

BACKGROUND

3. The Debtor is a diversified retailer operating fifty-nine (59) full-line department stores and three (3) specialty stores in six western states: California, Washington, Alaska, Oregon, Idaho and Nevada. It was founded in 1904 in Fresno, California, and expanded within California and the western states. The Debtor's stores operate under the "Gottschalks" and "Village East" names and are generally large, free-standing and mall-based outlets of between 30,000 and 200,000 square feet, primarily located in mid-sized cities that are otherwise underserved by the larger national chains. The Debtor carries a broad line of brand name and private label merchandise, including fashion clothing, shoes, cosmetics, jewelry, home furnishings and other products. Brands carried by the Debtor include Estee Lauder, Lancome, Clinique, Chanel, Dooney & Bourke, Nine West, Liz Claiborne, Calvin Klein, Nautica, Karen Kane, Ralph Lauren, Columbia, Fossil, Levi Strauss, Southpole, Izod, Quiksilver, Roxy, Woolrich and Carters.

4. The Debtor employs more than 5,282 full time and part time employees. Like other retailers, the Debtor's retail sales are subject to seasonal fluctuations – approximately 33% of the Debtor's annual sales occur in the fourth fiscal quarter (November 1 through January 31).³ Of its 62 retail locations, the Debtor owns 5 stores and leases the balance. The Debtor is publicly owned. One of its largest investors is The Harris Company ("Harris"), which sold certain stores to the Debtor in 1998 and is an affiliate of Spanish retailer El Corte Ingles.

5. The Debtor as borrower, the lenders party thereto and General Electric Capital Corporation, as administrative agent and collateral agent ("GECC"), are parties to that certain Second Amended and Restated Credit Agreement dated as of September 26, 2007 (as amended, the "GECC Facility"). The current amount outstanding under the GECC Facility is approximately \$73 million. The obligations under the GECC Facility are secured by a lien in most of the Debtor's assets including inventory, accounts receivable, equipment, most (but not all) of its real property, and intellectual property (among other things). The Debtor's principal

³ The Debtor's fiscal year ends on the Saturday nearest to January 31.

unsecured obligations consist of, among others, a note in favor of Harris with an outstanding principal amount of approximately \$16 million and approximately \$29 million owed to its trade vendors.

6. In November 2008, the Debtor signed an agreement with Everbright Development Overseas Securities, Ltd., a British Virgin Islands corporation (“Everbright”). Everbright agreed to invest up to \$30 million in exchange for common stock of the Debtor. The Everbright transaction was subject to a diligence condition through December 15, 2008.

7. Shortly after the Everbright agreement was signed, the Debtor was advised that (a) new, lower appraisals conducted by independent appraisers of the value of the Debtor’s inventory and other assets that comprise the “borrowing base” and control the Debtor’s asset-based credit facility agented by General Electric Capital Corporation (“GECC”) and (b) reserves due to a decline in the Debtor’s same-store sales trends in the current retail environment would lead to a reduction in the Debtor’s liquidity compared to budget under its credit line ranging from approximately \$18 million in December 2008 to a projected \$12 million in January, 2009. The Debtor had not anticipated the adjustments at the time it entered the proposed transactions with Everbright. GECC agreed to delay certain of the adjustments in availability under the credit facility for a period of time.

8. Everbright subsequently advised the Debtor that it was unable to go forward with its proposed investments, at least as it was previously structured. The Debtor attempted to modify the amount of the proposed investment from Everbright or raise additional capital from third parties (principally its existing investor, Harris). However, the Debtor’s efforts to secure such infusion of funds outside of a chapter 11 proceeding were ultimately unsuccessful, and its sales (like those of virtually all retailers) continued to be impacted by the very weak retail and credit environment. The combination of these factors (and the resulting impact on its access to cash and its line of credit) resulted in the filing of this case.

9. The Debtor filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code on January 14, 2009 (the “Petition Date”). The Debtor intends to use this

chapter 11 case to (i) gain access to liquidity, and (ii) execute on one or more options to create value for stakeholders (including a sale of assets or other transaction with a third party investor). The Debtor is considering all possible options for maximizing stakeholder value. Among other things, it will focus on the sale of certain portions or all of its business as well as other third party investments and asset disposition options.

10. GECC has agreed to provide postpetition financing to the Debtor and consented to the use of cash collateral. The proposed postpetition financing arrangement (the “DIP Loan Facility”) will provide the Debtor with cash advances and other extensions of credit in an aggregate principal amount not to exceed \$125 million. The proposed DIP Loan Facility contemplates a sale of the Debtor’s business within approximately 60 days of the Petition Date.

11. The Debtor plans to seek approval for a sale process using the following timetable (which is incorporated into the DIP Loan Facility): the acceptance of a stalking horse bid on or about March 2, 2009 and an auction on or about March 17, 2009. The sale would close on an agreed schedule. To further its sale efforts, the Debtor has retained FTI Consulting, Inc. as its financial advisor and Financo, Inc. (“Financo”) to act as its investment banker. Financo served as the Debtor’s investment banker prior to the Petition Date and is very familiar with the Debtor. It is already working with interested investors and potential buyers. The Debtor believes that the DIP Loan Facility gives it the liquidity to execute on its sale effort.

RELIEF REQUESTED

12. By this Motion, the Debtor seeks, inter alia, entry of an order pursuant to section 105(a) of the Bankruptcy Code that authorizes, but does not direct, the Debtor to pay undisputed prepetition sales, use and franchise tax obligations (collectively, the “Taxes”) owed to the appropriate taxing authorities (the “Taxing Authorities”) in the ordinary course of business, on an unaccelerated basis, as payments become due and payable and to the extent adequate funds are available to make such payments, in an aggregate amount not to exceed \$9.5 million.⁴ To the extent that a check used prior to the Petition Date had not cleared the bank as of

⁴ Some Taxing Authorities require monthly remittance of sales and use tax obligations, while others

the Petition Date, the Debtor also seeks entry of an order (i) authorizing the Debtor's banks to honor such checks and/or any prepetition wire transfer requests and (ii) authorizing the Debtor to issue replacement checks, submit replacement fund transfer requests or provide other means of payment to the Taxing Authorities to the extent necessary to pay all undisputed prepetition sales, use and franchise tax obligations.

BASES FOR RELIEF REQUESTED

13. On a periodic basis, the Debtor pays to the Taxing Authorities all sales and use taxes collected by funds drawn by check or by means of an electronic funds transfer or check. Accordingly, prior to submitting payment to the appropriate Taxing Authority for a given period, the Debtor may hold a significant balance of collected but unremitted Taxes. In particular, the Debtor may hold a significant balance of sales taxes collected from customers who purchase merchandise from the Debtor.

14. As of the Petition Date, the Debtor's financial records indicate that the Debtor is substantially current on its payment of Taxes to all Taxing Authorities. Therefore, the Debtor seeks this relief out of an abundance of caution and to the extent that any Taxes accrued prepetition were not paid prepetition, paid in an amount that is less than actually owed, or if any payments sought to be made prepetition are rejected, lost or otherwise not received in full by any Taxing Authority. The Debtor estimates that the total amount of Taxes collected or accrued prepetition but not yet paid is approximately \$7,902,434.35. The Debtor also estimates that of this amount, \$476,570.94 will come due in January 2009 and \$7,392,729.41 will come due in February 2009. The Debtor is not seeking to pay the Taxes all at once but only such portions thereof as become due in the ordinary course of the Debtor's business and consistent with prepetition business practices.

15. The Debtor believes that the failure to pay the Taxes could have a material adverse impact on its ability to operate in the ordinary course of business. The Debtor operates

require payments only quarterly. This amount includes sales tax amounts relating to December 2008, when retail sales are typically at their highest.

stores in six states throughout the western United States and many disputes that could impair its ability to conduct business in a particular jurisdiction could affect the Debtor's operations as a whole. Tax collections in various jurisdictions are treated as trust fund taxes and are not property of the Debtor's estate. Texas Comptroller of Public Accounts v. Megafoods Stores, Inc. (In re Megafoods), 163 F.3d 1063 (9th Cir. 1998). Furthermore, the Debtor believes that many Taxing Authorities may cause the Debtor to be audited if certain of the Taxes are not paid, and such audits will unnecessarily divert the Debtor's attention from its business operations and reorganization. The payment of the Taxes is also necessary to avoid potential administrative difficulties. Withholding of payment of the Taxes will likely cause the Taxing Authorities to take immediate action, including an increase in state audits and lien filings or motions for relief from stay. While the Debtor reserves all legal positions, prompt and regular payment of the Taxes will help avoid these unnecessary government actions.

16. Given the potential harm discussed above if the Taxes are not timely paid, the Debtor believes that the relief requested herein should be granted as it is in the best interests of the Debtor's estate.

APPLICABLE AUTHORITY

17. There is ample authority for allowing payment of the Taxes in the ordinary course. Section 105(a) of the Bankruptcy Code provides that "(t)he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." 11 U.S.C. §105(a). The purpose of section 105(a) is "to assure the bankruptcy courts [sic] power to take whatever action is appropriate or necessary in aid of the exercise of their jurisdiction." 2 Collier on Bankruptcy, ¶ 105.01 (15th ed. rev. 2006). Thus, section 105 essentially codifies the Bankruptcy Court's inherent equitable powers. See Mgmt. Tech. Corp. v. Pardo, 56 B.R. 337, 339 (Bankr. D. N.J. 1985) (noting court's equitable power derived from section 105).

18. Numerous courts have used their section 105 equitable powers under the "necessity of payment doctrine" to authorize payment of a debtor's prepetition obligations where, as here, such payment is necessary to effectuate the "paramount purpose" of a chapter 11

reorganization, which is to prevent the debtor from going into liquidation and preserve the debtor's potential for rehabilitation. See In re Lehigh & New England Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981); In re Ionosphere Clubs, Inc., 98 B.R. 174, 176-77 (Bankr. S.D.N.Y. 1989) (citing NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984)). This doctrine, first articulated by the United States Supreme Court in Miltenberger v. Logansport, C. & S.W.R. Co., 106 U.S. 286, 311-312 (1882), recognizes the existence of judicial power to authorize a debtor in a reorganization case to pay prepetition claims where such payment is essential to the continued operation of the debtor.

19. Moreover, under Bankruptcy Code Section 105(a), numerous courts have authorized debtors in possession to pay a variety of prepetition claims of creditors, including claims similar to the Taxes herein. See, e.g., In re Tribune Co., Case No. 08-13141 (KJC) (Bankr. D. Del. Dec. 10, 2008); In re NetVersant Solutions, Inc., Case No. 08-12973 (PJW) (Bankr. D. Del. Nov. 20, 2008); In re Motor Coach Indus. Int'l, Inc., Case No. 08-12136 (BLS) (Bankr. D. Del. Sept. 16, 2008); In re Dan River Holdings LLC, Case No. 08-10726 (BLS) (Bankr. D. Del. Apr. 24, 2008); In re Diamond Glass, Inc., Case No. 08-10601 (CSS) (Bankr. D. Del. Apr. 2, 2008); In re Wickes Holdings, LLC, Case No. 08-10212 (KJC) (Bankr. D. Del. Feb. 5, 2008); In re Buffets Holdings, Inc., Case No. 08-10141 (MFW) (Bankr. D. Del. Jan. 23, 2008); In re Avado Brands, Inc., Case No. 07-11276 (MFW) (Bankr. D. Del. Sept. 6, 2007); In re Tweeter Home Entm't. Group, Inc., Case No. 07-10787 (PJW) (Bankr. D. Del. June 12, 2007); In re Dura Auto. Systems, Inc., Case No. 06-11202 (KJC) (Bankr. D. Del. Oct. 31, 2006).

20. The Debtor submits that because the relief requested in this Motion is necessary to avoid immediate and irreparable harm to the Debtor for the reasons set forth herein, Rule 6003 of the Federal Rules of Bankruptcy Procedure has been satisfied.

NOTICE

21. No trustee, examiner or creditors' committee has been appointed in this chapter 11 case. Notice of this Motion has been provided to: (1) the Office of the United States Trustee for the District of Delaware; (2) counsel to General Electric Capital Corporation, agent for the Debtor's senior secured creditors; (3) the 20 largest unsecured creditors of the Debtor as identified in the Debtor's chapter 11 petition; (4) the Internal Revenue Service; (5) the Securities and Exchange Commission; and (6) the Office of the United States Attorney General for the District of Delaware. As this Motion is seeking first day relief, notice of this Motion and any order entered hereon will be served as required by Rule 9013-1(m) of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware. Due to the urgency of the circumstances surrounding this Motion and the nature of the relief requested herein, the Debtor respectfully submits that no further notice of this Motion is required.

NO PRIOR REQUEST

22. No previous motion for the relief sought herein has been made to this or any other Court.

WHEREFORE, the Debtor requests entry of an order, substantially in the form attached hereto as Exhibit A, granting the relief requested herein and such other further relief the Court deems just and proper.

Dated: January 14, 2009
Wilmington, Delaware

Respectfully submitted,



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EXHIBIT A

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authorities (the "Taxing Authorities") in the ordinary course of business, on an unaccelerated basis; provided, however, that the Debtor shall not pay prepetition sales, use and franchise tax obligations to the Taxing Authorities in an aggregate amount in excess of \$9.5 million without further permission from the Court.

3. The Debtor is authorized, but not directed, to issue postpetition checks, or to effect postpetition transfer requests, in replacement of any checks or fund transfer requests in respect of prepetition sales and use tax obligations dishonored or rejected as of the commencement of this chapter 11 case.

4. Nothing in this Order or the Motion shall be construed as prejudicing the Debtor's right to contest the amount or basis of any sales, use or franchise tax obligations allegedly due any Taxing Authority, or a waiver of any right to assert property rights in such funds.

5. The requirements as set forth in Bankruptcy Rule 6003(b) are satisfied by the contents of the Motion.

6. This Court shall retain jurisdiction over all matters arising from or related to the interpretation or implementation of this Order.

7. The Debtor, its officers, employees and agents, are authorized to take or refrain from taking such acts as are necessary and appropriate to implement and effectuate the relief granted herein.

Date: January _____, 2009
Wilmington, Delaware

UNITED STATES BANKRUPTCY JUDGE