting such other relief as this Court may deem just and appropriate.

Dated: August ~~18~~ 23, 2005

Washington, D. C.

By:

Alan M. Lieberman
Attorney for Plaintiff
United States Securities and
Exchange Commission
100 F St., N. E.
Washington, D. C. 20549-4631
Tel: 202-551-4474
Fax: 202-772-9245

Of Counsel:

Peter H. Bresnan
Cheryl J. Scarboro
Reid A. Muoio
Timothy P. Peterson

Local Counsel:

Ellen Christensen
Assistant United States Attorney
211 W. Fort Street
Suite 2001
Detroit, MI 48226-3211
Tel: 313/226-9112
Fax: 313/226-3800