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UNITED STATES DISTRICT COURT FOR THE
EASTERN DISTRICT OF MICHIGAN

SECURITIES AND EXCHANGE COMMISSION, Plaintiff, v.	**COMPLAINT**
JOHN PAUL ORR, MICHAEL J. FRANK, ALBERT M. ABBOOD, DARRELL J. EDQUIST, DAVID C. KIRKPATRICK, DAVID N. BIXLER, THOMAS L. TAYLOR and RANDALL M. STONE, Defendants.	04 Civ.

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

NATURE OF THE ACTION

1. The SEC brings this accounting fraud action as the result of the improper recognition of vendor "allowances" by Kmart Corporation ("Kmart" or "company") with the knowledge and involvement of representatives of

several of the company’s major vendors, including Eastman Kodak Company, Coca Cola Enterprises Inc and PepsiCo Inc.’s wholly-owned subsidiaries, Pepsi-Cola Company and Frito-Lay, 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 secret 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 John Paul Orr, Michael K. Frank and Albert M. Abbood, 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, executing side agreements, and, in some instances, providing false or misleading third party confirmations to the company’s

independent auditor, PricewaterhouseCoopers LLP ("PwC"). They include defendants Darrell J. Edquist of Eastman Kodak Company, David C. Kirkpatrick of Coca Cola Enterprises Inc., David N. Bixler of Pepsi-Cola Company, and Thomas L. Taylor and Randall M. Stone of Frito-Lay, 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 $24 million or 10 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. **John Paul Orr** ("Orr") was Divisional Vice President of Kmart's photo division from October 1999 to February 15, 2001, when he was terminated. Orr is currently Executive Vice President of Sales for National

In-Store, a division of Omnicon Group Inc., a NYSE-traded company.

8. **Michael K. Frank** ("Frank") was Divisional Vice President ("DVP"), Senior DVP, and General Merchandise Manager of Kmart's food and consumables division from October 2000 until May 2002, when he was terminated.

9. **Albert M. Abbood** ("Abbood") was Divisional Vice President of non-perishable products in Kmart's food and consumables division from April 2000 until October 200l, when he left the company.

10. **Darrell Edquist** ("Edquist") was a Vice President of Eastman Kodak Company ("Kodak") in charge of the Kmart account at all relevant times through March 2004, when he left the company. Edquist worked principally out of Kodak's Northville, Michigan, field office during the relevant period.

11. **David C. Kirkpatrick** ("Kirkpatrick") was National Sales Director for Coca Cola Enterprises, Inc. in charge of the Kmart account at all relevant times through January 2004, when he was asked to resign. Kirkpatrick worked out of a Farmington Hills, Michigan, field office during the relevant period.

12. **David N. Bixler** ("Bixler") was National Sales Director for Pepsi-Cola in charge of the Kmart beverage account during the relevant period. Bixler worked out of a

Troy, Michigan, field office at all relevant times through the present. From October 2003 through the present, Bixler has been Vice President and General Manager of PepsiCo in charge of Kmart's beverage and snack accounts.

13. **Thomas L. Taylor** ("Taylor") was Director of Sales for Pepsico's Frito-Lay division in charge of the Kmart snack account during the relevant period. Taylor worked out of Frito-Lay's Plano, Texas, headquarters.

14. **Randall M. Stone** ("Stone") was National Account Manager for PepsiCo's Frito-Lay division assigned to the Kmart snack account during the relevant period. Stone worked out of Frito-Lay's field office in Plymouth, Michigan. Frito-Lay terminated Stone in May 2004.

ISSUER

15. **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.

16. 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.

VENDORS

17. **Eastman Kodak Company** ("Kodak") is a New Jersey corporation headquartered in Rochester, New York. Kodak is one of the world's largest photo imaging companies and a major Kmart vendor. Kodak'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.

18. **Coca Cola Enterprises Inc.** ("CCE") is a Delaware corporation headquartered in Atlanta, Georgia. CCE is the world's largest bottler of Coca-Cola products and a major Kmart vendor. CCE'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.

19. **PepsiCo Inc.** ("PepsiCo") is a North Carolina corporation headquartered in Purchase, New York. PepsiCo is one of the world's largest beverage and snack companies

and a major Kmart vendor. PepsiCo’s common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act and is listed on the New York and Chicago Stock Exchanges. During the relevant period, PepsiCo’s business was carried out through a number of wholly-owned subsidiaries, including Pepsi-Cola Company (“Pepsi-Cola”) and Frito-Lay, Inc. (“Frito-Lay”).

20. **Pepsi-Cola** manufactures, markets and sells to licensed bottlers concentrate used to make such name brand beverages as Pepsi, Mountain Dew, Sierra Mist, Mug and Slice. The licensed bottlers sell the product to independent distributors and retailers.

21. **Frito-Lay** manufactures, markets and sells to independent distributors and retailers brand name snacks such as Lay’s, Doritos, Cheetos, Fritos, Tostitos, Ruffles, Rold Gold, Sun Chips and Cracker Jack.

DEFENDANTS’ ACCOUNTING FRAUD

A. KMART’S ACCOUNTING FOR VENDOR ALLOWANCES

22. 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 (“SG&A”)). Kmart’s profitability

became increasingly dependent upon allowances in the years preceding bankruptcy.

23. 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.

24. 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.

25. 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

26. 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, executing side agreements, and, in some instances, providing false or misleading third party audit confirmations to Kmart's independent auditor, PricewaterhouseCoopers LLP ("PwC").

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

27. 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.

28. 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**

29. 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.

30. 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.

31. Kmart's vendor allowance accounting policies and procedures were communicated to Kmart officers and employees with responsibilities over allowances, including Orr, Frank and Abbood, 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.

32. 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 FORWARDS BY KMART'S PHOTO DIVISION

33. Orr was Divisional Vice President in charge of Kmart's photo division from October 1999 until February 2001. During that period, Orr had primary responsibility for merchandising film and camera product and services at Kmart's approximately 2,100 stores.

34. At Orr's direction, the photo division pulled forward at least one $2.5 million allowance from FY 2000 into FY 1999, and at least ten allowances totaling $12.35 million from FY 2001 into FY 2000.

35. Edquist was a Kodak employee and head of "Team Kmart" during the relevant period. At the request of Orr, Edquist participated in the pulling forward of at least one $2.5 million allowance from fiscal year 2000 into fiscal year 1999. At the request of Orr's subordinates, Edquist participated in the pulling forward of at least three allowances totaling $9.5 million from fiscal year 2001 into fiscal year 2000. Edquist filled out and co-signed three VATS forms that contained false and misleading information provided by Kmart. Edquist also provided Kmart's independent auditor with an inaccurate third party confirmation concerning a $7 million allowance.

36. Edquist was motivated by a desire to increase Kodak's share of Kmart's film business. Wal-Mart had recently entered into a long-term contract with Kodak's

archrival, Fuji, for photofinishing services. As a result, maintaining good relations with Kmart was a top priority at Kodak during the relevant period.

1. $2.5 Million Kodak Payment

37. Towards the end of fiscal year ended January 26, 2000 ("fiscal year 1999"), Kmart's photo division was projecting a profit shortfall, meaning actual results were short of what senior management expected.

38. Orr dealt with the profit shortfall in part by asking Edquist for additional allowances to help the photo division make its numbers. When Edquist resisted, Orr threatened to sell the exclusive right to display product at the front of Kmart stores to Kodak's archrival, Fuji. At the time, Edquist was newly in charge of the Kmart relationship.

39. To avoid losing business to Fuji, Edquist agreed to pay $2.5 million to secure for Kodak the right to display product at the front of Kmart stores during calendar year 2000, and, at Orr's request, to help paper the transaction to enable Kmart to take the money into income immediately.

40. On or about January 24, 2000, Edquist, per Orr's instructions, directed a subordinate to co-sign VATS No. 197017. VATS No. 197017 misrepresented the effective date of the $2.5 million allowance as 2/1/99 to 1/25/00. VATS

No. 197017 also misrepresented that the allowance related to an "Annual Rolling Rack Program for 1999." This information was false or misleading because the allowance related to activity scheduled for calendar year 2000.

41. Orr and Edquist knew, or were reckless in not knowing, that the VATS form misrepresented the true terms of the $2.5 million allowance. Edquist's handwritten notes concerning VATS No. 197017 read in relevant part, "Kmart, per J.P. [Orr] . . . requested we mark [on the VATS form] # 5 [effective date] and # 11 [special comments] to indicate 1999 payment for 1999 year performance due to the fact that it is for '99 P&L & we could not reference that this is for 2000 front end exclusivity. This is for front end exclusivity for 2000."

42. On or about January 27, 2000, Kmart's accounting department entered the false VATS information into the company's computerized accounting system, where it was eventually posted to the general ledger. VATS No. 197017 caused COGS to be understated by $2.5 million in FY 1999.

2. $7 Million Kodak Advance

43. Kmart's photo division was projecting another margin shortfall towards the end of fiscal year ended January 31, 2001 ("fiscal year 2000"). Orr met regularly with his staff to discuss the pulling forward of vendor allowances. During these meeting, Orr reviewed schedules prepared by his staff that expressly referenced several

pull forward opportunities, including a $7 million allowance from Kodak.

44. On or about January 31, 2001 -- the last day of the fiscal year – one of Orr’s subordinates asked Edquist to advance $7 million worth of allowances to be earned throughout calendar year 2001, which Edquist agreed to do.

45. On or about January 31, 2001, Edquist filled out and signed VATS No. 222946. VATS No. 222946 misrepresented the effective date of the $7 million Kodak allowance as 01/01/01 to 01/31/01. As a result, Kmart recognized the advance immediately. Edquist wrote the effective date on the VATS form by hand. This information was false because the payment represented an advance of allowances to be earned throughout calendar year 2001.

46. The true terms of the $7 million Kodak allowance were set forth in a memorandum written by Edquist on or about January 31, 2001. Edquist’s memorandum made clear that the money constituted an “advance” of allowances to be earned by Kmart throughout calendar year 2001. Edquist sent a copy of his memorandum to one of Orr’s subordinates on or about February 19, 2001. Edquist’s memorandum was not provided to Kmart’s accounting department or independent auditor.

47. On or about February 1, 2001, 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. VATS No. 222946 caused COGS to be understated by $7 million in fiscal year 2000.

3. <u>Kodak's False Third-Party Confirmation</u>

48. Kmart's independent auditor, PwC, sought to confirm with the vendors the terms of Kmart's "Top 15" allowances during the fiscal year 2000 audit, including the $7 million allowance from Kodak. As part of this effort, on or about February 14, 2001, Edquist received an audit confirmation form, asking that he confirm to PwC certain information relating to VATS No. 222946, including the agreement's effective date.

49. The audit confirmation form, which was on Kmart letterhead, provided in relevant part: "Our auditors, PricewaterhouseCoopers L.L.P., are performing an annual audit of our financial statements. They have requested of us to confirm directly with you the following vendor allowance agreement: Agreement # 222946 . . . please fax your reply directly to PricewaterhouseCoopers L.L.P."

50. Edquist responded to this request by taking information from the VATS form and inserting it onto the audit confirmation form. Edquist also attached a copy of VATS No. 222946 to the confirmation before sending it to PwC. Both the VATS form and audit confirm misrepresented the effective date of the $7 million Kodak allowance as 01/01/01 to 01/31/01.

51. Edquist was reckless in not knowing that the third party confirmation he provided to PwC was false or misleading because he knew that the $7 million payment represented an advance of allowances to be earned by Kmart during calendar year 2001.

4. <u>$3.25 Million Other Kodak Allowances</u>

52. An additional $3.25 million in Kodak pull forward opportunities were listed on the allowance schedules Orr reviewed and discussed with his staff towards the end of fiscal year 2000. All these allowances related to promotional and marketing activities scheduled for calendar year 2001 and beyond.

53. To pull forward these allowances, Orr directed subordinates to execute a series of eight VATS forms totaling $3.25 million (VATS Nos. 222920, 222921, 222922, 222924, 222935, 222936, 222947 and 222985). All eight VATS forms misrepresented the effective dates of the allowances as falling within Kmart's fiscal year 2000.

54. On or about January 31, 2001, Edquist co-signed the two largest of these VATS forms totaling $2.5 million (VATS Nos. 222947 and 222985). The true terms of these Kodak allowances were set forth in memoranda Edquist wrote on or about January 31, 2001. Edquist's memoranda made clear that the money constituted advances of allowances to be earned by Kmart during calendar year 2001. Edquist sent a copy of his memoranda to Orr and his subordinates in

February 2001. Edquist's memoranda were not provided to Kmart's accounting department or independent auditor.

55. Kmart's accounting department entered the false VATS information into the company's computerized accounting system, where it was eventually posted to the general ledger. This caused COGS to be understated by $3.25 million in FY 2000.

5. <u>$2.1 Million Fuji Payment</u>

56. The photo division also pulled forward one Fuji allowance at the end of FY 2000 with Orr's knowledge and assistance.

57. In January 2001, Fuji agreed to pay $2.1 million to secure the placement of product at favorable locations within Kmart stores during the upcoming year. To pull forward this allowance, on or about January 31, 2001, the parties executed VATS No. 222915, which misrepresented the effective date as 01/31/01 to 01/31/01.

58. The true terms of the agreement with Fuji were set forth in a letter sent to Orr and one of his subordinates, but not provided to Kmart's accounting department or independent auditor. This allowance was on the list of pull forwards Orr reviewed and discussed with his staff.

59. On or about February 1, 2001, Kmart's accounting department entered the false VATS information into the

company's computerized accounting system, where it was eventually posted to the general ledger. VATS No. 222915 caused COGS to be understated by $2.1 million in FY 2000.

D. **PULL FORWARDS BY KMART'S FOOD AND CONSUMABLES DIVISION**

60. A substantial number of pull forwards occurred in Kmart's food and consumables division towards the end of fiscal year ended January 31, 2001 ("fiscal year 2000"), shortly after Frank took charge of the division.

61. Towards the end of fiscal year 2000, the food and consumables division was projecting a margin shortfall, meaning actual results were short of what senior management expected. Frank responded to the projected margin shortfall in part by instructing Abbood to pull forward vendor allowances. At Frank's direction, Abbood and his subordinates pulled forward at least $12 million worth of allowances from fiscal year 2001 into 2000.

62. Abbood and his subordinates accomplished this by executing 10 VATS forms that misrepresented the effective dates, and sometimes the purpose of, certain allowances to make it look like the payments were for past performance, when in truth they related to future obligations. Abbood personally signed 9 of the false VATS forms. Two of these were provided to PwC in connection with its audit of Kmart's fiscal year 2000 financial statements. The true terms of the allowances were generally set forth in side agreements negotiated by Abbood.

63. On or about January 31, 2001, Frank signed a representation letter addressed to Kmart's internal auditors and PwC that misrepresented that allowances in the food and consumables division had been recognized in accordance with company policy. Frank knew, or was reckless in not knowing, that these representations were false and misleading.

64. Kirkpatrick was in charge of CCE's Kmart account during the relevant period. Kirkpatrick participated in the pulling forward of $3 million worth of allowances from fiscal year 2001 into fiscal year 2000 by executing two false and misleading VATS forms and providing Kmart's independent auditor with a false third party confirmation. In so doing, Kirkpatrick violated CCE's Code of Business Conduct, which prohibited conduct that could undermine the integrity of a customer's books and records.

65. Bixler was in charge of Pepsi-Cola's Kmart account during the relevant period. Bixler participated in the pulling forward of $3 million worth of allowances from fiscal year 2001 into fiscal year 2000 by executing a false and misleading VATS form and misrepresenting orally to PwC the terms of an allowance.

66. Taylor and Stone were in charge of Frito-Lay's Kmart account during the relevant period. Taylor and Stone executed three misstated VATS forms which Kmart used to pull forward $2.8 million worth of allowances from fiscal

year 2001 into fiscal year 2000. Stone helped Kmart pull forward an additional $500 thousand worth of allowances from the second quarter into the first quarter of fiscal year 2001.

1. <u>$3 Million of CCE Pull Forwards</u>

67. At a meeting on or about January 5, 2001, Abbood told Kirkpatrick that the food and consumables division needed $5 million from CCE to help cover a divisional profit shortfall. Abbood explained in a subsequent e-mail to Kirkpatrick on January 11, 2001, “dave, i appreciate your efforts however i need to accelerate your schedule. with the close of our fiscal on 1/31 i need to line up another partner. the bottom line is we need the 5.0m stay in touch.” Kirkpatrick responded by e-mail, “Al- How about 7:30AM on Tuesday 1/16/0[1]? I’ll bring the donuts and the checkbook.”

68. Kirkpatrick attended additional meetings at Kmart in mid to late January 2001, after which CCE agreed to “advance” $3 million worth of allowances in exchange for sales and promotional activities by Kmart during calendar year 2001 and to pay $2 million to settle accounts for calendar year 2000.

69. To memorialize that agreement, Kmart and CCE entered into a written contract dated January 30, 2001 (“Coke Contract”), which was negotiated by Abbood and Kirkpatrick. The Coke Contract provided in relevant part

that CCE would pay $3 million to support mutually agreed-upon marketing activities during calendar year 2001. Kmart would earn this allowance if, and only if, it sold targeted amounts of Coke product during the calendar year.

70. At the end of January 2001, Abbood and Kirkpatrick signed several VATS forms, including two relating to the $3 million "advance." The first, VATS No. 226003, purported to relate to a $2.25 million "Case display allowance" with an effective date of 02/01/00 to 12/31/00; the second, VATS No. 226004, purported to relate to a $750,000 "Holiday Display activation" allowance with an effective date of 11/01/00 to 12/31/00. VATS Nos. 226003 and 226004 misrepresented the effective dates and purpose of these allowances.

71. Abbood and Kirkpatrick knew, or were reckless in not knowing, that these two VATS forms misrepresented the true terms of the $3 million advance. The true terms of the allowance was set forth in the Coke Contract and a subsequent letter Kirkpatrick wrote, neither of which was provided to Kmart's accounting department or independent auditor. As explained therein, CCE agreed to pay $3 million to support mutually agreed-upon marketing activities during calendar year 2001.

72. On or about January 30, 2001, Kmart's accounting department entered the false VATS information into the company's computerized accounting system, where it was

eventually posted to the general ledger. VATS Nos. 226003 and 226004 caused COGS to be understated by approximately $3 million in fiscal year 2000.

73. CCE paid the $3 million allowance by check dated April 4, 2001, but the money was subject to repayment if Kmart did not perform in accordance with the terms of the Coke Contract.

2. CCE's False Third Party Confirmation

74. PwC sought to confirm with CCE the terms of the $2.25 million allowance during the fiscal year 2000 audit. Towards that end, PwC faxed Kirkpatrick a third party confirm relating to VATS No. 226003 on or about February 19, 2001.

75. The third party confirm, which was on Kmart letterhead, read in relevant part, "Our auditors, PricewaterhouseCoopers L.P.P. are performing an annual audit of our financial statements. They have requested of us to confirm directly with you the following vendor allowance agreement [Vats No. 226003]"

76. On or about March 5, 2001, Kirkpatrick filled out by hand, signed, and faxed to PwC an executed third party confirm that, as he knew or was reckless in not knowing, misrepresented the nature of ("Case display allowance") and effective dates ("02/01/00 to 12/31/00") for the $2.25 million allowance.

3. **$3 Million Pepsi-Cola Pull Forward**

77. Kmart’s relationship with Pepsi-Cola was governed in part by a multi-year contract entered into on or about September 4, 1997 (“Pepsi Contract”). The Pepsi Contract obligated Pepsi to pay millions of dollars worth of allowances in exchange for sales and promotional activities by Kmart throughout the calendar year. The Pepsi Contract obligated Kmart to support sales of Pepsi-Cola products in a number of ways and, as a result, gave Pepsi-Cola preferred status over CCE within the Kmart system.

78. Towards the end of fiscal year 2000, Abbood pressured Bixler to increase allowances under the Pepsi Contract for no additional performance. When Bixler resisted, Abbood threatened to give an additional 10 million cases of Kmart business to Pepsi’s archrival, Coke, even if this meant breaking the Pepsi Contract.

79. In early January 2001, Bixler agreed to “advance” or “prepay” $3 million worth of allowances to be earned by Kmart during calendar year 2001 under the Pepsi Contract. To memorialize that agreement, on or about January 11, 2001, Abbood and Bixler signed a VATS form and a side letter. VATS No. 219971 misrepresented the effective date of the $3 million allowance as 01/01/01 to 01/31/01. The VATS form also misrepresented that the allowance related to “Incremental R.O.P Support” – a special type of advertising activity not covered by the Pepsi Contract.

80. Abbood and Bixler knew, or were reckless in not knowing, that VATS No. 219971 misrepresented the true terms of the allowances in part because the side letter made clear that the money was a “pre-payment” of allowances to be earned by Kmart during calendar year 2001 under the Pepsi Contract. The side letter was not provided to Kmart’s accounting department or independent auditor.

81. During January 2001, the false VATS information was entered into Kmart’s computerized accounting system, where it was eventually posted to the general ledger. VATS No. 219971 caused COGS to be understated by $3 million in FY 2000.

82. Pepsi-Cola paid this allowance by check dated April 4, 2001, approximately three months later.

4. Pepsi-Cola’s False Third Party Confirmation

83. PwC sought to confirm the terms of the $3 million Pepsi-Cola allowance during Kmart’s fiscal year 2000 audit. Towards that end, PwC sent Bixler a third party confirmation relating to VATS No. 219971 in February 2001.

84. The third party confirm, which was on Kmart letterhead, read in relevant part, “Our auditors, PricewaterhouseCoopers L.P.P. are performing an annual audit of our financial statements. They have requested of us to confirm directly with you the following vendor allowance agreement [VATS No. 219971].”

85. Bixler informed one or more PwC auditors that he was reluctance to execute the third party confirmation in writing. On or about February 27, 2001, a PwC auditor sent an e-mail in an attempt to set up a face-to-face meeting. On or about March 1, 2001, another PwC auditor sent Bixler a follow-up e-mail in an attempt "to get 10 minutes of your time to come over to your office and confirm the terms of the merchandise allowance agreements that you have previously discussed with [the other PwC auditor]."

86. A PwC auditor met with Bixler one-on-one at Pepsi-Cola's field office in Troy, Michigan, in early March 2001. Bixler convinced the PwC auditor during their face-to-face meeting that Kmart had earned the $3 million allowance during FY 2000. Bixler knew, or was reckless in not knowing, that this was false because he and Abbood had agreed that the money constituted an advance of allowances to be earned during calendar year 2001.

87. Bixler also failed to provide PwC with a copy of the side letter memorializing that agreement. This was despite the fact that the PwC auditor brought with him a copy of VATS No. 219971 without the letter attached.

88. Upon returning to PwC's offices, the PwC auditor relayed the conversation with Bixler to other member of the audit team and documented it in his work papers.

5. **$2.8 Million Frito-Lay Pull Forward**

89. Towards the end of Kmart's fiscal year ended January 31, 2001 ("fiscal year 2000"), Abbood explained to Taylor and Stone that Kmart needed Frito-Lay's help in overcoming a profit shortfall. As Taylor and Stone were aware, this projected shortfall was caused in part by Frito-Lay's refusal to pay Kmart a $2.3 million "growth incentive" in late-December 2000.

90. With Taylor and Stone's knowledge and assistance, Frito-Lay agreed to make a $2.8 million "space payment" to Kmart in January 2001. Taylor and Stone understood that the purpose of the $2.8 million was to secure favorable placement of Frito-Lay product within Kmart stores during calendar year 2001. Taylor and Stone understood this in part because around the same time they helped draft a written agreement that explained the $2.8 million was a "pre-payment" of allowances to be earned by Kmart during calendar year 2001.

91. Taylor co-signed VATS form Nos. 224301, 224302, 224303 on January 4, 2001. These VATS forms misrepresented the effective dates of the allowances as 1/1/01 to 1/31/01. They were also misleading in that they failed to indicate that the $2.8 million was a "prepayment" against calendar year 2001 activity. Taylor e-mailed the VATS forms to Stone shortly after signing them. Abbood signed the documents shortly thereafter.

92. On or about January 19, 2001, 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. VATS Nos. 224301, 224302, 224303 caused COGS to be understated by $2.8 million in fiscal year 2000.

93. Stone helped Kmart pull forward an additional $500 thousand worth of allowances from the second quarter into the first quarter of fiscal year 2001. Stone then attempted to cover up his actions by altering a document relating to this pull forward during the SEC investigation. Frito-Lay terminated Stone for this misconduct in May 2004.

6. $4 Million Of Additional Pull Forwards

94. At Frank and Abbood’s direction, the food and consumables division pulled forward an additional four allowances totaling approximately $4 million from other salty snacks vendors in January 2001.

95. The VATS forms involved were Nos. 201886 ($1 million/Nabisco), 206431 ($1.7 million/Nestle), 207031 ($800 thousand/Procter & Gamble) and 186913 ($450 thousand/Superior Nuts), all or which were false and misleading in that they placed the allowance activity within Kmart’s fiscal year 2000. In reality, the relevant sales and promotional activity occurred in calendar year 2001. Abbood’s signature or initials appear on the three largest VATS forms.

96. Kmart's accounting department entered the false VATS information into the company's computerized accounting system, where it was eventually posted to the general ledger. These four VATS forms caused COGS to be understated by approximately $4 million in FY 2000.

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

1. **Kmart's Earnings Were Overstated**

97. On March 13, 2001 Kmart filed its Form 10-K for the period ended January 31, 2001 ("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. Kmart reported net income for the fiscal year of $219 million or $0.47 per share, excluding special charges. Defendants' accounting irregularities caused net income to be overstated, however, by approximately $24 million or 10 percent.

2. **Kmart's Management Letter Was False And Misleading**

98. 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.

99. 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 number of allowances had been recognized before the earnings process was complete, as required by GAAP and the company's internal accounting policies.

100. 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 number of allowance transactions were not executed in accordance with company policies and procedures.

FIRST CLAIM FOR RELIEF

(Violations of Section 10(b) and Rule 10b-5 of the Exchange Act)

101. Plaintiff SEC hereby incorporates ¶¶ 1 through 100 with the same force and effect as if set out here.

102. In the manner described in ¶¶ 1 through 101, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler and Stone, in connection with the purchase or sale of

securities, 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.

103. By reason of the foregoing, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler, Stone and, by their conduct Kmart, violated, or aided and abetted the violation of, and unless restrained will continue to violate, or continue to aid and abet the violation of, Section 10(b) of the Securities Exchange Act of 1934 (“Exchange Act”) [15 U.S.C § 78j(b)] and Rule 10b-5 [17 C.F.R. § 240.10b-5] promulgated thereunder.

SECOND CLAIM FOR RELIEF

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

104. Plaintiff SEC hereby incorporates ¶¶ 1 through 103 with the same force and effect as if set out here.

105. In the manner described in ¶¶ 1 through 104, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler, Taylor and Stone, directly or indirectly, falsified

or caused the falsification of, the books, records or accounts of Kmart.

106. By reason of the foregoing, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler, Taylor and Stone violated, and unless restrained will continue to violate, Rule 13b2-1 of the Exchange Act [17 C.F.R. § 240.13b2-1].

THIRD CLAIM FOR RELIEF

(Violations of Section 13(b)(5) of the Exchange Act)

107. Plaintiff SEC hereby incorporates ¶¶ 1 through 106 with the same force and effect as if set out here.

108. In the manner described in ¶¶ 1 through 107, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler and Stone knowingly circumvented Kmart's internal accounting controls or knowingly falsified the books, records or accounts of Kmart.

109. By reason of the foregoing, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler and Stone violated, and unless restrained will continue to violate, Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)].

FOURTH CLAIM FOR RELIEF

(Violations of Rule 13b2-2 of the Exchange Act)

110. Plaintiff SEC hereby incorporates ¶¶ 1 through 109 with the same force and effect as if set out here.

111. In the manner described in ¶¶ 1 through 110, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick and Bixler, directly or indirectly, (a) made or caused to be made a materially false or misleading statement, or (b) omitted to state, or caused another person to omit to state, a material fact necessary in order to make statements made, in light of the circumstances under which they were made, not misleading to an accountant in connection with (1) an audit or examination of the financial statements of Kmart or (2) the preparation or filing of Kmart's Form 10-K.

112. By reason of the foregoing, defendants Orr, Frank and Abbood violated, and unless restrained will continue to violate, and defendants Edquist, Kirkpatrick and Bixler aided and abetted violations of, and unless restrained will continue to aid and abet violations of, Rule 13b2-2 of the Exchange Act ("Exchange Act") [17 C.F.R. § 240.13b2-2].

FIFTH CLAIM FOR RELIEF

(Violations of the Reporting Provisions of the Exchange Act)

113. Plaintiff SEC hereby incorporates ¶¶ 1 through 112 with the same force and effect as if set out here.

114. Section 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-1 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-1] require every issuer of a registered security to file reports with the SEC that accurately reflect the issuer's financial performance and provid other true and accurate information to the public.

115. In the manner described in ¶¶ 1 through 114, defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler and Stone aided and abetted, and unless restrained will continue to aid and abet, violations of Sections 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-1 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-1], pursuant to Section 20(e) of the Exchange Act [15 U.S.C. § 78t(e)].

PRAYER FOR RELIEF

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

(a) permanently enjoining defendants Orr, Frank and Abbood, 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; (ii) violating Rule 13b2-1 of the Exchange Act [17 C.F.R. § 240.13b2-1]; (iii) violating the Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]; (iv) violating Rule 13b2-2 of the Exchange Act [17 C.F.R. § 240.13b2-2]; and (v) aiding and abetting violations of Sections 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-1 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-1];

(b) permanently enjoining defendants Edquist, Kirkpatrick and Bixler, 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; (ii) violating Rule 13b2-1 of the Exchange Act [17 C.F.R. § 240.13b2-1]; (iii) violating Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]; (iv) aiding and abetting violations of Rule 13b2-2 of the Exchange Act [17 C.F.R. § 240.13b2-2]; and (v) aiding and abetting violations of Sections 13(a) of the Exchange Act [15 U.S.C.

§ 78m(a)] and Rules 12b-20 and 13a-1 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-1];

(c) permanently enjoining defendant Stone, and his 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; (ii) violating Rule 13b2-1 of the Exchange Act [17 C.F.R. § 240.13b2-1]; (iii) violating Section 13(b)(5) of the Exchange Act [15 U.S.C. § 78m(b)(5)]; and (iv) aiding and abetting violations of Sections 13(a) of the Exchange Act [15 U.S.C. § 78m(a)] and Rules 12b-20 and 13a-1 promulgated thereunder [17 C.F.R. §§ 240.12b-20 and 240.13a-1];

(d) ordering defendants Orr, Frank, Abbood, Edquist, Kirkpatrick, Bixler, Taylor and Stone to pay civil money penalties pursuant to Section 21(d)(3) of the Exchange Act [15 U.S.C. § 78u(d)(3)];

(e) permanently barring defendants Orr and Frank 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

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

Dated: December 2, 2004

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