

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION**

In re:

KMART CORPORATION,

Debtor.

Chapter 11

Case No. 02-02474

Hon. Susan Pierson Sonderby

Hearing Date: September 22, 2009
11:00 a.m.

**KMART CORPORATION'S SUPPLEMENT TO MOTION FOR ORDER
DIRECTING RELEASE OF REMAINING FUNDS HELD FOR
DEFERRED COMPENSATION PLANS**

Kmart Corporation ("Kmart") files this supplement to its Motion for Order Directing Release of Remaining Funds Held for Deferred Compensation Plans (the "Motion"). Kmart files this Supplement to address questions raised by the Court at the August 5, 2009 hearing on the Motion. Specifically, this pleading addresses: (i) what interest, if any, did the Kmart Creditors' Trust, or Kmart's creditors in general, have in the remaining money held in two Rabbi trusts created for deferred compensation plans and (ii) what rights, if any, do the former participants in the deferred compensation plans have to the money in the Rabbi trusts. As set forth below, Kmart's Plan of Reorganization granted neither the Creditors Trust nor the creditors in general any rights in the Rabbi trusts, and all Kmart employees who were participants in the deferred compensation plans have either received their account balances, or have made claims against Kmart which have been settled and paid and full releases exchanged, or (in one case) failed to timely assert any claim to his account balance. As for former Kmart directors, their account balances in the Rabbi trusts became property of Kmart's bankruptcy estate by operation of law.

Background

The Motion concerns the disposition of about \$2.95 million remaining funds held by BNY Mellon Bank in accounts (the “Accounts”) created to hold money Kmart deposited for benefits accrued under two deferred compensation plans it maintained pre-petition. One plan was for employee-managers of Kmart (the “Manager Plan”), the other plan was for non-employee directors of Kmart (the “Director Plan”). As of August 1, 2009, the Manager Plan held \$957,987.55¹ (including \$141,349 in accrued earnings) and the Director Plan held \$2,060,267.70 (including \$421,775 in accrued earnings).

The Accounts are referred to as “Rabbi Trusts,” a device used to allow an employee to accrue deferred compensation that is not taxable until the amount accrued is actually paid out to the employee. The hallmark of a Rabbi Trust is that, should the employer become bankrupt, the money reverts to the employer/debtor. *Brend v. Sames Corp.*, 2002 U.S. Dist. LEXIS 12648, fn. 1 (N.D. Ill., Grady, J.) (“Thus, once a grantor files for bankruptcy, the rabbi trust corpus becomes part of the grantor’s bankruptcy estate”), citing *In re Outboard Marine Corp.*, 278 B.R. 778, 785 (N.D. Ill. 2002 (Aspen, J.)). In the Kmart bankruptcy case, the normal disposition of the Rabbi Trusts money was altered for the Manager Plan by an order of this Court entered on April 23, 2002 (the “2002 Order”) and by the Plan of Reorganization. Under the 2002 Order and the Plan of Reorganization, the Manager Plan was modified to provide, notwithstanding Kmart’s bankruptcy filing, for the distribution of money held in the Rabbi Trust for the Manager Plan to the participants in the plan, with the exception of those former executives (the “Former Executives”) who were the targets of litigation claims transferred to the Creditor Trust. The terms of the Director Plan, which provided that “[a]ssets contained in the Rabbi Trust [(created

¹ \$2,172 of this amount relates to account balances of 108 plan participants who did not cash their distribution checks.

under the plan)] shall at all times be specifically subject to the claims of the Company's general creditors in the event of insolvency....," were not modified.²

I. Disposition of Rabbi Trust Fund for the Manager Plan Under the Plan of Reorganization.

Under Kmart's Joint Plan of Reorganization, with an exception discussed below, the funds in the Rabbi Trust for the Manager Plan, to the extent not previously distributed under the 2002 Order, were to be paid to the employees who were participants in the deferred compensation plan.³ In fact, Kmart paid out about \$12 million, leaving about \$1 million for the account balances of the Former Executives.

The exception concerned the deferred compensation plans account balances of 20 Former Executives who were possible targets of litigation to be brought by the Creditor Trust. The account balances for the Former Executives (the "Reserved Funds") were to be transferred to the Creditor Trust to be "held in escrow by the Kmart Creditor Trust pending resolution of any Trust Claims against such account holder." The Plan does not otherwise set forth the conditions of the

² Unlike the 2002 Order, which distinguished between the Manager Plan, which was modified by the order to permit distributions notwithstanding Kmart's bankruptcy filing, and the Director Plan, which was not so modified, the Plan of Reorganization simply provided that amounts accrued under the "deferred compensation plans" would be distributed to "the respective account holders." Kmart reads this language to mean that the remaining balances in the Manager Plan would be distributed, but not account balances under the Director Plan, which had become part of the bankruptcy estate. Had it been the intent to convert unsecured claims of former insiders to full-pay administrative claims, the language chosen would have been clearer and more specific.

³ Two participants (Jerry Uhrich and Harvey Higgins), upon receiving a copy of Kmart's Motion, notified Kmart looking for confirmation that they had been paid the amounts they had accrued under the Kmart Deferred Compensation Plan. Because the payments were made in 2002 and 2003 by the Prudential Insurance Company, the records of payment have been requested from Prudential, who must retrieve the records from archives. Kmart notes that neither Mr. Uhrich nor Mr. Higgins appear on a list of uncashed distribution checks. Nonetheless, under the Order proposed by Kmart, the Order will be without prejudice to any of the rights of the participants, who were to have received their money in 2002 and 2003, to obtain their money from Kmart in the event they had not previously been paid.

escrow, i.e., under what circumstance would the Reserved Funds be released to the Creditors Trust, to Kmart, or to the Former Executives.⁴

Beyond providing that the Reserved Funds would be held in escrow, the Plan did not otherwise address the disposition of the Reserved Funds. Specifically, the Plan did not include the Reserved Funds in the assets to be transferred to the Creditor Trust. Section 11.2 of the Plan provides for the transfer of the “Trust Assets” to the Creditor Trust. Section 1.159 of the Plan defines “Trust Assets” as “those assets, including the Trust Claims, to be transferred to and owned by the Kmart Creditor Trust pursuant to Section 11.2 of the Plan.” Because Section 11.2 does not identify any assets to be transferred to the Creditor Trust other than the “Trust Assets,” the only assets transferred to the Creditor Trust under the Plan of Reorganization were the “Trust Claims.” Section 1.160 of the Plan defines “Trust Claims” as “any and all Causes of Action against any Person or entity arising from, in connection with, or relating to the subject matters of the Investigations which, for purposes hereof, means the Accounting and Stewardship Investigations ...” Under Section 1.24 of the Plan, “Causes of Action” means, in essence, legal claims.

The Plan’s omission of the Reserved Funds from the assets to be transferred to the Creditors Trust comports with the provisions of the Kmart Credit Trust Agreement (the “Trust Agreement,” attached hereto as Exhibit A). The Trust Agreement, in Section 2.37, defines “Trust Assets” as including (i) the Trust Claim, as defined in the Plan, (ii) the Initial Deposit, and (iii) the Additional Deposit. As explained above, the Plan’s definition of Trust Claim does not

⁴ The account balances for the Former Executives were not transferred to a separate escrow account opened by the Creditor Trust. Rather, the funds remained in the BNY Mellon Trust account. However, as evidenced by statements the Creditor Trust made in pleadings filed in actions against the Former Executives, the Creditor Trust acted as if it had control of the funds. See Complaint in *Kmart Creditor Trust v. Crow*, adv. Proc no. 03-04776 (“Pursuant to Section 7.7 of the POR, Defendant’s Deferred Compensation Account is being held by the Trust in escrow . . .”).

include the Reserved Funds. Section 2.23 of the Trust Agreement defines Initial Deposit as “the funding to be made on the Effective Date by the Debtors and/or Reorganized Debtors to the Kmart Creditor Trust, in accordance with Article 11.3(d)(i) and Article 11.3(d)(ii) of the Plan.” Neither of the referenced articles refers to or includes the Reserved Funds. Article 11.3(d)(i) provides that Kmart will contribute \$5 million cash to the Creditor Trust. Article 11.3(d)(ii) provides that Kmart will contribute an additional amount equal to “any funds re-paid to the Debtors prior to the Effective Date on account of loans made pursuant to the 2001 Retention Program...”

Section 2.2 of the Trust Agreement defines Additional Deposit as “funding that shall be made by the Reorganized Debtors to the Kmart Creditor Trust after the Effective Date, in the amount and to the extent required, if at all, by Article 11.3(d)(ii) and Article 11.3(d)(iii) of the Plan.” Again, neither of the referenced articles refers to or includes the Reserved Funds. Article 11.3(d)(ii) covers any amounts collected by Kmart after the Effective Date on account of the 2001 Retention Program. Article 11.3(d)(iii) provides that Kmart will contribute an additional \$5 million cash to the Creditor Trust if Kmart has not reconciled 75 percent of the trade vendor/landlord claims by the first anniversary of the Effective Date of the Plan of Reorganization.

Although the Trust Agreement does not include the Reserved Funds as property of the Creditor Trust, the Trust Agreement creates a mechanism for the holding of the Reserved Funds in escrow, as provided by the Plan. Section 2.21 of the Agreement defines “Escrow Account” as an account to be created by the Trustee of the Creditor Trust to hold the “Deferred Compensation Distributions that would be otherwise distributable for the account of Trust Claim Defendants pursuant to Article 7.7 of the Plan [(i.e., the Reserved Funds)] ... in escrow pending a final

determination of liability or non-liability in respect of the Trust Claim with respect to such Trust Claim Defendant.”

The purpose of the escrow arrangement is not set forth in either the Plan or the Trust Agreement. The Creditor Trust’s understanding of the purpose of the escrow was set forth in complaints that the trust filed in this Court against some of the Former Executives: “Pursuant to Section 7.7 of the POR, Defendant’s Deferred Compensation Amount is being held by the Trust in escrow to offset against any judgments against Defendant on account of Trust Claims.” See Complaint in *Kmart Creditor Trust v. Timothy Crow*, adv. proc. 03A4775. Because the Creditor Trust never actually obtained a judgment against any Former Executive, and settled all of its cases against the Former Executives, the Creditor Trust never had occasion to look to the Reserved Funds that were being held in escrow.

Based on the foregoing, the only conclusion is that the Reserved Funds did not become part of the Creditor Trust. Had the litigation against the former officers and directors resulted in large unpaid judgments it is possible that the Creditor Trust might have claimed rights to the money in escrow, but that did not happen. In fact, since the filing of the present motion, former counsel for the Creditor Trust (the Trust was dissolved at the end of 2005) has affirmed to Kmart’s counsel that the Creditor Trust did not recognize the Reserved Funds as an asset that became part of the Creditor Trust.

This conclusion is consistent with how the Reserved Funds were described in the Disclosure Statement. The Creditor Trust is described in pages 16 to 120 of the Disclosure Statement. On page 116, the Disclosure Statement says only that the “Trust Assets” will be transferred to the Trust. Because Trust Assets is not defined in the Disclosure Statement, it has

the meaning given it in the Plan, which was discussed above. The Disclosure Statement does not mention the escrow arrangement for the Reserved Funds that is described in the Plan and the Trust Agreement.

No creditor reading the Disclosure Statement or the Plan of Reorganization could have expected that the Reserved Funds would become part of the Creditor Trust, for ultimate distribution to the creditors. Nor could any creditor otherwise expect that Kmart would distribute the Reserved Funds to creditors. The issue presently, therefore, is not whether the creditors, as a body, have any right to the Reserved Funds. As discussed below, the issue is whether any of the Former Executives, whose deferred compensation plan account balances became the Reserved Fund, now have a claim to any portion of the Reserved Fund.

II. No Former Participant in the Manager Plan Has an Interest in the Reserved Funds

The 2002 Order and the Plan of Reorganization provided that all money held in the Rabbi Trusts Account for the Manager Plan would be returned to the plan participants, except for the Former Executives. In 2002 and 2003, over \$12 million was distributed to participants in the Manager Plan. As of August 1, 2009, 108 participants, with an aggregate balance of \$2,172, had not cashed their distribution checks (the Trustee of the Accounts has issued replacement checks since the initial release of distribution checks in 2002 and 2003, most recently on June 7, 2007).

Remaining in the Rabbi Trust for the Manager Plan is about \$960,000 from the account balances of the Former Executives. Of the 18 Former Executives, six had zero balances in the

Manager Plan, and five more had balances of less than \$1,500. In fact, 99% of the balance in the Manager Plan relates to only eight former managers.⁵

As between Kmart and the Former Executives, the Plan of Reorganization contains no specific provision as to who receives the money once it comes out of escrow, other than to provide (in Section 12.1 of the Plan) that all residual assets of the Kmart bankruptcy estate shall revert in Kmart. Each of the Former Executives had the right to file a claim for any amounts owed to him/her, and in fact seven of the eight Former Executives who had a balance of greater than \$1,500 in the Manager Plan filed claims. Each of these seven settled their claims with Kmart under which settlements, in exchange for substantial cash payments, they released all claims against Kmart.

There was one Former Executive who had a \$51,662 account balance under a deferred compensation plan who did not file a proof of claim. Kmart has served this Supplemental Pleading on that person at his last known address, and has served the lawyer who represented him in the lawsuit filed by the Creditor Trust. Kmart has received no response.

Accordingly, to the extent a Former Executive made a claim in the bankruptcy case, the claim has been settled and paid, and a release given to Kmart. Such a Former Executive would have no further rights to the Reserved Funds, to the extent any rights survived confirmation of Kmart's Plan of Reorganization. Any Former Executive that did not file a claim has no further right to funds in the Account. In this respect, a "Rabbi Trust" is not a real trust: the participants do not have a vested interest in the trust which they own. Rather, a Rabbi Trust is a deferred

⁵ Kmart will provide to the Court and, upon request, to any Former Executive, the detail showing account balance and claim settlement terms. However, because of privacy laws, Kmart has not included this information in its public filing.

compensation mechanism, under which the money placed into trust remains property of the employer, available to the employer or its creditors in case of the employer's insolvency. *Brend v. Sames Corp.*, 2002 U.S. Dist. LEXIS 12648 (N.D. Ill., Grady, J.) ("Thus, once a grantor files for bankruptcy, the rabbi trust corpus becomes part of the grantor's bankruptcy estate"), citing *In re Outboard Marine Corp.*, 278 B.R. 778, 785 (N.D. Ill. 2002 (Aspen, J.); see *Goodman v. Resolution Trust Corp.*, 7 F.3d 1123 (4th Cir. 1993); ("The trust assets [for a deferred compensation plan] are not 'vested' or 'funded' since they are available to Yorkridge's creditors.").

For the reasons set forth above, BNY Mellon Bank, the holder of the Account, should be directed to payover the Account, to the extent of the Reserved Funds, to Kmart.

III. No Former Director in the Director Plan Has an Interest in the Reserved Funds

Unlike the Manager Plan, Kmart did not modify the "Rabbi Trust" provision of the Director Plan.⁶ Under that provision and under the case law cited above, the assets in the Director Plan reverted to case law upon Kmart's bankruptcy filing.

By operation of the plan documents and law, the assets in the Director Plan became property of the Kmart bankruptcy estate. Unlike the Manager Plan, whose participants were generally current Kmart employees, Kmart ultimately elected not to seek leave to amend the Director Plan to permit distribution of the account balances of the plan notwithstanding Kmart's bankruptcy. Accordingly, Kmart has moved for entry of an order directing BNY Mellon Bank to

⁶ Kmart sought to modify the Rabbi Trust provision of the Director Plan in 2002 when it obtained permission to modify the Manager Plan. Kmart withdrew its request to modify the Director Plan in the face of strong opposition from the Financial Institution Creditors Committee.

payover to Kmart the money held by the bank in the Rabbi Trust account created for the Director Plan.

SERVICE

Kmart served the Motion on the ECF list for this case, on all parties who filed claims under the deferred compensation plans, on all of the Former Executives, and on all directors of Kmart from 2000 to the 2002 bankruptcy filing. Kmart served this supplemental pleading on the same parties, plus on the full service list in force immediately before confirmation of Kmart's Plan of Reorganization, which was the most extensive service list that existed in this case. Notice of the Motion and this supplement has been given to over 1,300 parties.

Dated: August 25, 2009

KMART CORPORATION

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