

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

EOD AUG 03 2003

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

NOTICE OF FILING

To: Attached Service List

PLEASE TAKE NOTICE that Otterbourg, Steindler, Houston & Rosen, P.C., lead co-counsel to the Official Committee of Unsecured Creditors, has today filed the attached **Application For Final Allowance of Compensation of Otterbourg, Steindler, Houston & Rosen, P.C., Counsel to the Official Committee of Unsecured Creditors** with the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division, 219 South Dearborn Street, Chicago, Illinois 60604, Courtroom 642.

FILED
UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF ILLINOIS

JUL 31 2003


KENNETH S. GARDNER, CLERK
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U.S. BANKRUPTCY COURT

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Dated: July 31, 2003
Chicago, Illinois

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COMMITTEE OF UNSECURED CREDITORS

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**APPLICATION FOR FINAL ALLOWANCE OF COMPENSATION OF
OTTERBOURG, STEINDLER, HOUSTON & ROSEN, P.C.,
COUNSEL TO THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS**

TO: THE HONORABLE SUSAN PIERSON SONDERBY
UNITED STATES BANKRUPTCY JUDGE:

Otterbourg, Steindler, Houston & Rosen, P.C. (the "Applicant"), counsel to the Official Committee of Unsecured Creditors (the "Committee") of Kmart Corporation ("Kmart") and certain of its domestic subsidiaries and affiliates (collectively, the "Debtors"), respectfully represents and alleges:

I. INTRODUCTION

1. Applicant, as lead co-counsel to the Committee, makes this Application for payment of professional fees for services rendered and expenses incurred in its representation of the Committee pursuant to Sections 330 and 331 of Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") and Federal Rule of Bankruptcy Procedure 2016(a).

2. Applicant submits this Final Application in connection with the successful prosecution of the largest retail chapter 11 case ever filed. At the time of the Debtors' bankruptcy filing, Kmart operated over 2,100 retail stores, employed approximately 240,525 people and had relationships with over 4,000 trade vendors. In the short span of fifteen (15) months, Applicant, on behalf of a huge portion of the stated \$4-5 billion of trade, service, and similar debt, provided critical legal and other leadership in steering this chapter 11 case towards a successful conclusion. Along the path of this unprecedented success, numerous issues and obstacles were overcome. This case also led to numerous landmark decisions, including, this Court's denial of the Debtors' request for permission to extend the period to assume or reject leases beyond confirmation of the Plan (defined, *infra*), the District Court's reversal of, among other things, the decision allowing the payment of certain pre-petition claims of "critical vendors", and this Court's decision defining the Debtors' obligations with respect to payment of percentage rent owed under numerous store leases.

3. Applicant seeks a final allowance of compensation in the amount of \$6,665,593.00 for professional services¹ and reimbursement of disbursements in the amount of \$297,586.12². These services were rendered and the disbursements were recorded from January 31, 2002 through and including May 6, 2003.

4. Pursuant to the Administrative Order Establishing Procedures for Interim Compensation and Reimbursement of Expenses of Professionals, entered on January 25, 2002

¹ Included in this amount are 16,120.8 hours of professional time and 1,995.6 hours of paraprofessional time. The blended hourly rate for professionals and paraprofessionals is approximately \$367.93.

² This amount includes \$1,000.90 which was inadvertently omitted from our monthly fee statements submitted during the Final Fee Period (defined, *infra*).

(the "Administrative Order"), the Debtors were authorized to pay certain professionals, including Applicant, 90% of fees and 100% of disbursements on a monthly basis. During the pendency of these cases, Applicant has sought \$6,665,593.00 for professional fees and \$297,586.12 for disbursements of which, as of the date of this Application, \$6,118,480.45 and \$300,609.46, respectively, has been paid pursuant to the Administrative Order, two Interim Fee Orders (defined, *infra*), and Section 10.2(b) of the Debtors' First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-In-Possession, dated February 25, 2003 (the "Plan")³. Applicant has not been paid \$547,112.55 for professional fees but has been overpaid \$3,023.34 for disbursements incurred (see paragraph 4(a) *infra* for application), leaving an aggregate balance of \$544,089.21. The final award of compensation and reimbursement of expenses consists of the following components:

- (a) The allowance of compensation for services rendered and disbursements incurred from January 1, 2003 through May 6, 2003 (the "Final Fee Period"), aggregating \$2,266,831.50 in fees and \$100,164.69 in disbursements, of which, including the Overpayment, \$2,043,801.00 and \$103,188.03 has been paid by the Debtors pursuant to the Administrative Order and in accordance with the Plan, leaving an aggregate balance of \$220,007.16 (\$223,030.50 in fees, less \$3,023.34 in overpaid disbursements).

³ As required by Section 10.2(b) of the Plan, prior to the Effective Date (defined, *infra*) of the Plan, Applicant provided an estimate to the Debtors of their fees and disbursements incurred from April 1, 2003 through the Effective Date, in the amount of \$690,000.00 and \$45,000.00, respectively. On the Effective Date, the Debtors paid to Applicant the amount of \$666,000 (90% of estimated fees and 100% of estimated expenses). Applicant's actual fees and disbursements for such period were \$617,347.35 and \$40,975.76, respectively, resulting in an overpayment of \$7,676.89 (the "Overpayment"). The application of the Overpayment is addressed *infra*.

(b) The final fee request includes allowance of the prior interim awards of compensation and reimbursement of expenses for the first, second and third interim periods⁴, aggregating \$4,398,761.50 in professional fees and \$197,421.43 in disbursements, of which \$4,074,679.45 in fees and \$197,421.43 in disbursements has been paid by the Debtors pursuant to orders entered by this Court on September 19, 2002 and December 31, 2002⁵ (the "Interim Fee Orders"), and the Administrative Order, leaving a balance on the prior interims of \$324,082.05 in fees.

5. The filing of this Application was preceded by the filing of applications for the First, Second, and Third Interim Periods, which are on file with the Clerk of the Court. The applications for the First and Second Interim Periods have been previously reviewed and approved by this Court. As of the date of this Application, a hearing on the application for Third Interim Period has not yet been scheduled. Annexed hereto as Exhibit "A" is a schedule which reflects the amount of interim fees and disbursements sought by Applicant and the corresponding awards granted by this Court.

⁴ Fees and disbursements of \$1,155,030.00 and \$44,830.00, respectively, were incurred during January 31, 2002 through April 30, 2002 (the "First Interim Period"); fees and disbursements of \$1,503,144.00 and \$82,272.38, respectively, were incurred during May 1, 2002 through August 31, 2002 (the "Second Interim Period"); and fees and disbursements of \$1,740,587.50 and \$70,319.05, respectively, were incurred during September 1, 2002 through December 31, 2002 (the "Third Interim Period").

⁵ Pursuant to the December 5, 2002 Order, the 10% holdback for the Second Interim Period has not been paid.

6. In consultation with the United States Trustee's Office and the Debtors, the Debtors, the Committee, the Official Financial Institutions' Committee (the "Finance Committee") and the Office of the United States Trustee (the "U.S. Trustee") agreed to form a Joint Fee Review Committee (the "JFRC") comprised of a member of the Committee, a member of the Finance Committee, a member of the Committee of Equity Security Holders (the "Equity Committee" and together with the Committee and Finance Committee, the "Committees"), three (3) representatives of the Debtors, and a representative of the U.S. Trustee⁶. The JFRC reviewed the interim fee applications filed in the cases in an attempt to address any issues relating to fees in advance of the objection deadlines and filed reports with the Court regarding the fee applications. To further one of the goals of the JFRC (e.g. to avoid unnecessary expenses), the JFRC agreed that interim fee applications were to be filed in an abbreviated format. Applicant has filed this Application consistent with the agreed upon abbreviated format.

II. BACKGROUND

7. On January 22, 2002 (the "Petition Date"), Kmart and thirty-seven (37) of its affiliates filed voluntary petitions in this Court for reorganization relief under Chapter 11 of the Bankruptcy Code. The Court, on the Petition Date, entered an order directing the joint administration of these cases. During the pendency of the cases, Kmart and its affiliates continued to operate their businesses and were in possession of their properties as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code. No trustee or examiner was appointed in these cases.

⁶ After the approval of the Debtors' Plan, the JFRC was reconstituted to remove the Equity Committee representative and reduce the number of the Debtors' representatives to two.

8. As of the Petition Date, the Debtors represented that they were the nation's second largest discount retailer and the third largest general merchandise retailer with more than 2,100 stores in all 50 United States, Puerto Rico, the U.S. Virgin Islands and Guam. Kmart reported that it was (and still is) considered one of the top employers in the United States with approximately \$5.2 billion in annual payroll and benefits and had approximately 240,525 associates worldwide. In addition, Kmart reported relationships with more than 4,000 vendors worldwide and was (and still is) one of the country's largest purchasers of products. According to the Debtors' filed 10-K, for the year ending January 30, 2002, Kmart had sales of approximately \$36.1 billion and approximately \$14.2 billion of assets and \$10.8 billion of liabilities. The Debtors' bankruptcy filing was the largest reported "retail" bankruptcy filing in the history of the United States.

9. The Committee was formed by the U.S. Trustee on January 31, 2002. The thirteen (13) member Committee included representatives of a broad spectrum of the Debtors' unsecured creditors, including (i) vendors of hard goods, video and electronics, and food; (ii) a landlord; (iii) a factor of accounts receivable; (iv) an insurer of accounts receivable; and (v) a governmental regulatory agency. On or about October 4, 2002, Newell Rubbermaid resigned from the Committee. As a result, on October 9, 2002, the U.S. Trustee appointed The Gillette Company as a member of the Committee, replacing Newell Rubbermaid. The Committee acted as a fiduciary for holders of unsecured debt believed to be in excess of \$4 billion.

10. Pursuant to an Order entered on March 6, 2002, the Court approved the employment of Applicant as lead co-counsel to the Committee effective as of January 31, 2002.

11. On January 31, 2002, the U.S. Trustee also formed the Finance Committee which consisted of seven (7) financial institutions holding unsecured debt under various pre-

petition financing facilities. The Finance Committee designation was subsequently amended on several occasions to reflect resignations and new appointments. As of the Effective Date of the Debtors' Plan, there were five (5) members of the Finance Committee.

12. In addition to the formation of the Committee and the Finance Committee, on June 17, 2002, the U.S. Trustee appointed the Equity Committee which consisted of seven (7) members. As of the Effective Date, there were six (6) members of the Equity Committee.

13. When these cases were filed on January 22, 2002, the challenges facing Kmart and its creditors were extensive. These cases presented the Debtors, the Committees, other creditors, and the Court with a host of complicated legal and factual issues that were novel, and which required a concerted effort on the part of both the Debtors and the Committees to effectively and promptly achieve the goal of a consensual reorganization that would be in the best interests of the Debtors and their creditors.

14. Applicant drew upon the specialized expertise of the attorneys in its insolvency, litigation, finance and corporate restructuring departments in order to address the sophisticated and complex areas of law presented by these cases. Applicant was required to devote substantial time and energy to the cases. Every effort was made, however, to minimize the time expended, consistent with Applicant's responsibilities. Applicant achieved these results without unnecessary duplication and cooperated with the Debtors' professionals, the Financial Committee, the Equity Committee and the Committee's other professionals to allocate tasks which arose in these cases.

15. Applicant, as lead co-counsel to the Committee, played a pivotal role throughout the reorganization process in order to protect the rights of and to maximize the recovery for unsecured creditors. Applicant worked closely with the Committee's financial

advisors, KPMG, LLP ("KPMG"), as well as the Debtors, the Debtors' professionals, the Finance Committee, and the Equity Committee, and others, in order to further the Debtors' rehabilitative goal of confirming a consensual plan as promptly as possible.

16. As discussed in detail below, Applicant successfully utilized its skills in the bankruptcy process, to coordinate with the Debtors' counsel and numerous other interested parties to confirm, in only fifteen (15) months, a consensual plan which provides for a meaningful recovery for unsecured creditors. The Plan provides for holders of general unsecured claims against the Debtors to share in a pool of approximately 32 million shares, or 37%, of the common stock of the reorganized Debtors. Holders of the Debtors' pre-petition bonds shared in 29% of the equity of the reorganized Debtors and ESL Investments ("ESL") and Third Avenue Trust ("Third Avenue"), the Plan investors, received the remaining 34% of the equity. Under the Plan, a trust was created to pursue the Debtors' claims against, among others, former officers and directors of the Debtors for certain acts and omissions some of which clearly seems to have contributed to the need for the bankruptcy filing. Holders of general unsecured claims, the bondholders and holders of the Debtors' pre-petition trust preferred securities, among others, will share in any recoveries on a pro rata basis. On April 23, 2003, this Court confirmed the Plan with the overwhelming support of the creditors of the Debtors' estates. The Plan became effective on May 6, 2003 (the "Effective Date"). The shares of Kmart which were valued in the Plan and related Disclosure Statement at approximately \$13 per share have consistently been trading above \$20 per share for several weeks peaking at \$26.99 per share, and were trading at \$22.85 on the close of business on July 28, 2003.

III. PROFESSIONAL SERVICES RENDERED

A. FINAL FEE PERIOD

17. During the Final Fee Period, the services performed by Applicant were extensive and of great benefit to the unsecured creditors and the Debtors. As a result of Applicant's guidance, the Committee was able to promptly address the myriad of complex issues arising in these "super-mega" Chapter 11 cases in order to give the Debtors the opportunity to reorganize their business in a manner that preserved and maximized value for the Debtors and their creditors. Applicant worked closely with the Debtors to resolve issues on a consensual basis, when possible, without miring the cases in unnecessary and costly litigation which would have diverted the Debtors' efforts from the operation and reorganization of their businesses. The services performed by Applicant included, among others, the following:

- a. extensive review, analysis and negotiation with the Debtors, the Debtors' professionals, the Plan Subcommittee (defined, *infra*) and other parties-in-interest regarding the formulation and filing of the Plan and the disclosure statement (the "Disclosure Statement"), and modifications thereto, which enabled the Debtors to confirm their consensual Plan and effectuate a remarkably rapid emergence from bankruptcy;
- b. substantive analysis and discussions with the Debtors, the Debtors' counsel and the Committees regarding the various investigations of the Debtors, including investigations by the SEC, the Debtors and the U.S. Attorney's Office relating to, among other things, allegations of wrongdoing raised in anonymous letters and the transfer of claims arising out of these investigations to a trust for the benefit of creditors under the Plan;

c. extensive review, analysis and negotiation with the Debtors, the Debtors' professionals, and other parties-in-interest regarding the creation of a trade vendors' lien program to assist the Debtors in securing favorable trade terms from vendors post-emergence;

d. review and analysis with respect to the Debtors' real estate, including the Debtors' plan to close unprofitable stores, the Debtors' rejection or assumption and assignment of certain leases and their request for extensions of time to assume or reject leases, in order to realize the value of the leases for the estate; as well as participation in the disposal of three hundred and seventeen (317) stores the Debtors determined to close; and

e. communications with the members of the Committee, their representatives and counsel, the Committee's Co-Chairpersons, and the financial advisors on issues relating to these cases and preparation for and attendance at numerous meetings and conference calls of the Committee.

18. In order to assist the Court, the Debtors, the U.S. Trustee and other parties-in-interest in evaluating this Application, a summary sheet of the attorneys and paraprofessionals working on the cases and their corresponding initials, billing rates and the number of hours incurred by each in the Final Fee Period is annexed hereto as Exhibit "B." Annexed hereto as Exhibit "C" is a summary sheet that identifies the services performed by Applicant's professionals and paraprofessionals during the Final Fee Period categorized into "project codes" that group time entries by subject area, together with Applicant's computerized time records, also grouped by project code. In addition, annexed hereto as Exhibit "D" is a summary sheet providing a list of each attorney and paraprofessional that billed to a specific project code during the Final Fee Period, along with the total amount of hours and fees incurred under that project code by that attorney or paraprofessional. Under certain circumstances, more than one attorney

attended the same hearing or conference or worked on the same matter. Given the size of these cases and complexity of the issues involved, this coordination of effort was necessary. Applicant was also careful to avoid multiple billing for intra-office conferences. In addition, the many responsibilities were delegated among the various professionals working on these cases and Applicant made every effort to limit the participation of multiple attorneys to avoid duplication of activities performed.

19. A computerized printout of Applicant's disbursements necessarily incurred in the performance of Applicant's duties as counsel to the Committee during the Final Fee Period is annexed hereto as Exhibit "E."

20. Additionally, pursuant to the Protocol set forth by the JFRC, each professional submitted proposed budgets covering the fees incurred during the Fourth Interim Period. Attached to the Application as Exhibit "F" is an analysis of Applicant's budgeted fees compared to the actual fees incurred during the Fourth Interim Period. During the Fourth Interim Period, Applicant's actual fees were slightly above the proposed budget (0.8%).

21. Set forth below, is a recitation of certain of the professional services rendered by Applicant in the Final Fee Period. As the Court is familiar with the issues that have arisen in these cases, the following presentation is not intended to be a complete statement of all professional services rendered, but serves only to list certain of the services of major importance, grouped by project code, rendered by Applicant during the Final Fee Period.

a. Plan of Reorganization (\$804,765.50) / Disclosure Statement (\$117,477.50)

Plan Negotiation

22. In November 2002, the Debtors, the Committees and other parties-in-interest intensified discussions regarding the framework for a plan of reorganization. ESL, which had acquired a large portion of the pre-petition bank debt and also held significant amounts of bond and general unsecured debt, expressed an interest in acting as a sponsor for a plan that would result in an expedited exit from bankruptcy.

23. Applicant, at the request of the Committee, researched numerous issues that would be relevant to the formulation of a plan. Among these issues were the formation of, and the transfer of assets to, various subsidiary corporations in the years leading up to the Petition Date and the guarantees granted by such subsidiaries to the Debtors' pre-petition lenders (the "Pre-Petition Lenders") pursuant to a pre-petition credit facility. This research enabled Applicant to better understand the rights and positions of the differing constituents, and to establish an equitable framework for the distribution of the Debtors' assets.

24. The first draft of a term sheet for a plan of reorganization (the "Plan Term Sheet") was circulated in late November. By the time the Final Fee Period began a second draft had been circulated, and the Committee had engaged in extensive discussions with respect to, among other things, (a) whether it was appropriate for the Debtors to emerge from bankruptcy on the expedited timeline that had been proposed and (b) the terms upon which the Committee would support a plan. The Committee also formed a plan of reorganization subcommittee to lead the negotiations on behalf of the Committee (the "Plan Subcommittee").

25. On January 3, 2003, Debtors' counsel circulated the third draft of the Plan Term Sheet, which incorporated many of the changes requested by Applicant. Applicant reviewed and analyzed this version of the Plan Term Sheet and reported to the Committee. With the knowledge that unsecured trade creditors and landlords (the group that made up the largest portion of the Committee's constituency) would receive the bulk of their distribution in shares in the reorganized Debtors, the Committee sought certain concessions from the Debtors and other interested parties that the Committee believed would maximize the amount and the value of those shares. Among the items the Committee considered extremely significant were the creation of a meaningful, enforceable trade vendors' lien program (the "Vendor Lien Program") and the timely reconciliation of trade claims. The Committee believed that these items would enhance the ability of the Debtors to garner support from the vendors post-emergence, which is critical to the Debtors' success as a reorganized company.

26. The Committee, aware that a retail chain cannot survive with empty shelves and without the merchandise that consumers expect to find at its stores, believed that these concessions would do a great deal to ensure that the reorganized Debtors would have the strongest possible relationship with their vendors. The Vendor Lien Program would give vendors an incentive to continue to provide trade credit going forward. The timely reconciliation of claims would prevent vendors from having to wait extended periods to receive their distributions on account of pre-petition claims while continuing to ship to the Debtors post-bankruptcy.

27. This version of the Plan Term Sheet was still unacceptable to the Committee for numerous reasons. Accordingly, Applicant provided extensive written and verbal comments to the Debtors regarding the Committee's proposed changes to the Plan Term Sheet.

28. During the ensuing weeks, numerous additional drafts of the Plan Term Sheet were circulated, and Applicant continued to analyze them for the Committee, solicit the Committee's views and provide comments to counsel for the Debtors' and ESL. In addition to the various drafts of the Plan Term Sheet circulated by the Debtors, Applicant also reviewed the changes proposed to the Plan Term Sheet by other parties-in-interest, including ESL, the Finance Committee, the Pre-Petition Lenders, the Equity Committee and the indenture trustee for the Debtors' pre-petition bonds.

29. During the second week of January, the Debtors also circulated a preliminary draft of a term sheet describing the Vendor Lien Program (the "Vendor Lien Term Sheet"). Applicant reviewed and analyzed the Vendor Lien Term Sheet and reported to the Committee. Applicant and the Committee decided that the Vendor Lien described in the initial draft needed substantial revisions.

30. Applicant, on behalf of the Committee, negotiated with the Debtors and ESL with respect to the Vendor Lien Program during the remainder of the Final Fee Period. Numerous drafts of the Vendor Lien Term Sheet were circulated by the Debtors, each of which Applicant reviewed, analyzed and revised to reflect the Committee's demands. Ultimately, a final Vendor Lien Term Sheet was agreed to by the Debtors and the Committee. As a result of Applicant's efforts, the Vendor Lien Program was substantially improved in numerous areas, including, among other things, (i) the inclusion of subordination rights for participants in the Vendor Lien Program in the event of the future disposition of the Debtors' leases, (ii) the reorganized Debtors' ability to dispose of Collateral was significantly limited, (iii) the requirements for becoming a "Qualified Vendor" and thus to receive the benefits of the Vendor Lien Program were reduced and clarified and (iv) the benefits of the Vendor Lien Program were

significantly enhanced. These revisions significantly improved the program from that which was initially proposed and will help to boost trade support for the reorganized Debtors.

Investment Agreement

31. On January 8, 2003, the Debtors' counsel circulated for review a draft of the Investment Agreement (the "Investment Agreement") to be entered into between the Debtors, on the one hand, and ESL and Third Avenue Trust (together, the "Plan Investors"), on the other hand. Applicant reviewed the Investment Agreement and reported to the Committee. The Committee was particularly concerned with the provisions in the Investment Agreement prohibiting ESL from disposing of its shares before trade claims were resolved. In light of the control that ESL was expected to exert over the Company and the importance of a timely and effective reconciliation of unsecured claims, the Committee believed that it was essential that ESL be given incentive to commit sufficient resources to the claims reconciliation process.

32. As a result of the Committee's demands, the final Investment Agreement barred ESL from transferring greater than 20% of the shares it received pursuant to the Plan prior to the earlier of one year following the Effective Date of the Plan or the date upon which all unsecured claims of trade vendors are resolved.

33. Applicant also reviewed the Investment Agreement to determine whether the fees to be paid by the Debtors were appropriate. The Committee decided not to object to the fees in light of the substantial investment being made by the Plan Investors, as well as the other concessions that were made.

34. On January 22, 2003, following extensive negotiation of the Plan Term Sheet, the Debtors circulated a draft of the Plan and Disclosure Statement. Applicant conducted a thorough review of the documents to ensure that they complied with the provisions of the Plan

Term Sheet and continued to negotiate those points that had not been resolved. Applicant provided these documents, as well as a summary, to the Committee and communicated extensively with the Plan Subcommittee. Following a comprehensive review and discussions with the Plan Subcommittee, Applicant provided extensive comments to the Debtors' counsel with respect to both the Plan and the Disclosure Statement.

35. Although numerous issues remained open, on January 24, 2003, the Debtors, in order to remain on track for an expedited exit from bankruptcy, filed the Plan and Disclosure Statement with the Court. Applicant prepared for the Committee a comparison of the most important provisions of the Plan against the Plan Term Sheets. The Committee requested that Applicant continue to work with the Debtors, the Committee and other interested parties to improve the treatment of unsecured creditors under the Plan. Those negotiations led to the subsequent filing of the First Amended Plan and Disclosure Statement on February 25, 2003, which contained significantly more, but not all, of the concessions and provisions that the Committee considered essential to its support for the Plan.

36. One of the areas that was considered most important by the Committee was the transfer to a trust (the "Kmart Creditor Trust") of the Debtors' interests in claims arising out of the investigations conducted during these cases (the "Trust Claims"). In order to ensure that the Trust Claims were properly transferred and that no Trust Claims were waived as a result of the Plan, Applicant worked closely with counsel for the Finance Committee and the Debtors' counsel to include the requisite language in the Plan and Disclosure Statement.

37. Another important provision of the Plan involved the Debtors' efforts to extend their right to assume or reject leases after the confirmation of the Plan. Applicant's

efforts in connection with this issue are described *infra*, in the Section entitled "Lease and Real Estate Analysis Related Work."

38. During the entire Plan process, discussions among Applicant and the Debtors' counsel, counsel for ESL and the bondholders were almost constant. In addition to the extensive written comments provided by Applicant and countless telephone conversations, in-person meetings with the Debtors' counsel and/or counsel for ESL were held on January 26, January 27, January 29, February 5, February 11, February 13, February 25, March 19, April 13, and April 14.

39. The Committee, after considering the totality of the Plan and the benefits achieved via the global economic settlement amongst the Pre-Petition Lenders, bonds and general unsecured creditors, determined that the Plan was in the best interests of unsecured creditors. The Committee, therefore, supported the Plan and instructed Applicant to draft a letter (the "Committee Support Letter") in support of the Plan that would be included in the solicitation materials to be sent to creditors along with the Plan and Disclosure Statement. Applicant drafted the Committee Support Letter, which explained the salient provisions of the Plan, advised creditors to review the Plan for themselves, and stated the Committee's support for the Plan. In addition to the Committee Support Letter, Applicant also responded to countless telephonic inquiries from unsecured creditors requesting further information and clarification of the Plan. Applicant assisted these creditors by explaining the Plan and informed them of the Committee's support for the Plan and the reasoning therefore. Ultimately, the vast majority of creditors in the classes represented by the Committee voted to accept the Plan.

Confirmation Hearing

40. Prior to the hearing to confirm the Plan (the "Confirmation Hearing"), which began on April 14, 2003, approximately 175 objections to confirmation of the Plan (the "Plan Objections") were filed. Applicant reviewed each of the Plan Objections to determine whether legal arguments existed that could prevent confirmation of the Plan and conferred with the Debtors' counsel on their response to the objections, as well as providing research and legal theories in response to certain objections.

41. The Committee determined that one Plan Objection necessitated the filing of a written response by Applicant. Appaloosa Management, L.P. ("Appaloosa") objected to the Plan on the grounds that it unfairly discriminated against unsecured creditors (the "Appaloosa Objection"). Among the potential witnesses listed by Appaloosa was Glenn B. Rice, a member of Applicant, and one of the primary counsels for the Committee. Applicant, at the request of and on behalf of the Committee, prepared and filed a motion seeking a protective order (the "Motion for Protective Order") preventing Appaloosa from calling Mr. Rice as a witness. The Committee disputed that there was justification for calling Mr. Rice as a witness because (a) Mr. Rice was intensely involved in negotiating on behalf of the Committee throughout the confirmation process and the Committee believed it would have been unfair and unnecessary to require Mr. Rice to testify, (b) most of Mr. Rice's relevant knowledge was arguably subject to the restrictions of Federal Rule of Evidence 408, and (c) any testimony that was not otherwise precluded or unnecessary was available from other sources. The Motion for Protective Order was ultimately withdrawn when Appaloosa agreed not to call Mr. Rice as a witness. Pursuant to negotiations that took place during the Confirmation Hearing, the Appaloosa Objection was settled and withdrawn.

42. Capital Factors also filed an objection to the Plan and an emergency motion to postpone the Confirmation Hearing on the grounds that the District Court's then recent decision with respect to the Critical Vendor Order (defined, *infra*) required a change in the Plan and resolicitation of creditor votes on the Plan. Applicant was involved in the negotiations between the Debtors, ESL and Capital Factors to resolve these disputes. The parties reached a settlement, and the Committee concluded to support the resolution in order to allow the Confirmation Hearing to continue and the Debtors to emerge from bankruptcy.

43. In addition to the Plan Objections, Applicant also reviewed and provided extensive comments to the Debtors' counsel with respect to the proposed form of confirmation order (the "Confirmation Order"). Many of Applicant's comments concerned the provisions of the Confirmation Order that related to the transfer of Trust Claims to the Kmart Creditor Trust and the prosecution of the Trust Claims by the Kmart Creditor Trust. Ultimately, many of the suggested changes were included and the Committee concluded that the Confirmation Order was acceptable.

44. Applicant prepared for and attended the Confirmation Hearing, which was conducted over four days spanning two weeks. During the conduct of the hearing, extensive negotiations continued with respect to numerous outstanding objections. Applicant, together with the Debtors, the Debtors' counsel, and counsel for ESL and the Finance Committee reached resolutions of most objections with representatives for the objecting parties without requiring a court hearing. After overruling the remaining objections, on April 22, 2003 the Court entered the Confirmation Order and approved the Plan.

Kmart Creditor Trust

45. As described above, the Plan provided for the creation of the Kmart Creditor Trust to oversee the prosecution of the Trust Claims. Applicant actively negotiated the sections of the Plan relating to the creation and the powers of the Kmart Creditor Trust.

46. In addition to Applicant's involvement in the drafting of the Plan's provisions with respect to the Kmart Creditor Trust, Applicant drafted the Kmart Creditor Trust Agreement that, together with the Plan, governs (a) the conduct of the Kmart Creditor Trust and (b) the relationship between the reorganized Debtors and the Kmart Creditor Trust. To facilitate the orderly conduct of the affairs of the Kmart Creditor Trust, Applicant also drafted Bylaws for the Kmart Creditor Trust Advisory Board (the "TAB").

47. The Committee, pursuant to the Plan, was authorized to appoint three of the four members of the TAB, which would oversee the Kmart Creditor Trust and would be responsible for making decisions to be carried out by the trustee (the "Creditor Trustee"). The Plan also authorized the Committee, subject to this Court's approval, to appoint the Trustee. Applicant solicited interest from the members of the Committee to participate as members of the TAB. Three Committee members, Euler American Credit Indemnity, Pepsico and American Greetings Service Corp., were chosen by the Committee to serve on the TAB. Members of the Committee were also invited to recommend individuals to serve as the Creditor Trustee. Various recommendations were made, and the prospective members of the TAB conducted interviews of candidates with the assistance of Applicant. Following this process, at the recommendation of the prospective TAB members, the Committee selected Douglas J. Smith ("Smith"), of Huron Consulting Group, LLC, to serve as Creditor Trustee. Applicant, on behalf of the Committee, prepared and filed (a) notices designating the three members of the TAB and the Creditor Trustee

and (b) an affidavit of disinterestedness on behalf of Smith. Applicant also drafted Bylaws for the Kmart Creditor Trust Board

Collateral Trust

48. One of the Plan's most significant provisions was the creation of the Vendor Lien Program to encourage vendors to provide trade credit to the reorganized Debtors. Applicant, together with the Committee, took an active role in ensuring that the Vendor Lien Program would provide the greatest benefit to Vendors in order to increase the Debtors' liquidity following the bankruptcy.

49. Applicant drafted an agreement between the Collateral Trust and the Debtors (the "Collateral Trust Agreement") and By-laws for the Collateral Trust Board (the "Collateral Trust Board"). In addition, Applicant reviewed, revised and advised the Collateral Trust Board with respect to (a) an Intercreditor Agreement with General Electric Capital Corporation ("GECC"), the agent for the Debtors' exit financing facility and (b) the mortgages granted by the Debtors with respect to their owned real estate.

50. Pursuant to the Plan, a trust (the "Collateral Trust") was established to enforce the rights of participants in the Vendor Lien Program. The Committee was authorized to appoint the three members of the Collateral Trust Board and the trustee (the "Collateral Trustee") of the Collateral Trust. The same members of the Committee that were chosen as members of the TAB also volunteered to serve on the Collateral Trust Board. The Committee chose Mr. William Kaye to serve as the Collateral Trustee. Applicant, on behalf of the Committee, prepared and filed notices designating (a) the three members of the Collateral Trust Board and (b) the Collateral Trustee.

51. The Plan also provided for the formation of a Post-Effective Date Committee to, among other things, oversee the claims reconciliation process. Pursuant to the Plan, the Committee selected three of the four members of the Post-Effective Date Committee and filed notices of their designation. Applicant also drafted By-laws for the Post-Effective Date Committee.

b. Debtor-In-Possession Financing (\$10,676.50)

52. In anticipation of their exit from bankruptcy, the Debtors entered into negotiations with GECC and various other financial institutions to arrange for an exit financing credit facility. Negotiations were conducted during the entire Final Fee Period resulting in a \$2 billion asset-backed revolving credit facility (the "Exit Facility") that the Debtors believed would provide them with the flexibility needed to manage their businesses going forward.

53. Applicant monitored the negotiations and reported to the Committee regarding the Exit Facility. Applicant also reviewed the documents related to the Exit Facility to ensure, among other things, (a) that the fees to be paid to GECC were not excessive and (b) that it was consistent with the terms of the Vendor Lien Program.

c. Avoidance Power Work and Other Litigation (\$22,127.00)

Preference Actions

54. During the Final Fee Period, Applicant participated in multiple discussions with the Debtors in order to determine the potential value of pursuing preference actions in the cases. Applicant also reviewed and analyzed the Debtors' preference analysis. Moreover, Applicant analyzed the potential harm that pursuing such actions could have on the Debtors' vendor relationships, and its resulting effect on the estates.

Fleming

55. As of the Petition Date, pursuant to an agreement between Fleming Companies, Inc. ("Fleming") and the Debtors dated February 2, 2001 (the "Supply Agreement"), Fleming supplied to the Debtors substantially all food, consumables and core pantry products sold in Kmart stores. At the beginning of the year, for a variety of reasons, the Debtors determined that the continuation of their relationship with Fleming was no longer in the best interest of the estates and sought to immediately terminate the Supply Agreement. On Sunday, February 2, 2003, the Debtors filed a motion seeking authorization to reject the Supply Agreement (the "Termination Motion"), and a motion seeking an emergency hearing on the Termination Motion. The Court granted the Debtors' request for an emergency hearing and approved the termination of the agreement in an *ex parte* hearing held on Monday, February 3, 2003 (the "Termination Order"). During the weekend of February 2nd and 3rd, prior to filing the Termination Motion, Debtors' counsel notified Applicant of the Debtors' plan to file the Termination Motion and request an emergency *ex parte* hearing. Over the course of the weekend, late into the evening on the Sunday prior to the hearing, Applicant participated in several calls with Debtors' counsel to discuss the Debtors' strategy and necessity for filing the Termination Motion. This enabled Applicant to prepare for and participate, on behalf of the Committee, via teleconference, in the February 3rd hearing.

d. Claims Objection Work / Claims Administration (\$86,599.50)

Fleming

56. At the outset of the cases, in accordance with the Order Authorizing Payment of Pre-Petition Claims of Certain Critical Trade Vendors, dated January 25, 2003 (the "Critical Vendor Order"), and pursuant to a critical vendor agreement entered into between

Fleming and the Debtors, Fleming received payment from the Debtors of approximately \$76 million on account of its pre-petition claim. Additionally, Fleming reserved its right to assert a pre-petition claim for any remaining pre-petition balance, subject to the objection of the Debtors.

57. Pursuant to the Termination Order, Fleming had a March 5, 2003 deadline to file any claim arising under the Supply Agreement. Accordingly, Fleming filed a timely proof of claim asserting damages arising under the rejection of the Supply Agreement in the amount of approximately \$1.47 billion (the "Rejection Claim"), for among other things, certain minimum contract purchase requirements, procurement synergies, and the cost of goods savings, to which the Debtors filed an objection. Additionally, Fleming filed (i) an amended proof of claim in the amount of approximately \$27.0 million for outstanding pre-petition amounts (the "Pre-Petition Claim"), of which approximately \$2.6 million purportedly arose pursuant to the Perishable Agricultural Commodities Act ("PACA"); and (ii) an application for allowance and payment of its administrative expense claim in the amount of approximately \$30.3 million (the "Administrative Claim"). The Debtors, believing that Fleming waived its right to assert a PACA claim when it received payment pursuant to the Critical Vendor Order, filed a motion seeking a determination of Fleming's PACA claim. In light of the sheer magnitude of Flemings' claims, Applicant spent a considerable amount of time reviewing and analyzing, among other relevant documents, the Supply Agreement, the Rejection Claim, the Pre-Petition Claim, the Administrative Claim, and the related motions and responses, in order to assess the extent and validity of Fleming's various claims and to determine the impact of those claims upon the distribution to unsecured creditors.

58. The Debtors and Fleming entered into negotiations which resulted in a settlement (the "Fleming Settlement") among the parties resolving all disputes regarding the

Supply Agreement. Under the terms of the Fleming Settlement, the (a) Administrative Claim was reduced from \$30.5 million to \$15.0 million; and (b) the Rejection Claim in the amount of \$1.47 billion and the Pre-Petition Claim in the amount of \$27.0 million were collectively allowed in the amount of \$385 million (the "Allowed Pre-Petition Claim"). Additionally, the Debtors disclosed to the Court that ESL agreed to purchase Fleming's Allowed Pre-Petition Claim, for an undisclosed amount.

59. In light of the importance of the Fleming Settlement to the Debtors' reorganization, Applicant, after discussions with the Debtors' counsel, prepared the Statement of the Official Committee of Unsecured Creditors in Support of the Debtors' Motion for an Order Approving the Debtors' Settlement with Fleming Companies, Inc. and (ii) Approving Shortened Notice Procedures in Connection Therewith, which was filed with the United States District Court for the Northern District of Illinois. The Court authorized the settlement on March 25, 2003.

Claims Reconciliation

60. Prior to the January Omnibus Hearing, the Debtors filed a Motion for Order Authorizing Debtors (A) to Compromise or Settle and Allow Certain Pre-Petition Claims Without Further Court Approval and (B) to Establish Alternative Dispute Resolution Procedures for Disputed Claims, pursuant to which the Debtors sought authority to resolve pre-petition claims without court order. In light of the potential impact that the settlements could have on the distribution to unsecured creditors, Applicant engaged in extensive discussions with the Debtors' counsel and counsel to the Finance Committee regarding the parameters under which the Debtors could settle disputes. As a result, the aggregate amount of claims that could be resolved without approval was substantially reduced, and the amount of claims for which the Debtors would have

to provide notice of settlements to the Committees was increased to allow the Committees to be more involved in the claims reconciliation process.

Omnibus Claims Objections

61. Over 58,000 proofs of claims have been filed in the cases. During the Final Fee Period, the Debtors filed four omnibus objections to claims, pursuant to which they objected to thousands of proofs of claim filed in the cases on various grounds, including, among others, (a) claims are duplicate of other filed claims; (b) claims have been superceded by amended claims; (c) incorrectly asserting claims against multiple Debtors; (d) failing to indicate which Debtor the claim was to be asserted against; (e) redundant lease rejection claims; and (f) overstated lease rejection damages claims. As the claims reconciliations process and outcome will determine the ultimate distribution to creditors, Applicant reviewed, summarized and advised the Committee with respect to the Debtors' claims objections and the responses filed by claimants.

Critical Vendor Order

62. Pursuant to the Critical Vendor Order, the Debtors paid in excess of \$260 million towards pre-petition claims. Capital Factors filed an appeal of the Critical Vendor Order to the District Court for the Northern District of Illinois. Approximately one week before the scheduled date of the Confirmation Hearing, the District Court entered an order reversing the Critical Vendor Order, along with three other orders permitting payment of certain pre-petition claims. Applicant reviewed the decision and reported its analysis to the Committee. As a result of the District Court's decision, the Debtors, in consultation with Applicant and the Committee, amended the Plan to remove the waiver of avoidance actions with respect to post-petition transfers.

63. In light of the District Court's decision, Capital Factors, which had objected to the Plan, filed an emergency motion to postpone the Confirmation Hearing pending an amendment of the Plan and the resolicitation of acceptances and rejections of the Plan (the "Emergency Motion"). This Court denied the Emergency Motion and the Confirmation Hearing proceeded. During the Confirmation Hearing, the Debtors reached a settlement with Capital Factors whereby Capital Factors withdrew the Emergency Motion and its objection to the Plan and ESL purchased, upon information and belief, substantially all of Capital Factors' claim. Applicant informed the Committee of the Settlement and the Committee decided that the settlement was fair and provided the best opportunity to continue towards confirmation of the Plan.

64. The Debtors together with Knight-Ridder which had intervened in the District Court proceeding, appealed the District Court's decision to the Seventh Circuit Court of Appeals. Handleman Company and Irving Pulp and Paper were also granted permission by the Court of Appeals to intervene. As of the date of this Application, that appeal is still pending.

Bar Date

65. For the vast majority of claimants, the deadline to file proofs of claim in these cases expired on July 31, 2002; and for certain claimants who were not listed on the Debtors' original schedules, the deadline to file proofs of claim was January 22, 2003. In connection therewith, numerous motions have been filed by parties, who failed to timely file proofs of claim, requesting leave to file a late proof of claim. During the Final Fee Period, Applicant reviewed these motions, along with the Debtors' objection to the late proof of claim motions, and monitored the Court allowance of such requests. Where appropriate, Applicant participated in hearings on some of these claims.

e. Acquisition/Divestiture/Asset Disposition (\$16,261.00)

66. After the 2002 holiday season, the Debtors performed an analysis of the financial performance of all of their retail store locations and determined to close an additional 317 unprofitable stores (the "2003 Closing Stores"). The Debtors decision was based on both strategic and financial concerns with respect to their store base. Once the decision to close stores was made, the Debtors and the Committee directed their attention to maximizing the value of the assets located at such locations. As opposed to holding an auction for the rights to conduct the store closing program as had been done for the store closing program conducted in the Spring of 2002 (the "2002 Store Closing Program"), and in an effort to reduce the overall expense of conducting such sales, the Debtors negotiated and entered into an operating and monitoring agreement (the "Operating Agreement") with Abacus Advisors & Consulting Corp. ("Abacus"). The Operating Agreement provided for Abacus, along with other store closing consulting firms designated by Abacus, to conduct the store closing sales. Applicant scrutinized the Operating Agreement, and conferred with the Debtors, Abacus and the Committee's financial advisors in order to determine the economic benefit to the estates. Through this arrangement, the Debtors estimated that they saved approximately \$50 million in fees and expenses.

67. The Debtors sought Court authorization to conduct the store closing sales by motion filed on January 14, 2003, which sought an Order for the Approval of (I) the Conduct of Store Closing Sales by Debtors and/or Their Store Closing Agent, (II) an Operating Agreement with the Store Closing Agent to Conduct Store Closing Sales, and (III) Granting Other Relief (the "Store Closing Motion"). Notwithstanding fifteen (15) objections to the Store Closing Motion, the Store Closing Motion was approved at the January 28, 2003 Omnibus Hearing, in which the Applicant prepared for and attended.

68. Store closure sales began on January 30, 2003 and concluded in mid-April, 2003. During this entire process, Applicant kept the Committee fully informed as to the status and progress of the Debtors' efforts.

f. **Lease and Real Estate Analysis Related Work (\$97,295.50)**

Lease Disposition

69. In connection with the efforts to maximize the value of the 2003 Closing Stores, the Debtors undertook an effort to dispose of the real estate related to those stores, which consisted primarily of leases, but also included various fee owned properties. The Debtors entered into a joint venture agreement (the "Joint Venture") with KRC Property Management I, Inc. ("Kimco") whereby Kimco would market the properties to third parties and would share in any recoveries. The Debtors believed that this arrangement provided the opportunity for the greatest recovery because Kimco is the landlord for numerous Debtors' stores and a prominent owner of shopping centers across the country, and would, therefore, be particularly qualified to assist the Debtors in the marketing and disposition of the Properties.

70. The Committee also supported the Joint Venture and instructed Applicant to file a statement in support of the Debtors' motion to enter into the Joint Venture (the "Joint Venture Motion"). The United States Trustee objected to the Joint Venture Motion, and the Debtors abandoned the Joint Venture and marketed the properties with the assistance of Rockwood Gemini Associates, which had previously been retained to value the Debtors' real estate holdings.

71. On April 9, 2003, the Debtors conducted an auction for the properties (the "Auction"). Applicant attended and participated in the Auction which resulted in the realization

of over \$100 million by the Debtors' estates. Applicant conferred with Debtors' counsel throughout this process and kept the Committee informed of the status of the lease dispositions.

Extension Motions

72. During the First Interim Period, the Court entered several orders extending the deadline for the Debtors to assume or reject unexpired leases of nonresidential real property. Specifically, the Court set March 31, 2003 as the deadline to assume or reject certain leases (the "March 31 Leases"), and for all other unexpired leases the deadline was set for the date of the confirmation of the Plan, but no later than July 31, 2003. On February 5, 2003, the Debtors filed a (i) Motion for Order Further Extending the Deadline to Assume or Reject Unexpired Leases of Nonresidential Real Property of Certain Go-Forward Leases (the "Go-Forward Extension Motion"); and (ii) Motion for Order Further Extending the Deadline to Assume or Reject Unexpired Leases of Nonresidential Real Property of Certain Closing Stores (the "Closing Stores Extension Motion").

73. Pursuant to the Go-Forward Extension Motion, the Debtors sought to extend the deadline to assume or reject the March 31 Leases to the Confirmation Date, but no later than May 31, 2003. The Debtors believed that it was in the estates' best interest to assume the March 31 Leases at the same time they assumed other unexpired leases. Applicant reviewed, analyzed and summarized the Go-Forward Extension Motion, along with the objections filed by landlords and parties-in-interest in order to determine if it was in the best interests of the estates and its creditors. The Court granted this extension by Order dated February 25, 2003.

74. Pursuant to the Closing Store Extension Motion, the Debtors sought to extend the deadline to assume or reject unexpired leases relating to 2003 Closing Stores until 270 days after the Effective Date. The Debtors believed that the extension for the 2003 Closing

Stores was necessary in order to maximize the value of the assets of the Debtors' estates by allowing them sufficient time to market the leases to the eventual end users. The Debtors further believed that the Bankruptcy Code supported their request to extend the deadline past the Effective Date. Numerous objections were filed by landlords and parties-in-interests. Applicant reviewed, analyzed and summarized the Closing Store Extension Motion, along with the numerous objections filed by landlords and parties-in-interest, and reported to the Committee with regard to the matter. Applicant also researched relevant issues, including, the continuation of the estate post Confirmation. At the initial hearing on this matter, the Court determined that the complex issues involved required full briefing by the parties.

75. In light of the potential return to be gained from the disposition of the 2003 Closing Store leases, and believing that the relief sought by the Debtors was appropriate, Applicant, at the direction of the Committee, prepared a (i) Brief of the Official Committee of Unsecured Creditors in Support of the Motion for Order Further Extending the Deadline to Assume or Reject the Unexpired Leases of Nonresidential Real Property for Certain Closing Stores, and (ii) Reply Brief of the Official Committee of Unsecured Creditors in Support of the Motion for Order Further Extending the Deadline to Assume or Reject the Unexpired Leases of Nonresidential Real Property for Certain Closing Stores, which were filed with the United States District Court for the Northern District of Illinois. The Court, however, only granted an extension of the deadline until the date of Confirmation.

g. Special Litigation (\$643,258.50)

76. During the Final Fee Period, Applicant reviewed and analyzed information and extensive documents collected and prepared by the Debtors' professionals and/or the Committee's professionals in connection with the preparation of examinations of certain former employees and directors of the Debtors conducted pursuant to Bankruptcy Rule 2004 and the order dated August 29, 2002 (the "August 29 Order") which, among other things, authorized Bankruptcy Rule 2004 investigations. The documents included witness interviews, minutes and package of the Board of Directors, witness outlines, deposition exhibits, deposition transcripts and various documents produced by third parties, including former employees and directors of the Debtors in response to Bankruptcy Rule 2004 document requests.

77. In accordance with the August 29 Order and during the Final Fee Period, Applicant prepared various Bankruptcy Rule 2004 subpoenas and document requests directed to and served upon certain third parties. Thereafter, Applicant reviewed and analyzed objections to the subpoenas and engaged in negotiations with counsel for the deponents in an effort to resolve the objections. The negotiations resulted in an agreement, reached after the conclusion of the Final Fee Period, in which the deponents agreed to produce documents responsive to various document requests. Applicant also prepared, analyzed and, where appropriate, revised certain confidentiality agreements with third-parties in connection with their production of documents in response to various document requests.

78. During the Final Fee Period, Applicant had several in-person meetings with the Debtors' professionals, including one conducted on January 23, 2003, and frequent telephone conversations with the Debtors' professionals. The meetings and discussions concerned the status and progress of numerous examinations of former employees and directors

of the Debtors, the creation and funding of the Kmart Creditor Trust, the transfer of Trust Claims to the Kmart Creditor Trust and the transition of information, documents and privileges from the Debtors' estates to the Kmart Creditor Trust. Applicant also had in-person meetings and telephone conversations with co-counsel, KPMG and the professionals for the other Committees about the status and strategy of the Debtors' so-called Stewardship and Accounting investigations and the preparation, participation and attendance at Bankruptcy Rule 2004 examinations of former officers and directors of the Debtors.

79. Applicant prepared for and participated in examinations of three (3) former directors of the Debtors conducted under Bankruptcy Rule 2004 and the terms of the August 29 Order. Applicant reviewed, analyzed, and summarized the transcripts from more than fifteen (15) different days of examination. Applicant reviewed, analyzed, summarized and where appropriate prepared responses and objections to various motions including, without limitation, a motion to obtain relief from the automatic stay to pursue certain actions alleging violation of various securities laws and a former officer's motion to obtain payment and continued advancement of defense costs under the Debtors' directors and officers liability insurance policies.

80. Throughout the Final Fee Period, Applicant continued, as it did during the previous fee application periods, to keep the respective members of the Committee informed of the status and progress of the investigations.

h. Employee Benefits/Pension/General Labor (\$18,059.00)

81. At the beginning of 2003, James B. Adamson ("Adamson") stepped down as Chief Executive Officer of Kmart, and the Debtors promoted Julian C. Day ("Day") as the Company's new CEO, effective January 17, 2003. Adamson, however, continued to serve as the

Chairman of the Board of Directors until the Effective Date, as contemplated by the Plan. Accordingly, the Debtors entered into an amended and restated employment agreement with Day, to reflect Day's new position; and entered into a separation agreement with Adamson (the "Separation Agreement"). Applicant reviewed and analyzed the agreements; and had frequent discussions with the Debtors, particularly with respect to the terms of Separation Agreement. As a result of Applicant's efforts, an amendment was added to the Separation Agreement limiting the indemnity provided to Adamson, in order to more closely align it with the indemnity provided to other Directors pursuant to the Plan. During the Final Fee Period, Applicant also reviewed and analyzed the terms of the separation agreement entered into between the Debtors and Janet Kelley, former executive vice president and general counsel of the company; and reviewed, analyzed and summarized the motion filed by Hector Dominquez, former senior vice president, seeking to compel the Debtors to make certain severance payments.

B. FINAL ALLOWANCE

82. Applicant does not wish to burden the Court with an overly detailed or lengthy recitation of each and every other matter as to which it has rendered services to the Committee during the pendency of these cases, as such services are described in the Interim Applications already on file with the Court. Accordingly, the following is intended to serve only as a summary description of some of the primary services rendered by Applicant to highlight the benefits that are a result of Applicant's efforts. Principally, as directed by the Committee, Applicant's efforts focused on promptly formulating a consensual plan of reorganization, avoiding litigation with respect to the issues which could be resolved consensually, and preserving the value of the Debtors' estates for the benefit of its creditors.

a. **The Plan and Disclosure Statement**

Exclusivity

83. On February 28, 2002, the Debtors made a motion to extend their exclusive periods to propose and solicit acceptances of a plan of reorganization until March 31, 2003 and June 30, 2003, respectively. Applicant discussed the reasoning for the request with the Committee and the Committee supported the motion. The Finance Committee initially opposed the motion, but following discussions among the parties, including Applicant, the Finance Committee withdrew its objection and on July 24, 2002, this Court approved an extension of the periods until February 28, 2003 and April 22, 2003.

b. **Debtor-in-Possession Financing**

DIP Agreement

84. On the Petition Date, the Debtors filed a Motion for Interim and Final Order Authorizing Debtors to Obtain Postpetition Financing Pursuant to 11 U.S.C. 105, 361, 362, 264(c)(2) and 364(c)(3), and Scheduling Final Hearing Pursuant to Fed.R.Bankr.P. 4001(c). This Court entered an interim order (the "Interim Order") authorizing the Debtors to obtain post-petition financing, in the amount of \$1.15 billion, from a group of syndicated lenders (the "Syndicated Lenders") and scheduled a final hearing, pursuant to Bankruptcy Rule 4001(c), to approve the financing on a permanent basis for March 6, 2002.

85. After the appointment of the Committee, Applicant immediately analyzed the documents related to the Debtors' post-petition financing agreement (the "DIP Agreement"). Applicant also reviewed the Interim Order, proposed Final Order and various objections to the DIP Agreement and reported its findings to the Committee. Applicant participated in further discussions between the Debtors and the Lenders to ensure that any Committee concerns would

be addressed. On March 6, 2002, this Court entered the Final Order (I) Authorizing Debtors to Obtain Post-Petition Financing Pursuant to 11 USC Sections 105, 361, 362, 363, 364(c)(1), 364(c)(2) and 364(c)(4), (II) Granting Adequate Protection to Pre-Petition Secured Parties for Setoff Rights Pursuant to 11 USC Sections 361, 362, and 363 and (III) Approving Secured Inventory Trade Credit Program and Granting of Subordinate Liens Pursuant to 11 USC sections 105 and 364(c)(3).

Post-Petition Vendor Lien

86. As part of the DIP Agreement, the Debtors proposed a trade creditor lien program, whereby the Debtors, under specified conditions, were authorized to grant a lien (the "Post-Petition Vendor Lien"), subordinated to the claims of the lenders under the DIP Agreement, to approved trade creditors. The Post-Petition Vendor Lien secured amounts arising from shipments to the Debtors made by such trade creditors from and after January 22, 2002. Applicant closely analyzed the documents related to the Post-Petition Vendor Lien and worked with the Debtors and Debtors' Counsel to improve the terms of the program to make them more attractive to trade creditors.

DIP Amendments

87. On August 14, 2002, the Debtors filed a Motion for Order Approving Amendment to Post-Petition Credit Facility, Including Increase of Maximum Borrowings Thereunder (the "DIP Amendment Motion"). The DIP Amendment Motion initially provided for (i) the modification of the EBITDA covenants in order to provide the Debtors the flexibility required to implement their restructuring and avoid defaulting on the DIP agreement, (ii) an additional \$500 million commitment, and (iii) changes in the prepayment terms with respect to asset sales. Applicant analyzed the terms and conditions of the DIP Amendment Motion and

consulted with the Debtors and their advisors regarding the effect the DIP Amendment Motion would have on the estates, the need for an increased commitment, and to ensure that any Committee concerns would be addressed. The DIP Amendment Motion was subsequently amended to eliminate the \$500 million increase in the DIP commitment primarily on the grounds that the additional credit at an additional cost was unnecessary. The DIP Amendment Motion was approved by the Court at the August, 2002 Omnibus Hearing. Throughout this time, Applicant had several discussions with the Debtors and their advisors to determine the necessity and scope of the amendment. Applicant also kept the Committee informed about the DIP Amendment Motion and the ramifications it would have on the estates.

88. During the pendency of this case, Applicant, with the assistance of KPMG, continued to monitor the Debtors' financial condition and performance in connection with the financial covenants set forth in the DIP Agreement.

c. Employee Benefits/Pension/General Labor

KERP Motion

89. The Debtors, through their KERP motion, sought to alleviate any uncertainty or instability caused by the bankruptcy filing by implementing a program designed to provide economic incentive to employees for them to remain with the company during the reorganization process (the "Employee Retention Program"). Applicant, with the assistance of KPMG, performed an extensive review and analysis of the Employee Retention Program, made recommendations to the Committee on ways to improve the Employee Retention, and engaged in extensive negotiations with the Debtors' advisors to discuss the Committee's concerns and recommendations. Such efforts resulted in a modified plan that substantially reduced payments under the program, while still providing substantial economic incentives to the Debtors'

employees. The Employee Retention Program was approved by Orders dated March 6, 2002, March 20, 2002 and April 23, 2002. Applicant also monitored the implementation of the Employee Retention Program.

Executive Employment Agreements

90. During the first few months of these cases, the Debtors terminated the employment of almost all the members of their senior management. Prior to the Petition Date, the Debtors had entered into employment agreements with certain senior management members, which it sought Court authorization to assume. Because many of such senior management members were terminated soon after the case began, the Debtors entered into employment agreements with new executives, and filed subsequent motions for authority to enter into the postpetition agreements. Applicant, with the assistance of KPMG, expended a significant amount of time analyzing the proposed employment agreements. After extensive negotiations with the Debtors and counsel for certain executives, substantial modifications were made to certain of the employment agreements. Specifically, among other modifications, the overall compensation for Adamson, then CEO, was substantially reduced, and compensation was more closely tied to the outcome of the case and recovery for creditors. At the hearing on the motions to enter into the postpetition employment agreements, the Court stated that the such agreements did not require court approval and the Debtors were allowed, in their business discretion, to enter into such postpetition contracts (as modified based on Applicant's comments).

91. As the cases progressed, Applicant monitored the continuous efforts by the Debtors to remove those members of their management team who were involved or tainted by the alleged wrongdoings that occurred prior to the Petition Date, and kept the Committee

apprised of the Debtors' efforts to install a senior management team to lead the Company out of bankruptcy.

Loans

92. Prior to the Petition Date, the Debtors provided loans to a number of executives, which included loan forgiveness provisions (the "Loans"), which were purportedly designed to act as retention bonuses. The Loans were to be forgiven if the executive remained with the company for a specified period of time (the "Loan Forgiveness Program"). During the First and Second Interim Periods a number of recipients were terminated, which could have potentially resulted in automatic forgiveness of the Loans. The Committee, therefore, directed Applicant to examine the Loan Forgiveness Program, focusing on the history, reasoning and economic consequences of such Loans. Accordingly, Applicant analyzed a plethora of documents relating to the Debtors' Loan Forgiveness Program, prepared memoranda, researched relevant issues, and consulted with the Committee's financial advisors and the Debtors' professionals to determine the effect of the Loans on the estates.

93. The Debtors also delved into the Loan Forgiveness Program as part of the Stewardship Investigation. The Debtors ultimately terminated the employment of each Loan recipient, which the Debtors asserted was not in and of itself indicative of wrongful conduct by any individual Loan recipient. Pursuant to the Plan, claims arising out of the Loan Program have been transferred to the Kmart Creditor Trust.

Severance Benefits

94. Prior to the Petition Date, the Debtors had severance programs in place (the "Severance Programs") to provide benefits to certain terminated employees. In connection with the bankruptcy, particularly in light of the number of employees that would be terminated

pursuant to management changes and the 2002 and 2003 Store Closings, Applicant, together with KPMG, spent a significant amount of time reviewing the Severance Programs. Applicant, with the assistance of KPMG found certain provisions of the Severance Program to be out of line with industry standards, and made recommendations to improve the program to the Committee. Applicant also engaged in discussions with the Debtors and the Debtors' advisors with respect to the Committee's concerns and recommendations.

d. Special Litigation

95. On January 25, 2002, the Debtors publicly stated that they had received an anonymous letter dated January 9, 2002, which expressed concern about unspecified accounting matters (the "Letter"). The Letter was purportedly sent by certain employees of the Debtors to the Securities & Exchange Commission (the "SEC"), with copies sent to the Debtors' independent auditors and the Debtors' Board of Directors (the "Board"). Thereafter, the Board directed that an internal investigation under the direction of the Audit Committee of the Board be undertaken by the Debtors' outside legal counsel and assisted by certain accountant advisors. At or about that time the SEC also commenced its own investigation into matters alleged in the Letter. Additional anonymous letters were subsequently received by the Debtors and others, the last one dated March 5, 2003, concerning various matters including those allegedly involving the Debtors' former management (collectively, with the Letter, the "Anonymous Letters").

96. On or about May 15, 2002, the Debtors filed their Form 10-K Annual Report for the fiscal year ended January 30, 2002 (the "January 2002 10-K Report"), which disclosed that the U.S. Attorney's Office for the Eastern District of Michigan (the "U.S. Attorney's Office") was also conducting an investigation of the matters included in the Anonymous Letters. In connection with the filing of the January 2002 10-K Report, the Debtors

announced that they had substantially completed their investigation of the accounting-related matters, designated by the Debtors as the "Accounting Investigation", and were continuing their investigation of the Debtors' former management, which the Debtors labeled as the "Stewardship Investigation". The Debtors also communicated that they would provide additional procedural and substantive information to the Committees and that they would consult with the Committees regarding the conduct and completion of the investigations.

97. On June 6, 2002, and thereafter on June 24, 2003, each time at the invitation of the Debtors, Applicant met and conferred with the Debtors and their professionals and representatives of the Committees concerning the background, status and work undertaken by the Debtors' attorneys in connection with the Anonymous Letters. After, substantial negotiation, the Debtors and the Committees entered in to a joint interest agreement on June 26, 2002 (the "Joint Interest Agreement"), which, *inter alia*, provided for the Debtors' voluntary disclosure of confidential information related to the investigations without losing any privilege or protection attaching to the information. Pursuant to an August 29, 2002 order, the Court approved the Joint Interest Agreement, authorized Bankruptcy Rule 2004 investigations and granted other related relief. Thereafter, by order dated December 5, 2002 (the "Protective Order") the Court granted the Debtors' motion for a protective order with respect to certain documents, transcripts and other materials produced in response to Bankruptcy Rule 2004 document requests or produced at or in connection with the Bankruptcy Rule 2004 examinations. Subsequent to the execution and approval of the Joint Interest Agreement, Applicant together with its co-counsel negotiated and entered into a joint interest agreement with the Finance Committee and the Equity Committee (the "Committee Joint Interest Agreement"), which

provided, *inter alia*, for the voluntary exchange of certain confidential information related to the investigations without losing any privilege or protection attaching to the information.

98. Due to the restraints on the Committee and the Applicant under the terms of the Protective Order, the Joint Interest Agreement (which, among other things, requires that any information received in connection with the investigations be held in strict confidence and restricts the disclosure of such information), the Committee Joint Interest Agreement, and certain confidentiality agreements with third parties, Applicant has made every effort to protect and secure the confidentiality of such information. Therefore, in connection with the services rendered by Applicant with regard to the investigations, Applicant has excluded from its time entries (and this Application) any confidential information, including the names of witnesses who were examined or interviewed and the specific subject matters of the investigations.

99. Applicant had numerous in-person meetings with the Debtors, their professionals and/or the professionals for the Committees concerning the status and progress of the investigations. During the period of late June 2002 through early February 2003, Applicant participated in weekly conference calls with the professionals for the Debtors and the Committees concerning issues related to, among other things, protocol, strategy, proposed work plans, progress, the Committee's involvement and participation in the investigations, and the status and extension of the Debtors' director and officer insurance policies. Applicant also engaged in extensive negotiations with the Debtors' professionals, both telephonic and in-person, concerning among other things, the creation and funding of the Kmart Creditor Trust, the transfer of Trust Claims to the Kmart Creditor Trust, and the transition of information, documents and privileges from the Debtors' estates to the Kmart Creditor Trust, all for the benefit of the Beneficiaries, as such term is defined in the Trust Agreement.

100. Applicant participated in ten briefing presentations by the Debtors and their professionals during the months of August and September, 2002 concerning the status of the work undertaken by the Debtors, their interim findings, and anticipated future work plans in connection with the investigations. Applicant also prepared memoranda which summarized the briefing presentations.

101. Applicant reviewed and analyzed information and extensive documents collected and prepared by the Debtors' professionals and/or the Committees' professionals in connection with the investigations and in preparation of numerous interviews of current and former employees of the Debtors and more than twenty (20) Bankruptcy Rule 2004 examinations of former employees and directors of the Debtors. Applicant prepared for and attended numerous interviews of the Debtors' current and former employees concerning the investigations.

102. In the Fall of 2002, Applicant prepared for and conducted an interview of a then current employee of the Debtors as well as a Bankruptcy Rule 2004 examination of a third-party witness in December 2002. Applicant also prepared memoranda which summarized the interview and the examination. In addition, in accordance with the August 29 Order, Applicant prepared various Bankruptcy Rule 2004 subpoenas and document requests directed to and served upon certain third parties. Several of the deponents asserted objections to document requests, which Applicant reviewed and analyzed. Thereafter, Applicant engaged in discussions with counsel for the deponents and after the Effective Date reached an agreement in which the deponents agreed to produce documents responsive to various document requests. Applicant also prepared, analyzed and, where appropriate, revised confidentiality agreements with third-parties concerning the parties' production of documents related to the investigations.

103. Applicant also had numerous in-person meetings and telephone conversations with co-counsel, KPMG and the professionals for the Committees concerning the focal points, strategy, status and progress of the investigations and the delegation of duties related to the investigations. These discussions were necessary in order to avoid duplication of work and to coordinate the parties' efforts in connection with the preparation, participation and attendance at examinations of former officers and directors of the Debtors.

104. Applicant prepared for and participated in three examinations of former directors of the Debtors conducted in accordance with terms of the August 29 Order. Applicant reviewed and analyzed numerous transcripts from the examination of approximately twenty (20) former employees and three (3) directors of the Debtors and summarized the transcripts from more than fifteen (15) different days of examination. Applicant also conducted research on several topics related to the investigations and prepared related memoranda. Applicant reviewed, analyzed, summarized and where appropriate prepared responses and objections to various motions related to the investigations including, without limitation, motions to compel witnesses to produce documents responsive to the Bankruptcy Rule 2004 document requests and a former officer's motion to obtain payment and continued advancement of defense costs under the Debtors' directors and officers liability insurance policies. Applicant also kept the respective members of the Committee informed about the status and progress of the investigations during the pendency of the Debtors' bankruptcy cases.

105. As a direct result of Applicants' efforts and substantial negotiations, on the Effective Date, the initial funding for the Kmart Creditor Trust was \$6,550,000. In addition, under the Confirmation Order, the Plan and the Trust Agreement, the Kmart Creditor Trust has been afforded certain powers and privileges regarding the prosecution of Trust Claims on behalf

of all Beneficiaries, the primary beneficiaries of which are the holders of allowed general unsecured claims.

e. **Review of Financial Information/Business Operations**

106. Throughout the Debtors' cases, Applicant, with the assistance of KPMG, reviewed, analyzed and regularly discussed with the Committee the myriad of financial documents, analyses, valuations, projections and reports that pertained to the Debtors' ongoing business and financial operations and business plan. The financial information encompassed, among other things, various motions filed with the Court, monthly operating reports, weekly flash reports, financial presentations prepared for and on behalf of the Committee, and exit financing documents. Applicant also reviewed the Debtors' various pre-petition financing documents, including credit facilities, indentures and debt offerings, and SEC filings in order to have a better understanding of the Debtors' pre-petition credit, debt and equity arrangements. Additionally, Applicant regularly engaged in discussions with the Debtors and their counsel regarding the Committee's concerns with respect to the Debtors' earnings projections and the effect on the value of distributions to unsecured creditors.

License Agreements

107. At the beginning of these cases, the Debtors determined that their key licensing agreements would be critical to a successful reorganization, and accordingly sought to assume several of their license agreements (the "License Agreements"). Applicant, together with the Committee and KPMG, conducted a thorough analysis of the License Agreements, in order to determine if the assumption of the License Agreements would be beneficial to the Debtors and the potential administrative expense the Debtors were incurring as a result of the assumptions. Applicant presented its review and analysis of each agreement to the Committee in conjunction

with the critical financial analysis provided by KPMG, and the Committee concluded that the assumption of the License Agreements was in the best interests of the estates. The Court authorized the assumption of all of the License Agreements for which approval was sought.

Surety Program

108. In March 2002, the Debtors filed a Motion for Entry of an Order (I) Approving Settlement of Surety-Related Claims; (II) Authorizing Continuation of Surety Bond Program; (III) Approving Extension of Secured Surety Credit; (IV) Granting Licns and Super Priority Administrative Expense Claims; (V) Providing Adequate Protection; and (VI) Shortening Notice (the "Surety Motion"). Prior to the bankruptcy filing, several of the Debtors' sureties notified the Debtors that they were cancelling their surety bonds. Postpetition, the Debtors actively negotiated with their sureties to create a new surety bond program. Recognizing both the importance of implementing of a post-petition surety bond program and the potential administrative liabilities as a result of the new program, Applicant reviewed and analyzed the Surety Motion and was actively involved in the negotiations of the new program. The program was approved on March 21, 2002.

f. Claims Objection Work / Claims Administration

Consignment

109. On the Petition Date, the Debtors sought authority to pay the pre-petition claims of vendors who provided goods to the Debtors on a consignment basis, regardless of whether they had taken the steps necessary to perfect their interests in the consigned goods. The Court entered an interim order authorizing the payments, but gave the Committees authority to object to the relief. After extensive analysis of the facts and law regarding the issue by Applicant, including analysis of schedules of inventory and accounts payable balances as of the

Petition Date, the Committee decided to object and instructed Applicant to prepare and file an objection to the payment of those consignment vendors that had not properly perfected their interests (the "Consignment Objection").

110. Both prior to and following the filing of the Consignment Objection, Applicant communicated extensively with the Debtors' Counsel, counsel for the Finance Committee as well as various consignment vendors. As a result of these negotiations, a settlement was reached with Universal Music and Video Distribution Corp. ("Universal"), the largest unperfected consignment vendor, whereby the Debtors would pay a portion of Universal's consignment claim in cash and Universal would waive a portion of its remaining unsecured claim. This settlement resulted in a savings of almost \$25 million for the Debtors' estates.

111. Following the settlement of the Universal claim, the Debtors also sought authority to assume their consignment agreements with two jewelry vendors, Samuel Aaron and M. Fabrikant (collectively "Fabrikant"). The Debtors had negotiated certain concessions in the agreements, including limited cure obligations, and argued that the revised agreements would afford access to a greater amount of consignment credit, and thereby decrease the Debtors' borrowings under the DIP Agreement. Applicant filed an affidavit disclosing certain services it had provided to Fabrikant. In order to avoid any potential conflict, Winston & Strawn advised and represented the Committee in connection with the motions to assume the agreements, which the Committee ultimately decided to support. After revisions were agreed to at the request of the Finance Committee, the Court approved the settlements. At the request of the Committees, the Debtors agreed not to make any further payments to unperfected consignment vendors on account of pre-petition claims without the Committees' consent.

Reclamation

112. On the Petition Date, the Debtors also made a motion to establish procedures for the reconciliation and administrative payment of reclamation claims. Applicant reviewed the motion with the Committee and the Committee decided to support the program. The Committee also formed a subcommittee to handle issues related to reclamation (the "Reclamation Subcommittee"). The Reclamation Subcommittee met with representatives of the Debtors to assist in formulating a procedure for the payment of reclamation claims prior to the confirmation of a plan of reorganization. In part as a result of the discussions with the Reclamation Subcommittee, the Debtors, on September 11, 2002, made a motion for authority to pay compromised reclamation claims. Pursuant to the Motion, holders of compromised reclamation claims were given the option to be paid (a) 75% of their claim immediately or (b) 100% of their claim on the Effective Date. Applicant, after reviewing the Motion with the Reclamation Subcommittee, requested certain changes to the proposed order. Many of these changes were accepted and the Committee supported the relief, which was granted by the Court.

Vendor Relations Subcommittee

113. Following the formation of the Committee, Applicant received numerous complaints from members of the Committee and other vendors regarding the Debtors' relationships with, and treatment of, their vendors. At Applicant's suggestion, the Committee formed a subcommittee of vendors (the "Vendor Relations Subcommittee") to compile these complaints and to interact with the Debtors to improve their vendor relations. Applicant organized numerous meetings between the Vendor Relations Subcommittee and representatives of the Debtors to discuss a wide variety of issues, including, among other things, how the Debtors handle returns, the timely payment of invoices, vendor allowances and communications