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JUDGE : Edmunds, Nancy G.
DECK : S. Division Civil Deck
DATE : 08/29/2005 @ 09:57:08
CASE NUMBER : 2:05CV73328
CMP SEC V. DAVID P. LEVINE, ET AL, SI, TAM

MAGISTRATE JUDGE R. STEVEN WHALEN

UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v. DAVID P. LEVINE, MICHAEL W. SPAKE, BARRY S. BERLIN, and DOUGLAS J. ELY, Defendants.	**COMPLAINT** 05 Civ.

Plaintiff Securities and Exchange Commission (the "SEC") alleges as follows:

NATURE OF THE ACTION

1. The SEC brings this action as the result of the improper recognition of vendor "allowances" by Kmart Corporation ("Kmart" or "company") with the involvement of representatives of one of the company's major vendors, Newell Rubbermaid, Inc.

2. Kmart obtained allowances from its vendors for various promotional and marketing activities. A significant number of allowances were recognized prematurely - or "pulled forward" - on the basis of false information provided to Kmart's accounting department, while the true terms of the payments were set forth in undisclosed side agreements. As a result, Kmart's cost of goods sold was understated, and earnings were materially overstated, in the years preceding the company's bankruptcy in January 2002.

3. Kmart officers and employees participated in the pulling forward of vendor allowances in an effort to meet senior management's earnings expectations for their divisions. They include defendants David P. Levine and Michael W. Spake, each of whom is responsible for pulling forward millions of dollars worth of vendor allowances.

4. Representatives of certain Kmart vendors participated in the pulling forward of allowances by co-signing false or misleading accounting documents and executing side agreements. They include defendants Barry S. Berlin and Douglas J. Ely, both of Newell Rubbermaid, Inc.

5. Defendants' misconduct caused Kmart's net income for the fourth quarter and fiscal year ended January 31, 2001, to be overstated by approximately $4.8 million or almost 2 percent, as originally reported. The company

restated its financial statements after filing for bankruptcy to correct these and other accounting errors.

JURISDICTION

6. This Court has jurisdiction over this action pursuant to Sections 21(d), 21(e) and 27 of the Securities Exchange Act of 1934 ("Exchange Act") [15 U.S.C. §§ 78u(d), 78u(e) and 78aa]. Defendants have, directly or indirectly, made use of the means or instrumentalities of interstate commerce and/or of the mails in connection with the transactions described in this Complaint.

DEFENDANTS

7. **David P. Levine** ("Levine") was Divisional Vice President of Kmart's do-it-yourself division from April 1997 to July 2002.

8. **Michael W. Spake** ("Spake") was a buyer in Kmart's Home Storage division from 1998 until June 2001.

9. **Barry S. Berlin** ("Berlin") was Director of Sales at Rubbermaid Home Products, a division of Newell Rubbermaid Inc., for the Kmart account from June 1999 through March 2002.

10. **Douglas J. Ely** ("Ely") was National Account Manager for Kmart at Rubbermaid Home Products, a division of Newell Rubbermaid Inc., reporting to Berlin, from 1999 until March 2002, when he was promoted to Director of Sales for the Kmart account.

ISSUER

11. **Kmart Corporation** ("Kmart" or the "company") was a Michigan Corporation headquartered in Troy, Michigan, during the relevant period. On January 22, 2002, Kmart filed a voluntary petition for reorganization relief under Chapter 11 of the Bankruptcy code. The company's common stock was registered with the Commission pursuant to 12(b) of the Exchange Act [15 U.S.C. § 78l(b)] and traded on the New York Stock Exchange until December 19, 2002, when trading was suspended. Kmart's fiscal year ends the last Wednesday in January.

12. Before filing for bankruptcy, Kmart operated approximately 2,100 stores throughout the United States and employed approximately 250,000 workers. Kmart's annual sales were approximately $37 billion, and the company was the nation's second largest discount retailer and third largest general merchandise retailer. Kmart's successor corporation emerged from bankruptcy on May 6, 2003, with new management, new ownership and a new board of directors, having closed approximately 600 stores and cut more than 60,000 jobs.

VENDOR

13. **Newell Rubbermaid, Inc.** ("Newell") is a Delaware corporation headquartered in Atlanta, Georgia. Newell Rubbermaid is a Fortune 500 corporation and was a major Kmart vendor during the relevant period. Subdivisions

include Rubbermaid Home Products and EZ Paintr. Rubbermaid manufactures and distributes plastic products for home storage and organization. EZ Paintr manufactures and distributes paint applicator tools and related products. Newell's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is listed on the New York Stock Exchange.

DEFENDANTS' ACCOUNTING IRREGULARITIES

A. KMART'S ACCOUNTING FOR VENDOR ALLOWANCES

14. Kmart obtained from vendors "allowances" for advertising, special displays, price protection, exclusivity, and other promotional and marketing activities. Kmart accounted for most vendor allowances as a reduction in cost of goods sold ("COGS"). The balance was accounted for as a reduction of selling and general administrative expenses. Kmart's profitability became increasingly dependent upon allowances in the years preceding bankruptcy.

15. Kmart recognized vendor allowances using an accrual methodology. At the outset of each fiscal year, management estimated the amount of allowances it expected to collect. These estimates were based upon prior year experience and adjusted for expected increases in sales, promotional activity and other factors. Those "plan" amounts were recognized evenly on a pro rata basis throughout the fiscal year.

16. In each fiscal year, the actual collection of many of these monies did not occur until the end of the fourth quarter. As a result, the company booked an accrual during the first three quarters, representing the difference between allowances subject to written agreement and planned amounts. Thus, if the plan called for $400 million of allowances in first quarter, but only $150 million was subject to written agreement, Kmart booked a $250 million accrual. The same methodology was applied in the second and third quarters.

17. At fiscal year end, Kmart's officers and employees were expected to collect enough allowances to cover the accruals for the first three quarters and to meet management earnings expectations for the fourth quarter and fiscal year as a whole.

B. KMART "PULLED FORWARD" VENDOR ALLOWANCES AT FISCAL YEAR END

18. Kmart's accrual methodology, together with senior management's unrealistic earnings expectations, put tremendous pressure on Kmart officers and employees at the end of the fiscal year to collect allowances. A number of them responded to these pressures by submitting false information to Kmart's accounting department so that vendor allowances were recognized prematurely - or "pulled forward" - at fiscal year end. Representatives of certain

vendors participated by co-signing false or misleading accounting documents and by executing side agreements.

1. **Kmart's Vendor Allowance Tracking ("VATS") Forms**

19. The principal document involved in the pulling forward of vendor allowances was Kmart's Vendor Allowance Tracking System ("VATS") form. VATS forms summarized the basic terms of vendor allowances for Kmart's accounting department. Bookkeepers inputted information from the VATS form into the company's computerized accounting system, where it was eventually posted to the general ledger.

20. To ensure proper accounting for a particular allowance, the VATS form should have reflected the true purpose of, and effective dates for, the payment. To pull forward an allowance, this information was misrepresented on the VATS form to make it look like the payment was for past performance, when in truth it related to future obligations.

2. **Kmart's Allowance Accounting Policies And Procedures**

21. Kmart had a number of safeguards designed to ensure the accuracy of the VATS forms and proper recognition of vendor allowances. These included requiring vendor signatures on VATS forms and certain internal and independent audit procedures.

22. The pulling forward of allowances violated generally accepted accounting principles and Kmart's accounting policies, both of which generally required that allowances be recognized only when earned and the proper matching of income to the related expense.

23. Kmart's vendor allowance accounting policies and procedures were communicated to Kmart officers and employees with responsibilities over allowances, including Levine, by written memorandum dated June 26, 2000. That memorandum provided in relevant part (emphasis in original):

> **Timing:** Allowances may only be recorded in the period for which they are earned. For example: . . . 2) If an allowance agreement is signed today, but related to activity in fiscal 2001, none of the allowance can be recorded in 2000; 3) If allowance monies are actually paid in cash today, but relates to activity in fiscal 2001, none of the allowance can be recorded in 2000. Please note that timing issues relate to both actual VATS agreements and forecast accruals . . .
>
> **Matching:** There must be a proper matching of income to the period in which a related expense is incurred. To record allowances for 2000, the related Kmart activity must be

completed in 2000. If, at year-end, any future obligation remains to "earn" an allowance, then the Company's ability to record the allowance in the current year is greatly impaired.

24. The cover page to the June 26, 2000 memorandum explained that, "[t]he policy is based upon Securities and Exchange Commission (SEC) publications, Generally Accepted Accounting Principles (GAAP) and Audit Services' recommendations. The SEC continues to focus on overly aggressive accounting issues in income statements. We suggest that you review these guidelines with your merchandising personnel to ensure proper recording of allowances throughout fiscal 2000."

C. PULL FORWARD BY KMART'S DO-IT-YOURSELF DIVISION

25. Levine was Divisional Vice President in charge of Kmart's do-it-yourself division from April 1997 until July 2002. During that period, Levine had primary responsibility for merchandising home improvement product and services at all of Kmart's stores.

26. At Levine's direction, the do-it-yourself division pulled forward at least one $2 million allowance from fiscal year 2001 into fiscal year 2000.

27. As background, in late calendar year 1997, Levine negotiated a contract with EZ Paintr, a Newell Rubbermaid subdivision, whereby Kmart agreed to purchase goods from EZ

Paintr pursuant to various terms and conditions ("EZ Paintr Contract"). The EZ Paintr Contract was executed on January 22, 1998 and expired at the earlier of either Kmart's purchase of $45 million of goods from EZ Paintr or December 31, 2001. The EZ Paintr Contract further allowed for various volume-based allowances from EZ Paintr to Kmart.

28. In late calendar year 2000, Levine began negotiating an addendum to the EZ Paintr Contract.

29. Towards the end of fiscal year ended January 31, 2001 ("fiscal year 2000"), Kmart's do-it-yourself division was projecting a profit shortfall, meaning actual results were short of what senior management expected.

30. On January 22, 2001, Levine and EZ Paintr's president executed a contract addendum pursuant to which EZ Paintr agreed to issue Kmart a credit memo in the amount of $2 million titled a "2000 Promotional Fund" in exchange for Kmart's agreement to purchase an additional $15 million in goods. Levine and EZ Paintr further agreed that if during the life of the addendum, Kmart exited the paint applicator business, the $2 million would be refunded to EZ Paintr on a pro-rata basis.

31. In conjunction with the contract addendum, on or about January 29, 2001, Levine also signed VATS form No. 219052 relating to the $2 million allowance from EZ Paintr. However, the VATS form misrepresented the effective date of the $2 million allowance as 2/1/00 to 1/30/01.

32. Kmart's accounting personnel entered this false or misleading VATS information into the company's computerized accounting system, where it was eventually posted to the general ledger. As a result, Kmart's COGS was understated by $2 million in fiscal year 2000.

D. PULL FORWARDS BY KMART'S HOME STORAGE DIVISION

33. The home storage division pulled forward at least three allowances totaling approximately $2.8 million from fiscal year 2001 into fiscal year 2000.

34. Spake was a buyer in the home storage division from 1998 until June 2001, and was responsible for merchandising container and storage products from Rubbermaid Home Products during that time period. Spake's principal contacts at Rubbermaid Home Products were Ely and Berlin.

35. Towards the end of fiscal year 2000, Kmart's home storage division was projecting a profit shortfall. Spake asked Ely and Berlin for help in overcoming a shortfall in allowances in the home storage division. With Berlin and Ely's knowledge and assistance, Newell agreed to advance allowances to Kmart against future shipments of goods. Spake, Ely, and Berlin understood that the majority of the advances related to sales and promotional activity that had not occurred during Kmart's fiscal year 2000.

36. On or about January 25, 2001, Spake and Ely executed VATS form Nos. 227901 and 227902 covering a $2.2 million portion of the advance. On or about January 31, 2001, Spake and Berlin executed VATS form No. 227910 covering a $600 thousand portion of the advance. Each of these three VATS forms misrepresented the effective dates of the allowances as falling within Kmart's fiscal year 2000. On or about February 20, 2001, Ely sent a letter to Spake and Berlin in which Ely made clear that "we did not identify the correct reasons for the VATS."

37. Kmart's accounting personnel entered the false or misleading VATS information into the company's computerized accounting system, where it was eventually posted to the general ledger. As a result, Kmart's cost of goods sold was understated by $2.8 million in fiscal year 2000.

E. KMART'S FORM 10-K WAS FALSE AND MISLEADING

1. Kmart's Earnings Were Overstated

38. On March 13, 2001 Kmart filed its Form 10-K for fiscal year 2000 and issued a related press release. According to the financial statements incorporated into both the Form 10-K and press release, Kmart reported net income for the fourth quarter of $249 million or $0.48 per share, exceeding Wall Street analyst expectations of $0.47 by a penny. Defendants' accounting irregularities caused net income to be overstated, however, by approximately $4.8 million or almost 2 percent.

2. **Kmart's Management Letter Was False And <u>Misleading</u>**

39. Kmart's Form 10-K included a letter entitled, "Management's Responsibility for Financial Statements," which was signed by the company's CEO and CFO ("Management Letter"). The Management Letter provided investors certain assurances concerning the *quality* of Kmart's financial statements.

40. Defendants' misconduct rendered the Management Letter false and misleading in at least two respects. First, the Management Letter stated that Kmart's "financial statements have been prepared in conformity with generally accepted accounting principles" ("GAAP"). This was not true because a significant amount of allowances had been recognized before the earnings process was complete, as required by GAAP and the company's internal accounting policies.

41. Second, the Management Letter stated that Kmart "maintain[s] comprehensive systems of internal controls designed to provide reasonable assurance that assets are safeguarded and transactions are executed in accordance with established procedures." This was not true because Kmart's internal controls were circumvented and a significant amount of allowance transactions were not executed in accordance with company policies and procedures.

CLAIM FOR RELIEF

(Violations of the Books and Records provisions of the Exchange Act)

42. Plaintiff SEC hereby incorporates ¶¶ 1 through 41 with the same force and effect as if set out here.

43. In the manner described in ¶¶ 1 through 42, defendants Levine, Spake, Berlin, and Ely, directly or indirectly, falsified or caused the falsification of, the books, records or accounts of Kmart.

44. By reason of the foregoing, defendants Levine, Spake, Berlin, and Ely violated Rule 13b2-1 of the Exchange Act [17 C.F.R. § 240.13b2-1].

PRAYER FOR RELIEF

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

(a) ordering defendants Levine, Spake, Berlin, and Ely to pay civil money penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)]; and

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

Dated: August 29, 2005

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