

## Jury Finds Ex-Kmart CEO Liable for Making Misleading Statements About Kmart's Liquidity Months Before its 2002 Bankruptcy Filing

### *Introduction*

Publicly-reporting companies in financial distress often ask what they have to disclose about a potential bankruptcy filing and when. Although there is no line-item SEC requirement to announce that a company is considering filing for bankruptcy, the company cannot make misleading statements or make material omissions in disclosures filed with the SEC or other disclosures including conference calls with investors. For example, Item 303 of Regulation S-K (which applies to 10-Qs and 10-Ks) requires a description of any known trends or uncertainties that the registrant reasonably expects will have a material unfavorable impact on net sales or revenues and the outlining of ways the registrant is addressing its liquidity. Further, Item 503 of Regulation S-K (which also applies to 10-Qs and 10-Ks) requires a discussion of the most significant factors that make the investment in the registrant's securities speculative or risky.

It is not unusual for a company on the verge of bankruptcy to start "slow-paying" its vendors, either to avoid a bankruptcy or to generate additional liquidity to fund a bankruptcy case by stretching out payables until the imposition of the automatic bankruptcy stay. It may not be readily apparent to a company implementing such a slow-pay program that it consider publicly disclosing the program, particularly because that type of disclosure may cause the company's vendors to demand immediate payment – which is the very problem the company was trying to avoid.

However, recently, on June 1, 2009, in a civil fraud trial, the former CEO of Kmart was found liable for misleading investors about Kmart's finances before its 2002 bankruptcy filing by failing to disclose just such a slow-pay program.

### *History*

On January 22, 2002, Kmart filed for chapter 11 bankruptcy protection. In 2005, the SEC filed a complaint in the United States District Court for the Eastern District of Michigan against Kmart's former CEO and CFO accusing them of violating the anti-fraud provisions of the Securities Exchange Act of 1934 and the SEC's disclosure rules, in particular with respect to Kmart's MD&A (Management's Disclosure & Analysis).<sup>1</sup> The complaint sought permanent injunctions, disgorgement of ill-gotten gains with prejudgment interest, civil penalties, and bars on the defendants from serving as officers or directors of other public companies.

The SEC did not allege that the financial statements were inaccurate. Instead, the SEC alleged that the discussion surrounding the financial statements was misleading because it did not describe Kmart's scheme of delaying payments to creditors without their consent to generate liquidity, in what was allegedly dubbed as Project SID, an acronym for "slow-it-down."

Specifically, the SEC accused the defendants of making false statements in response to questions on Kmart's 2001 third quarter conference call by attributing Kmart's failure to pay its vendors timely on its new inventory and payables software, rather than on Kmart's Project SID. The SEC also accused the defendants of failing to describe (in the MD&A for the third quarter of 2001) why accounts payable and merchandise inventory had materially changed from the same period in the previous year. The SEC's position was that: (i) by not describing Project SID, Kmart provided incomplete and inaccurate disclosure because it did not describe a significant cause for a material change in accounts payable; (ii) by not describing Project SID as a course of action Kmart had taken — and proposed to take — to address liquidity issues, the MD&A disclosure did not satisfy MD&A disclosure requirements; and (iii) Kmart's statement that the primary sources of its working capital were cash flows from operations and credit facility borrowings was misleading because hundreds of million of dollars in working capital was attributable to Project SID.

Shortly before trial, Kmart's former CFO settled without admitting or denying the SEC's allegations. He consented to: a permanent injunction prohibiting further violations of the relevant provisions of the federal securities laws; a five year officer and director bar; an administrative order suspending his privilege to appear and practice before the SEC as an accountant for three years; and a \$120,000 civil penalty.

The remedies against the former CEO will be determined at a later date.

### *Lessons Learned*

The SEC's complaint was somewhat atypical when brought because it alleged misstatements on conference calls and in MD&A without corresponding allegations of errors in actual financial statements, and may indicate that the SEC will increasingly focus on such disclosure in an increasingly aggressive enforcement environment. After the trial, the SEC's trial lawyer was quoted as saying: "It is never enough for the numbers to be right. For the average investor, the numbers being right do not tell the whole story. They need to know the material information that management knows."<sup>2</sup>

This case is a stark reminder that publicly-reporting companies struggling with liquidity must be fully transparent in their disclosures about the handling of payments to vendors, and are not excused from their disclosure obligations because they face a potential bankruptcy. Companies should expect that qualitative disclosures — or lack thereof — on conference calls and in SEC filings, and not just quantitative disclosure, will be closely scrutinized in the future.

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- 1 For a copy of the SEC's complaint please see: <http://www.sec.gov/litigation/complaints/comp19344.pdf>. Specifically, the SEC charged the defendants with violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and aiding and abetting Kmart's violations of Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 13a-13, and 12b-20 thereunder.
  - 2 Ed White, *Ex-Kmart Chief Found Liable in Civil Trial Tied to Retailer's Last Months Before Bankruptcy*, Associated Press, Jun. 1, 2009, available at [www.ap.org](http://www.ap.org).

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