

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

FILED
AUG 01 2003
UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS
JUL 30 2003
KENNETH S. GARDNER, CLERK
PS PER: - GW

In re)
)
KMART CORPORATION, et al.,) Chapter 11
) Case No. 02-B02474
Debtors.) Jointly Administered
) Judge Susan Pierson Sonderby
)

**APPLICATION OF MILLER BUCKFIRE LEWIS YING & CO., LLC, FOR
(A) ALLOWANCE OF FEES AND REIMBURSEMENT OF EXPENSES FOR THE
INTERIM PERIOD FROM JANUARY 1, 2003, THROUGH MAY 6, 2003, AND (B)
FINAL ALLOWANCE AND PAYMENT OF FEES AND REIMBURSEMENT OF
EXPENSES FOR THE PERIOD FROM JANUARY 22, 2002, THROUGH MAY 6, 2003**

Name of Applicant:	<u>Miller Buckfire Lewis Ying & Co., LLC¹</u>
Authorized to Provide Professional Services to:	<u>The above-captioned debtors and debtors-in-possession</u>
Date of Retention:	<u>January 22, 2002</u>
Period for Which Compensation and Reimbursement Are Sought:	Fourth: January 1, 2003, through May 6, 2003 <u>Final: January 22, 2002, through May 6, 2003</u>
Amount of Compensation Sought as Actual, Reasonable and Necessary:	Fourth: \$ 10,879,637.10 <u>Final: \$ 13,354,637.10</u>
Amount of Expense Reimbursement Sought as Actual, Reasonable and Necessary:	Fourth: \$ 260,913.17 <u>Final: \$ 763,970.16</u>

¹ This Court approved the Debtors' retention of Dresdner Kleinwort Wasserstein, Inc. ("DrKW") as financial advisor and investment banker by an Amended Order entered April 23, 2002. In July 2002 the financial restructuring group of DrKW completed a spin-off and became Miller Buckfire Lewis & Co., LLC ("MBL"). On September 25, 2002, the Court approved the assignment of DrKW's responsibilities to MBL. MBL subsequently changed its name to Miller Buckfire Lewis Ying & Co., LLC ("MBLY") in May 2003. This Fee Application seeks final allowance of all fees earned and expenses incurred by MBLY as well as expenses incurred by DrKW. Pursuant to the terms of this Court's September 25, 2002, Order, DrKW is entitled to reimbursement of its expenses.

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**APPLICATION OF MILLER BUCKFIRE LEWIS YING & CO., LLC, FOR
(A) ALLOWANCE OF FEES AND REIMBURSEMENT OF EXPENSES FOR THE
INTERIM PERIOD FROM JANUARY 1, 2003, THROUGH MAY 6, 2003, AND (B)
FINAL ALLOWANCE AND PAYMENT OF FEES AND REIMBURSEMENT OF
EXPENSES FOR THE PERIOD FROM JANUARY 22, 2002, THROUGH MAY 6, 2003**

Pursuant to Sections 330 and 331 of title 11 of the United States Code, 11 U.S.C. §§ 101 et seq. (the "Bankruptcy Code"), Rule 2016(a) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), and the Court's Administrative Order Pursuant to Sections 105(a) and 331 of the Bankruptcy Code Establishing Procedures for Interim Compensation and Reimbursement of Expenses of Professionals, entered January 25, 2002 (the "Fee Procedures Order"), Miller Buckfire Lewis Ying & Co., LLC ("MBLY"), financial advisor and investment banker to the above-captioned debtors and debtors-in-possession (collectively, the "Debtors"), hereby files this Application (this "Application") (1) for allowance of MBLY's fees for services rendered by MBLY during the most recent interim compensation period (January 1, 2003, through May 6, 2003), (2) for final allowance of MBLY's fees for services rendered during the entire period from the commencement of these Chapter 11 cases through and including May 6, 2003, and (3) interim and final allowance of MBLY's requested expense reimbursements for the same periods. MBLY also respectfully seeks entry of an Order directing the payment of the foregoing sums to the extent not previously paid to MBLY.

In support of this Application, MBLY respectfully represents as follows:

Background

1. On January 22, 2002 (the "Petition Date"), the Debtors commenced cases under Chapter 11 of the Bankruptcy Code.
2. On April 22, 2003, the Court entered an order confirming the Debtors' First Amended Joint Plan of Reorganization (the "Plan"), as modified, and on May 6, 2003, the Debtors emerged from Chapter 11.
3. The Court has jurisdiction over this Application pursuant to 28 U.S.C. §§ 157 and 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).
4. The statutory and other legal predicates for the relief requested herein are as follows:
(i) Sections 328(a), 330, and 331 of the Bankruptcy Code; (ii) Rule 2016 of the Bankruptcy Rules; and (iii) the Fee Procedures Order.
5. No prior request has been made for the relief sought herein, except as disclosed below with respect to the prior fee applications filed by MBLY and its predecessors.

Retention of MBLY

6. MBLY and its predecessors (hereafter referred to as "MBLY" for convenience) acted as financial advisors and investment bankers for the Debtors in these cases pursuant to the terms of a letter agreement dated January 17, 2002 (the "Engagement Letter"), a copy of which is attached as Exhibit A. The Engagement Letter specified the services that MBLY would provide and the compensation that it would receive for those services. The agreed compensation included, among other things, the following:
 - (a) a monthly financial advisory fee of \$225,000.00 (the "Monthly Fee") during the term of its engagement;

(b) a transaction fee (the "Transaction Fee"), contingent upon the consummation of a Restructuring¹ and payable at the closing thereof, equal to \$12,500,000.00; and

(c) the reimbursement of MBLY's actual and necessary expenses.

MBLY also agreed to credit an amount equal to 75% of the Monthly Fees against the aggregate amount of any Transaction Fee (the "Monthly Fee Credit").

7. The terms of MBLY's retention were approved in a minute order entered on April 1, 2002. On April 23, 2002, the Court entered an Amended Order with respect to MBLY's retention (the "Amended Retention Order"). On September 25, 2002, the Court entered an Order authorizing the assignment of the Engagement Letter to MBLY, the retention of MBLY as financial advisor and investment banker, and the continued retention of Dresdner Kleinwort Wasserstein, Inc. ("DrKW") as investment banker (the "Supplemental Retention Order", and together with the Amended Retention Order, the "Retention Order"). Pursuant to the terms of the Retention Order, MBLY has the right to payment of the fees requested in this Application.²

8. Pursuant to the terms of the Engagement Letter, MBLY has earned the following fees and is entitled to the following expense reimbursements for the period January 1, 2003, through and including May 6, 2003 (the "Fourth Interim Period"):

¹ As used in the Engagement Letter, the term "Restructuring" means any recapitalization or restructuring (including, without limitation, through any exchange, conversion, cancellation, forgiveness, retirement and/or a material modification or amendment to the terms, conditions or covenants thereof) of the Debtors' preferred equity and/or debt securities and/or other indebtedness, obligations or liabilities (including preferred stock, partnership interests, lease obligations, guarantees, trade credit facilities and/or contract or tort obligations), including pursuant to a repurchase or an exchange transaction, a plan of reorganization or a solicitation of consents, waivers, acceptances or authorizations, resulting in the consummation of a Chapter 11 plan. Notwithstanding anything to the contrary in the Engagement Letter, the term "Restructuring" shall include the consummation of any "Sale" (as such term is used in the Engagement Letter) pursuant to 363 of the Bankruptcy Code.

² DrKW has the right to seek reimbursement of its expenses, but has no right to seek additional fees.

(a) MBLY has earned Monthly Fees in the amount of \$943,548.39;

(b) MBLY has earned a Transaction Fee upon the consummation of the Debtors' plan of reorganization, in the amount (before credits) of \$12,500,000.00, which is reduced to \$9,936,088.71 after the application of the Monthly Fee Credit; and

(c) MBLY has incurred expenses of \$260,913.17, for which it is entitled to reimbursement.

Of the foregoing amounts, \$10,111,575.42 has previously been paid to MBLY pursuant to the terms of the Fee Procedures Order, which includes payment for estimated expenses pursuant to Section 10.2(b) of the Plan. Based on its final expense reconciliation, MBLY has determined that the Debtors' are entitled to a \$58,988.86 expense credit (the "Expense Credit").

9. MBLY has also earned the following fees and is entitled to the following expense reimbursements for the period beginning with the commencement of these Chapter 11 cases and continuing through and including May 6, 2003 (the "Final Period"):

(a) MBLY has earned Monthly Fees in the total amount of \$3,418,548.39;

(b) As noted above, MBLY has earned a Transaction Fee in the net amount (after the application of the Monthly Fee Credit) of \$9,936,088.71; and

(c) MBLY has incurred expenses totaling \$763,970.16.

Of the foregoing amounts, \$12,909,632.88 has previously been paid to MBLY pursuant to the terms of the Fee Procedures Order, which includes payment for estimated expenses pursuant to Section 10.2(b) of the Plan. As noted above, the Debtors are entitled to the Expense Credit of \$58,988.86.

Relief Requested

10. By this Application, MBLY requests entry of an Order, substantially in the form attached hereto as Exhibit J, approving and allowing the foregoing fees and expense reimbursements to the extent they were incurred during the Fourth Interim Period; finally allowing the foregoing fees and expense reimbursements for the Final Period; and authorizing and directing the Debtors to pay the foregoing amounts to the extent they have not already been paid. Accordingly, MBLY requests entry of an Order:

(a) granting allowance of compensation of \$10,879,637.10 and reimbursement of expenses of \$260,913.17 in respect of services rendered by MBLY for the Fourth Interim Period;

(b) granting final allowance of compensation of \$13,354,637.10 and reimbursement of expenses of \$763,970.16 in respect of services rendered by MBLY for the Final Period; and

(c) authorizing and directing the Debtors to pay MBLY any and all allowed and unpaid fees and expenses accrued, in an amount equal to \$1,208,974.38, which represents \$1,267,963.24 in respect of fees previously withheld in accordance with the "holdback" provisions of the Fee Procedures Order minus the Expense Credit of \$58,988.86.

11. MBLY submits that the payment of the foregoing fees and reimbursement of the foregoing expenses is appropriate, is in the best interests of the Debtors' estates and should be approved by the Court.

Supporting Materials

12. A copy of the Engagement Letter is attached as Exhibit A. An itemization of the requested fees is attached as Exhibit B. A summary of the hours expended by MBLY

professionals in connection with this engagement is attached as Exhibit C. A summary of the expenses for which reimbursements are being sought, together with a description of MBLY's policies with respect to reimbursement of expenses, is attached as Exhibit D. A copy of the Court's minute order dated April 1, 2002, is attached as Exhibit E. Copies of the Amended Retention Order and the Supplemental Retention Order are attached as Exhibits F and G, respectively. A copy of the Fcc Procedures Order is attached as Exhibit H. The certification of Henry S. Miller in support of this Application is attached as Exhibit I. A proposed Order granting the relief sought herein is attached as Exhibit J.

MBLY Professionals

13. The following MBLY professionals rendered services in these cases for which MBLY seeks compensation: Henry Miller, Derex Walker and Morgan Suckow. In addition, the following DrKW professionals rendered services in these cases: Kenneth Tuchman, Jeff Cohen, Kathleen Kress, David Randell, Robert Miller, Roopesh Shah (who has since become an employee of MBLY) and James Shillito. Under the terms approved by the Court, the services of DrKW are provided pursuant to an agreement between MBLY and DrKW. Although DrKW is entitled to expense reimbursements, the only fees that are payable are the fees that are payable to MBLY. By and through the above-named persons, MBLY has advised the Debtors on a regular basis with respect to various matters in these cases and has performed all the services described in detail below.

Summary of Services by Project Category

14. The services rendered by MBLY during the Fourth Interim Period and the Final Period are summarized by project category below, although certain services may have related to one or more project categories.

I. Case Administration/General

15. This category includes time spent by MBL Y on matters relating to general case administration. Among other things, MBL Y assisted the Debtors in preparing for the Debtors' Chapter 11 filing and in complying with certain administrative obligations that arose out of the filing, including, without limitation, preparing and filing the statements of financial affairs and the schedules of assets and liabilities as well as monthly operating reports. Additionally, MBL Y helped prepare the Debtors for the organizational meeting of creditors and equity holders and reviewed the Debtors' regulatory filings including the annual and quarterly reports filed with the Securities and Exchange Commission.

16. This category also includes time spent by MBL Y assisting the Debtors in preparing for omnibus hearings and reviewing motions filed with the Court relating to, among other things, (i) the various store closing initiatives; (ii) the assumption of certain key licensing and supply agreements; (iii) the liquidation of the auto service centers business; (iv) the approval of debtor-in-possession credit facility (the "DIP Credit Facility") and the exit financing facility (the "Exit Credit Facility"); and (v) the disclosure statement and the plan of reorganization. In addition, MBL Y assisted senior management in preparing for board and statutory committee meetings and drafted numerous presentations for use by management in connection with such meetings. MBL Y also participated in frequent telephone conversations and meetings with the Debtors, the Debtors' attorneys and other professionals and parties-in-interest regarding the status of these cases and the preparation and review of relevant court documents.

Total Hours – Fourth Interim Period: 8.00

Total Hours – Final Period: 260.80

II. Retention Issues

17. This category includes time spent by MBL Y in connection with its retention by the Debtors. Among other things, MBL Y drafted and negotiated the Engagement Letter and reviewed the application, the order and affidavits relating to its retention. In support of its fee arrangement with the Debtors, MBL Y also conducted an analysis of transaction fees paid to investment bankers both inside and outside Chapter 11, which was shared with the legal and financial advisors to the statutory committees. Finally, MBL Y undertook a firm-wide effort to check for conflicts among its professionals in connection with its retention.

18. This category also includes time spent by MBL Y drafting and reviewing the application, order and affidavits required to obtain the Court's approval of the assignment of the Engagement Letter from DrKW to MBL Y. MBL Y reviewed and responded to the objections of the Office of the United States Trustee to the terms of the assignment. In connection with the foregoing, MBL Y participated in numerous telephone conversations with its counsel as well as counsel to the Debtors and the statutory committees and helped draft a response to the trustee's objections.

19. MBL Y also prepared fee invoices, fee applications, expense summaries and time records for the Debtors' cases. This category includes time spent by MBL Y responding to requests from the Office of the United States Trustee for detailed expense records supporting prior fee applications and invoices.

Total Hours – Fourth Interim Period: 52.00

Total Hours – Final Period: 189.80

III. Travel to, from, and on behalf of the Debtors

20. This category reflects time spent traveling to and from the Debtors' offices or other destinations on the Debtors' behalf, including meetings and hearings in New York, Detroit and Chicago. This category also includes time spent traveling to due diligence sessions in San Francisco relating to the proposed sale of the Bluelight.com ISP business.

Total Hours – Fourth Interim Period: 197.50

Total Hours – Final Period: 1,465.80

IV. Sale Process

21. This category includes time spent by MBL Y assisting the Debtors evaluating strategic and restructuring alternatives in connection with developing a plan of reorganization. In particular, MBL Y worked with the Debtors to identify several potential strategic and financial buyers for the Debtors' assets. In connection with the foregoing, MBL Y (i) contacted several potential buyers, (ii) drafted and distributed informational materials relating to the Debtors' business, (iii) negotiated confidentiality agreements, (iv) responded to due diligence requests, (v) accompanied management and potential buyers on store visits, (vi) participated in meetings between the Debtors' management and possible buyers and (vii) assisted in preparing management for such meetings. The efforts undertaken by MBL Y in terms of marketing the Debtors' assets assisted the Debtors in determining that the plan of reorganization filed with the Court represented the best strategy for maximizing the value of the estate.

22. MBL Y also advised the Debtors with respect to the sale of the Bluelight.com ISP business. The sale was completed in October 2002 and generated more than \$8.0 million in cash proceeds for the estate. MBL Y played a key role in the transaction by, among other things, conducting an auction for the ISP assets, participating in management meetings, coordinating

due diligence, evaluating the bids received by the Debtors and negotiating the economic terms of the purchase agreement with United Online, the winning bidder for the ISP assets. The auction process undertaken by MBLY lasted for approximately thirty days and involved (i) identifying and contacting several potential buyers, (ii) drafting and distributing informational materials relating to the business, (iii) negotiating confidentiality agreements, (iv) responding to due diligence requests, and (v) participating in management meetings in San Francisco. At the conclusion of the auction process, the Debtors decided to proceed with the transaction with United Online based on the responses that MBLY received from prospective purchasers. MBLY played a key role in structuring and negotiating the proposed transaction with United Online. Specifically, MBLY assisted the Debtors in increasing the offer from United Online to \$8.4 million from \$6.0 million. MBLY also provided the Debtors with guidance in evaluating the proposed transaction by analyzing the purchase price paid in several recent transactions as well as the implied market valuation for certain publicly-traded internet service providers. In addition, MBLY helped the Debtors ensure that the transaction was consummated as quickly as possible and participated in negotiating the key transaction documents, including the asset purchase agreement. MBLY also assisted the Debtors in reviewing and preparing schedules relating to the asset purchase agreement.

23. In addition, MBLY solicited competing bids for an auction held on October 7, 2002, and worked with parties interested in participating in the auction in conducting their due diligence investigation of the Bluelight.com ISP business. Finally, MBLY assisted the financial advisors to the statutory committees in their review of the terms of the sale.

Total Hours – Fourth Interim Period: 0.00

Total Hours – Final Period: 308.10

V. Creditor Contacts

24. This category reflects time spent by MBLY in discussions with the Debtors' three statutory committees and their legal and financial advisors. Among other things, MBLY's contacts included (i) preparing for and participating in monthly joint committee meetings as well as equity committee meetings, (ii) preparing for and participating in vendor subcommittee meetings, (iii) attending dinner meetings with the statutory committees, and (iv) preparing for and participating in the Section 341 meetings. MBLY also discussed and negotiated numerous issues with the statutory committees relating to, among other things, the 2002 operating budget and plan exclusivity. In addition, MBLY briefed the statutory committees and their advisors on numerous business developments, including the wind-down of the auto service center business, the assumption of certain key agreements, the various store closing initiatives and certain aspects of the Debtors' business plan.

25. This category also includes time spent by MBLY in responding to information requests from each of the three statutory committees. Specifically, MBLY participated in due diligence sessions relating to, among other things, (i) the quarterly cash flow forecast, (ii) the amendments to the DIP Credit Facility, (iii) SKU rationalization, (iv) inventory management, (v) the restructuring proposal and emergence plan, (vi) the store closing plan, (vii) the business plan, (viii) the disposition of the Bluelight.com ISP business, (ix) the Debtors' decision to enter into a amended agreement with Cardinal Health and (x) the Debtors' decision to enter into a licensing agreement with Thalia and assume certain other key licensing agreements. In addition, MBLY was involved in monthly conference calls updating the financial advisors to the statutory committees on the Debtors' financial results.

26. MBLY also assisted the Debtors in resolving several key issues involving the statutory committees. Particularly noteworthy is the role that MBLY played in connection with the agreement to deliver store-level financial and operating data to the statutory committees on September 30, 2002. MBLY helped the Debtors articulate their position on disclosing such data and assisted in effectuating a compromise on the timing of the delivery of the data. MBLY also worked with counsel to the Debtors in drafting a confidentiality agreement relating to the disclosure of the store-level data and assisted the Debtors in checking the accuracy of such data.

27. In addition, this category includes time spent by MBLY on the formation of the official committee of equity holders. In June 2002, MBLY participated in the Section 341 meeting in Chicago and assisted the Debtors in preparing for that meeting. MBLY also participated in monthly equity committee meetings and frequent telephone conversations with the committee chairperson as well as the legal and financial advisors to the committee. MBLY also facilitated the due diligence investigation of the Debtors by the financial advisor to the equity committee.

28. This category also includes time spent by MBLY in discussions with individual creditors and shareholders, including the largest shareholder and the largest creditor in these cases. These discussions focused on the Debtors' plan of reorganization and timetable for emerging from Chapter 11 as well as the Debtors' future prospects.

Total Hours – Fourth Interim Period: 84.60

Total Hours – Final Period: 850.80

VI. Business Plan and Strategy

29. This category includes time spent by MBLY assisting the Debtors in stabilizing their business and in rationalizing their assets. Specifically, MBLY assisted the Debtors in, among

other things, (i) evaluating and renegotiating their supply arrangements with Cardinal Health, Fleming Companies and Kodak; (ii) evaluating and renegotiating their key licensing agreements; (iii) reviewing and analyzing certain service arrangements and agreements relating to certain of the company's leased departments; (iv) evaluating stores for closure; (v) developing the five-year business plan; and (vi) preparing and negotiating a plan of reorganization.

A. Key Supply Agreements

30. MBLY was involved in the Debtors' efforts to obtain significant concessions under their pharmaceutical supply agreement with Cardinal Health. Among other things, MBLY held numerous meetings with the Debtors' pharmaceutical management team as well as representatives from Cardinal Health to develop an understanding of the issues relating to the pre-petition supply agreement, including service level and inventory management problems. MBLY also worked with the Debtors to prioritize the key areas for contract negotiation and to develop a financial model for evaluating the costs and benefits of proposals made by Cardinal Health during the course of the negotiations. In addition, MBLY assisted the Debtors in evaluating alternatives to the amended supply agreement with Cardinal Health and identifying the business risks of transitioning to a new supplier during the Chapter 11 case.

31. MBLY's involvement in the negotiations with Cardinal Health generated significant financial benefits for the estate. Among other things, MBLY was instrumental in helping the Debtors finalize the discussions with Cardinal Health on a fast-track basis. MBLY also assisted the Debtors in negotiating a larger discount on branded Rx purchases and a greater share of the rebates obtained on generic purchases and advised the Debtors on structuring the agreement to minimize the financial impact of any future store closings. Partly because of MBLY's participation in the discussions, the Debtors successfully avoided a request for additional float

from Cardinal Health and preserved their ability to explore alternative supply arrangements in the future with minimal termination costs.

32. On October 10, 2002, the Debtors filed a motion with the Court seeking to amend and assume the pharmaceutical supply agreement with Cardinal Health. The Debtors expect to receive substantial savings under the amended supply agreement. On October 30, 2002, the Court entered an order approving the assumption of an amended pharmaceutical supply agreement with Cardinal Health.

33. MBL.Y also played a supporting role in the Debtors' decision to terminate their supply arrangement with Fleming Companies. Among other things, MBL.Y assessed the strengths and weaknesses of the Debtors' business arrangement with Fleming Companies and suggested possible modifications to the contract. MBL.Y also assisted the Debtors in evaluating alternative distribution arrangements (including self-distribution) and the possible business risks associated with rejecting the supply agreement with Fleming Companies. In February 2003, the Court approved the Debtors' motion to reject the Fleming Companies supply agreement.

34. In addition, the Debtors requested MBL.Y's assistance in analyzing the costs and benefits of a proposed amendment to the Debtors' photo-finishing services agreement with Kodak. In connection with its analysis, MBL.Y conducted extensive due diligence and had numerous meetings with the management team responsible for the business. MBL.Y also developed a financial model and assisted the Debtors in their efforts to negotiate a more favorable proposal.

B. Key Licensing Agreements

35. MBL.Y worked extensively with the Debtors to evaluate their pre-petition licensing agreements. MBL.Y played an active role in evaluating and renegotiating the Debtors' financial

obligations under the licensing agreements for Sesame Street, Route 66 and Curtis Mathes. MBLY also reviewed the business case supporting the Debtors' decision to enter into a new licensing agreement with Thalia, which is expected to be the leading celebrity brand among Hispanic consumers. Additionally, MBLY advised the Debtors on terminating a licensing arrangement relating to its household appliance business.

36. This category also includes time spent by MBLY advising the Debtors in negotiating an amendment to its software licensing agreement with Manhattan Associates, Inc., which was approved by the Court on September 24, 2002. Pursuant to the amendment, the Debtors' payment obligations under the licensing agreement were reduced by about 50%.

C. Customer Service Agreements/Leased Departments

37. MBLY also worked with the Debtors on reviewing their relationship with certain customer service providers. In particular, MBLY worked with the Debtors to evaluate a request from a key customer service provider for the assumption of its pre-petition licensing agreement. MBLY assisted the Debtors in developing a response to the request and in exploring possible alternative arrangements. MBLY worked with the Debtors on reviewing proposals for expanding the Debtors' existing relationship with the customer service provider and assuming its pre-petition licensing agreement. Additionally, MBLY worked with the Debtors to evaluate several proposals for leasing the space formerly occupied by Penske Auto Centers since the wind-down of the auto service center business.

38. MBLY also assisted the Debtors in evaluating several proposals related to outsourcing their data center under an extremely tight timetable. MBLY participated in the Debtors' discussions with each bidder and assisted management in modeling the benefits and

costs of an outsourcing arrangement. Based in part on MBL Y's input, the Debtors decided in August 2002 not to pursue any of the outsourcing proposals.

39. Finally, MBL Y assisted the Debtors in identifying strategies for making its E-commerce business more viable. In particular, MBL Y participated in discussions with the outsourcing and fulfillment partner for the Debtors' E-commerce business and worked with management to evaluate the importance of the E-commerce business to the Debtors' other businesses.

D. Store Closing Analysis

40. Since the closing of 283 stores in March 2002, MBL Y assisted the Debtors in rationalizing their asset base. MBL Y worked with the Debtors in analyzing their remaining stores in order to determine which additional locations should be closed subsequent to the 2002 holiday season. MBL Y and the Debtors considered numerous factors in their store-level review, including (i) historical and projected operating results; (ii) the impact of current and future competition; (iii) lease years to maturity, future lease liability and real estate value; (iv) the impact of rent and term concessions, where applicable, on projected operating results; (v) store age, size and estimated capital spending requirements; (vi) potential savings from exiting markets and regions; (vii) the potential impact of store closings on advertising costs, purchasing power and allowances; and (viii) the potential impact of store closings on market coverage and the Debtors' market position. In connection with its analysis, MBL Y participated in numerous meetings with the Debtors and prepared numerous reports and analyses for review by the board and senior management as well as the statutory committees.

41. This category also includes time spent by MBL Y examining numerous scenarios regarding possible operating strategies, some of which contemplated exiting certain markets or

regions. In particular, MBLY summarized for management the expected performance of the ongoing chain based on such scenarios. MBLY undertook with the Debtors a review of the financial and operational performance of the Debtors' 117 super-centers on a store-by-store basis and assisted the Debtors in evaluating their ongoing super-center strategy.

42. In early 2003, the Debtors announced their decision to close an additional 316 stores and one distribution center. The Debtors also scaled back their presence in Texas and reduced the geographic scope of their super-center business. These actions are expected to enhance the financial performance and competitive position of the Debtors.

43. MBLY also worked with the Debtors to determine which, if any, expiring lease renewal options should be exercised. Furthermore, MBLY worked closely with the Debtors' senior management team, internal legal professionals and individuals from the finance and real estate groups as well as the Debtors' legal and real estate advisors to analyze and assess numerous rent and term concessions and determine which concessions should be negotiated and documented. Such analysis helped the Debtors' keep open certain stores, which are projected to be positive contributors of cash flow with significantly reduced future lease liabilities to the estate.

E. Five-year Business Plan

44. MBLY assisted the Debtors by reviewing and evaluating their five-year business plan, which was the basis for the plan of reorganization confirmed by the Court. In the course of its work, MBLY held numerous meetings with management to understand the assumptions underlying the business plan. MBLY also analyzed current and historical trends relating to sales, gross margin, shrink, fixed and variable operating costs and capital spending. In addition,

MBLY analyzed the impact of various store closing scenarios on the future prospects of the business and identified the key risks associated with the business plan.

F. Restructuring Proposal

45. This category includes time spent by MBL Y advising the Debtors on the development of a plan of reorganization. MBL Y played a key role in structuring and negotiating the treatment of each creditor class and the terms of the consideration to be distributed to such classes under the plan of reorganization. In addition, MBL Y was actively involved in the negotiation of the terms of the investment from ESL Investments and Third Avenue Trust (the "Plan Investors"), including negotiating the conditions to closing, the terms of the stock option and the amount of the commitment fee. As noted above, MBL Y also explored various strategic and restructuring alternatives for the Debtors, including a possible sale of the business.

46. In connection with its work, MBL Y prepared extensive valuation analyses for use by the board and senior management. These analyses included (i) comparable public company analysis, (ii) discounted cash flow analysis and (iii) comparable acquisition analysis. In connection with the preparation of its valuation analyses, MBL Y conducted various sensitivity analyses based on the Debtors' business plan. MBL Y also spent time responding to questions from the statutory committees as well as individual creditors related to the valuation analysis and the plan of reorganization in general.

47. This category also includes time spent by MBL Y addressing issues raised by the Pension Benefit Guarantee Corporation ("PBGC") related to the treatment of the Debtors' pension obligations in the plan of reorganization. MBL Y participated in several conference calls and meetings with the Debtors, the Debtors' counsel and the PBGC during which the PBGC's concerns were addressed. MBL Y also prepared several analyses and a comprehensive

presentation to the PBGC that was key to garnering the PBGC's support for the Debtors' plan of reorganization.

48. In addition, MBLY assisted the Debtors in selecting an exchange for listing the equity of reorganized Kmart. This category includes time spent by MBLY participating in meetings and conference calls with the various major exchanges, as well as meeting internally with the Debtors, the Debtors' counsel and the Plan Investors.

49. In February 2003, the Debtors filed their first amended joint plan of reorganization, which was confirmed by the Bankruptcy Court on April 22, 2003. In connection with confirmation, MBLY prepared numerous slides that were utilized during the confirmation hearing in order to assist the Debtors and the Debtors' counsel in making their case. This category also includes time spent by MBLY in meetings with the Debtors, the Debtors' counsel and the Plan Investors relating to confirmation. Prior to confirmation, a substantial number of parties-in-interest filed objections to the Debtors' plan of reorganization. In particular, certain lease rejection claimants filed objections on the grounds that their claims were entitled to additional recovery due to the fact that such claims were validly enforceable against multiple Debtor entities. In response to these objections, MBLY prepared a detailed de-consolidated analysis, which demonstrated that recoveries to objecting creditors were only marginally different from that of creditors with claims against a single Debtor. As a result of, among other things, MBLY's analysis, the Debtors were able to settle all of such objections by granting the objecting claimants the right to receive additional recovery under the plan of reorganization. In addition, MBLY prepared a share allocation analysis based on the amount of Class 5 Claims in order to clearly illustrate the settlement between the Class 4 and Class 5 claimants. As a result of MBLY's analysis and testimony, numerous objections to confirmation were resolved.

Total Hours – Fourth Interim Period: 1,353.00

Total Hours – Final Period: 7,884.20

VII. Officer and Director Matters

50. This category includes time spent by MBL Y in attending board meetings and advising the board and senior management with respect to certain issues. MBL Y met frequently with the board and senior management to review and analyze the Debtors' long-term business plan as well as the plan of reorganization. Specifically, MBL Y made several presentations to the board and senior management regarding, among other things, (i) the DIP Credit Facility, (ii) the 2002 operating budget, (iii) the Debtors' decision to enter into new licensing arrangements, (iv) the five-year business plan, (v) the store closing initiatives, (vi) the strategic direction of the Super K business, and (vii) the Exit Credit Facility. In addition, MBL Y assisted the board in identifying and evaluating possible restructuring alternatives and in developing and negotiating the plan of reorganization. Finally, MBL Y assisted the board and senior management in considering exit financing alternatives and identifying the optimal capital structure for the Debtors.

Total Hours – Fourth Interim Period: 90.60

Total Hours – Final Period: 337.90

VIII. Employee Severance and Retention

51. This category includes time spent by MBL Y in negotiating a severance and retention plan for key employees of the Debtors, which improved employee morale and reduced the level of employee turnover.

Total Hours – Fourth Interim Period: 0.00

Total Hours – Final Period: 9.00

IX. Financing

52. This category includes time spent by MBL Y in negotiating and structuring the terms of the DIP Credit Facility and ensuring that the DIP Credit Facility was adequate to fund the Debtors' operating needs during these Chapter 11 cases. This category also includes time spent by MBL Y in identifying and contacting alternative sources of debtor-in-possession financing and in reviewing financial projections prepared by the Debtors in connection with the DIP Credit Facility.

53. In addition, MBL Y advised the Debtors in amending the DIP Credit Facility. In connection with the foregoing, MBL Y assisted the Debtors in evaluating their future prospects and proposing revised covenant levels. MBL Y also assisted the Debtors in preparing for their meeting with the lenders under the DIP Credit Facility regarding the requested amendments.

54. This category also includes time spent by MBL Y in identifying and contacting potential lenders for the \$2.0 billion Exit Credit Facility as well as time spent negotiating and structuring the terms of the Exit Credit Facility. Under extremely tight time deadlines, MBL Y developed the fundamental structure of the Exit Credit Facility taking into account the needs and preferences of the Debtors and the Plan Investors and initiated discussions with seven potential lenders beginning in November 2002 using an information memorandum drafted by the Debtors and MBL Y. The lenders contacted were identified by MBL Y in consultation with the Debtors. By early December, the Debtors had received six proposals for the Exit Credit Facility. MBL Y evaluated each of the proposals and assisted the parties making such proposals in conducting their due diligence investigation of the business. MBL Y also worked with the Debtors to identify a subset of lenders to submit revised proposals, which were also reviewed by MBL Y.

55. MBL Y played a central role in conducting an “auction process” for the right to lead the Exit Credit Facility, playing each of the institutions against each other to achieve very favorable terms and conditions. Three financial institutions, led by General Electric Capital Corporation, were selected to underwrite the Exit Credit Facility. As a result of MBL Y’s involvement, the Debtors were successful in obtaining a commitment for \$2.0 billion in bank financing by January 13, 2003, on terms that were considerably more favorable than expected (indeed, many parties believed no financing would be available at all). In particular, the Exit Credit Facility had (i) no material “outs” requiring successful syndication as a condition to funding, (ii) minimal triggers that could result in the lenders increasing the interest rate or adversely affecting other important terms to Kmart and (iii) fewer reserves and higher advance rates versus the DIP Credit Facility. In addition, the Exit Credit Facility is secured by only inventory and pharmacy scripts whereas the DIP Credit Facility was secured by all the assets of Kmart.

56. This category also includes time spent by MBL Y in assisting the Debtors in obtaining a rating for the Exit Credit Facility, including preparing analyses and presentations and participating in meetings with Moody’s and Standard & Poor’s. MBL Y also spent time responding to due diligence requests from both ratings agencies. MBL Y’s efforts helped the Debtors obtain favorable ratings from both Moody’s and Standard & Poor’s, which served to further limit the amount of pricing flex allowed under the Exit Credit Facility commitment.

57. MBL Y was also actively involved in the syndication of the Exit Credit Facility, including drafting presentations, participating in meetings with potential participants in the Exit Credit Facility and responding to due diligence requests from potential lenders.

Total Hours – Fourth Interim Period: 847.30

Total Hours – Final Period: 1,550.60

X. Due Diligence

58. This category includes time spent by MBLY in becoming more familiar with the business of the Debtors through management meetings, document reviews and site visits. In addition, this category includes time spent by MBLY in developing a comprehensive understanding of the industry in which the Debtors compete and the Debtors' operations.

Total Hours – Fourth Interim Period: 0.00

Total Hours – Final Period: 435.30

XI. Expert Testimony

59. This category includes time spent by MBLY in providing litigation support and testimony in connection with, among other things, (i) the assumption of licensing agreements and other material contracts, (ii) the approval of the DIP Credit Facility, (iii) the liquidation of the auto service center business, and (iv) the termination of the Fleming supply agreement. This category also includes time spent by MBLY preparing for and participating in the Debtors confirmation hearing. MBLY appeared in virtually all Court hearings and provided live or proffered testimony on numerous occasions.

Total Hours – Fourth Interim Period: 441.60

Total Hours – Final Period: 487.50

Basis for Payment of Requested Fees

60. MBLY is entitled to receive the fees it has requested in accordance with the express terms of the Engagement Letter and the provisions of Section 328(a) of the Bankruptcy Code.

61. Section 330 of the Bankruptcy Code provides for the award of compensation to professionals. 11 U.S.C. § 330. Section 330, by its terms, is “subject to” the provisions of Section 328 of the Bankruptcy Code. *Id.* Section 328(a) permits a debtor, with the Court’s approval, to employ a professional person “on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis.” 11 U.S.C. § 328(a).

62. Section 328 represents a departure from the practice that prevailed prior to the enactment of the Bankruptcy Code in 1978. The purpose of Section 328 was to permit the pre-approval of compensation arrangements as a method of insuring that the most competent professionals would be available to provide services in bankruptcy cases. *See In re Westbrooks*, 202 B.R. 520, 521 (Bankr. N.D. Ala. 1996) (percentage fee arrangements “comport with the Bankruptcy Code’s goal of attracting highly qualified professionals to the bankruptcy forum”); *In re Olympia Holding Corp.*, 176 B.R. 962, 964 (Bankr. M.D. Fla. 1994). Once the terms of a professional’s retention have been approved under Section 328(a), the agreed-upon compensation cannot be altered unless the agreed terms “prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.” 11 U.S.C. § 328(a); *see also In re Reimers*, 972 F.2d 1127, 1128 (9th Cir. 1992) (compensation agreement approved under Section 328(a) must be enforced in the absence of unforeseeable circumstances, and is not subject to a “reasonableness” review under Section 330); *In the Matter of National Gypsum Company*, 123 F.3d 861 (5th Cir. 1997) (same); *In re Olympia Holding Corp.*, 176 B.R. at 964 (same). As the Court explained in *National Gypsum*:

If the most competent professionals are to be available for complicated capital restructuring and the development of successful corporate reorganization, they must know what they will receive for their expertise

and commitment. Courts must protect those agreements and expectations, once found to be acceptable.

123 F.3d at 863.

63. In this case, the Retention Order stated that, “[f]ees to be paid to [MBLY] pursuant to the terms of the Engagement Letter, as modified herein, are approved and shall be subject to the standard of review provided in Section 328(a) of the Bankruptcy Code and not subject to any other standard of review under Section 330 of the Bankruptcy Code.”

64. MBL Y respectfully submits that the services rendered during the Fourth Interim Period and the Final Period were necessary and substantially benefited the estate, and that the compensation requested in this Application is fully justified and reasonable. No unforeseeable developments have arisen during the pendency of these cases that would render the approval of MBL Y’s fees to have been “improvident.”

Basis for Payment of Requested Expense Reimbursements

65. As set forth above, by this Application MBL Y seeks reimbursement for the reasonable out-of-pocket expenses incurred by MBL Y and DrKW during the Fourth Interim Period in the aggregate amount \$260,913.17³ and final allowance of expense reimbursements incurred during the Final Period in the aggregate amount of \$763,970.16. Attached hereto as Exhibit D is a summary of reasonable out-of-pocket expenses incurred by MBL Y and DrKW during the Fourth Interim Period and the Final Period.

66. Exhibit D also contains a summary of MBL Y’s policies regarding reimbursement of expenses by its clients. In summary, out-of-pocket expenses incurred by MBL Y are charged to a client if the expenses are incurred for the client or are otherwise necessary in connection with

³ Pursuant to the Retention Order, DrKW’s expenses continue to be reimbursable in this case.

services rendered for such particular client. MBL Y does not allocate general overhead expenses into disbursements charged to clients in connection with Chapter 11 cases.

67. MBL Y respectfully submits that the expenses for which reimbursement is sought are not “continuous administrative or general costs or expenses incident to the operation of [the applicant] which cannot be attributed to a particular client or case,” and that such expenses are therefore properly reimbursable under Section 330(a)(1)(B). *See In re Wildman*, 72 B.R. 700, 731 (Bankr. N.D. Ill. 1987) (also noting that an expense that is “both necessary and attributable to a particular client *or* case is reimbursable”) (emphasis in original).

68. The amount of the fees and expenses sought in this Application and MBL Y’s billing processes are consistent with market practice both in and out of a bankruptcy context. MBL Y does not bill its clients based on the number of hours expended by its professionals. Accordingly, MBL Y has not established hourly rates for its professionals, and MBL Y professionals generally do not maintain detailed time records of the work performed for its clients. MBL Y has, however, maintained contemporaneous time records in the Debtors’ cases in accordance with the Court’s order approving MBL Y’s retention.

69. No agreement or understanding prohibited by Section 504 of the Bankruptcy Code exists between MBL Y and any other person for the sharing of compensation received or to be received for services rendered by MBL Y in or in connection with these Chapter 11 cases.

70. No agreement prohibited by 18 U.S.C. §155 has been made or will be made by MBL Y in connection with these Chapter 11 cases.

71. As set forth in greater detail above, MBL Y respectfully submits that it has satisfied the requirements of Sections 328(a) and 330 of the Bankruptcy Code as set forth in the Retention Order. The services for which it seeks compensation in this Application were necessary for, and

beneficial to, the Debtors. MBLY's request for compensation reflects an appropriate amount of time expended in performing such services commensurate with the complexity, importance and nature of the problems, issues, or tasks involved. Additionally, the compensation sought by MBLY is based on customary compensation charged by comparable experts both in and out of a bankruptcy context. For all the foregoing reasons, MBLY respectfully requests that the Court grant the relief requested in this Application.

Notice

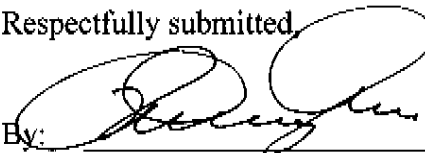
72. In accordance with the Fee Procedures Order, notice of this Application has been given to (i) the Debtors, Kmart Corporation, 3100 West Big Beaver Road, Troy, Michigan 48084-3163 (Attn: Harold W. Lueken, Senior Vice President and General Counsel); (ii) counsel for the Debtors, Skadden, Arps, Slate, Meagher & Flom (Illinois), 333 West Wacker Drive, Suite 2100, Chicago, Illinois 60606 (Attn: John Wm. Butler, Jr.); (iii) counsel to the administrative agents for the Debtors' post-petition lenders, Morgan, Lewis & Bockius, 101 Park Avenue, New York, New York 10178 (Attn: Robert H. Scheibe and Jay Teitelbaum) and Katten Muchin Zavis, 525 West Monroe Street, Suite 1600, Chicago, Illinois 60661 (Attn: Jeff Marwil and Brian Swett); (iv) lead counsel to the official unsecured creditors' committee, Otterbourg, Steindler, Houston & Rosen, 230 Park Avenue, New York, New York 10169 (Attn: Glenn Rice); (v) the designated chairperson of the unsecured creditors' committee, Euler ACI, 100 East Pratt Street, Baltimore, MD 21202-1008 (Attn: Gary H. Shapiro); (vi) local counsel to the official unsecured creditors' committee, Winston & Strawn, 35 West Wacker Drive, 40th Floor, Chicago, Illinois 60601 (Attn: Matt Botica); (vii) the designated chairperson of the finance committee, JP Morgan Chase, 380 Madison Avenue, 9th Floor, New York, New York 10017 (Attn: Agnes L. Levy); (viii) counsel to the official financial institutions' committee, Jones Day Reavis & Pogue, 901

Lakeside Avenue, Cleveland, Ohio 44114-1190 (Attn: Ray Schrock); (ix) counsel to the official committee of equity holders, Traub, Bonacquist & Fox LLP, 655 Third Avenue, 21st Floor, New York, New York 10017 (Attn: Paul Traub); and (x) Kathryn Gleason, The Office of the United States Trustee, Region 11, Northern District of Illinois, 227 West Monroe Street, Suite 3350, Chicago, Illinois 60606.

WHEREFORE, MBLY respectfully requests that the Court enter an order, substantially in the form attached hereto as Exhibit J: (i) granting allowance of compensation of \$10,879,637.10 for fees and \$260,913.17 for reimbursement of expenses in respect of services rendered by MBLY during the Fourth Interim Period; (ii) granting final allowance of compensation of \$13,354,637.10 for fees and \$763,970.16 for reimbursement of related expenses, for a total of \$14,118,607.26, in respect of services rendered by MBLY during the Final Period; (iii) authorizing and directing the Debtors to pay MBLY any and all allowed and unpaid fees and expenses accrued, in an amount equal to \$1,208,974.38, which represents \$1,267,963.24 in respect of fees previously withheld in accordance with the "holdback" provisions of the Fee Procedures Order minus the Expense Credit of \$58,988.86; and (iv) granting such other and further relief as the Court deems just and proper.

Dated: July 28, 2003

Respectfully submitted,

By: 

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