

**IN THE UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF DELAWARE**

<b>In re:</b>	:	<b>Chapter 11</b>
	:	
<b>ADVANCED MARKETING SERVICES, INC., a Delaware corporation, et al.,<sup>1</sup></b>	:	<b>Case No. 06-_____ ( )</b>
	:	
<b>Debtors.</b>	:	<b>Jointly Administered</b>
	:	
	:	

**DECLARATION OF CURTIS R. SMITH IN SUPPORT OF  
CHAPTER 11 PETITIONS AND REQUEST FOR FIRST DAY RELIEF**

I, Curtis R. Smith, hereby declare:

1. I am Executive Vice President and Chief Financial Officer of Advanced Marketing Services, Inc., a Delaware corporation (“AMS,”), Vice President and Chief Financial Officer of AMS’s wholly owned subsidiary Publishers Group Incorporated, a California corporation (“PGI”), and Senior Vice President, Chief Financial Officer and Secretary of PGI’s wholly-owned subsidiary Publishers Group West Incorporated, a California corporation (“PGW” and, together with AMS and PGI, the “Debtors”). My duties for the Debtors include responsibility for overseeing the daily financial operations of the Debtors, and in this capacity I am familiar with the Debtors’ day-to-day operations, business records and business affairs. I have served as Chief Financial Officer of AMS since December 14, 2004, as Vice President and Chief Financial Officer of PGI since December 20, 2004, and as Senior Vice President, Chief Financial Officer and Secretary of PGW since July 7, 2006. Prior to such times, I acted as Vice President - Controller of AMS. I am intimately familiar with the Debtors’ financial affairs and their related agreements and contracts.

2. I submit this Declaration in connection with the voluntary chapter 11 petitions and first-day motions of the Debtors in the above-captioned chapter 11 cases. Any capitalized term not expressly defined herein shall have the meaning ascribed to that term in the

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<sup>1</sup> The Debtors are the following entities: Advanced Marketing Services, Inc., a Delaware corporation, Publishers Group Incorporated, a California corporation, and Publishers Group West Incorporated, a California corporation.

relevant first-day motion or application. All facts set forth in this Declaration are based on my personal knowledge, upon information supplied to me by people who report to me at the Debtors' operations, upon information supplied to me by the Debtors' professionals and consultants, upon my review of relevant documents, or upon my opinion based on my experience and knowledge with respect to the Debtors' operations, financial condition and related business issues. If I were called upon to testify, I could and would testify competently to the facts set forth herein, and I am authorized to submit this Declaration on behalf of the Debtors.

3. Part I of this Declaration describes the businesses of the Debtors and the relevant background preceding the filing of their chapter 11 petitions. Part II of this Declaration sets forth the relevant facts in support of each first-day motion and application filed by the Debtors concurrently herewith.

## **I. BACKGROUND**

### **A. Introduction**

4. AMS is a wholesaler, and PGW is a distributor, of general interest books and other media to membership warehouse clubs, certain e-commerce companies and other retailers. In addition, through its Advantage Publishers Group division ("APG") division, AMS repackages and publishes various titles for redistribution and sale. The Debtors net sales, excluding intercompany sales, for the fiscal year ended March 31, 2005 were approximately \$822,987,153.

5. As discussed in more detail below, on January 14, 2004, AMS publicly announced a restatement of its financial statements for the years ended March 31, 2003. Although the Debtors have now substantially addressed the numerous business and legal matters arising from the restatement, as of the Petition Date the audit of Debtors' fiscal year 2004 financial statements had not been completed. The failure to complete the audit and the restatement has led to a default under the Debtors' prepetition asset based financing facility, and the financial impact of the restatement and resulting litigation and investigations (described below) has adversely affected their liquidity.

6. In an effort to increase liquidity, the Debtors have been seeking to recapitalize their businesses through a strategic transaction. Aided by their professional advisors, including investment bank Jefferies and Co., Inc. (“Jefferies”), the Debtors have been seeking sources of additional financing, infusions of debtor and/or equity capital, or a sale of their businesses to a strategic or financial investor for approximately eighteen months prior to the Petition Date (as defined below). As discussed in more detail below, the Debtors have entered into confidentiality agreements with, and provided due diligence to, a number of potential investors.

7. Despite the Debtors’ progress toward recapitalizing their businesses, the Debtors were unable to complete a transaction in the timeframe available under the forbearance from Wells Fargo Foothill, Inc. (“Foothill”) or to obtain further forbearances relating to their defaults under the Senior Facility, and no other sources of financing were reasonably available. The Debtors believe that consummation of a strategic transaction or recapitalization through the chapter 11 process will provide certain advantages, particularly with respect to contingent liabilities and other matters related to the restatement. Accordingly, the Debtors intend to continue their sale and refinancing efforts under the protection of chapter 11.

8. On December 29, 2006 (the “Petition Date”), the Debtors filed the instant petitions for relief. I am informed that a motion for joint administration of the Debtors’ bankruptcy cases is pending before the Court. The Debtors are operating their business and managing their affairs as debtors and debtors in possession.

**B. The Debtors**

9. Founded in 1982, AMS has two primary lines of business. First, AMS is a wholesaler of general interest books to membership warehouse clubs – including Costco Wholesale Corporation (“Costco”), SAM’s Club (a unit of Wal-Mart Stores, Inc.) (“SAM’s Club”), and BJ’s Wholesale Club – as well as certain specialty retailers, e-commerce companies, traditional bookstores and bookstore chains. General interest books include bestsellers; basic reference books, including computer and health books; books regarding business and

management; cookbooks; gift books, including art and coffee table books; calendars; travel books; regional books; mass market paperbacks; children's books; and Spanish-language books. AMS obtains most of the books it wholesales directly from publishers, primarily on a fully returnable basis, and it also sells such books primarily on a fully returnable basis.

10. Second, through its wholly owned subsidiary PGW, AMS provides a full range of book marketing and distribution services to smaller publishers under exclusive contractual arrangements. PGW stores such books at its distribution centers and ships them to customers based upon customer requirements, again primarily on a fully returnable basis. PGW also provides these smaller publisher clients with a range of related services, including marketing and publicity; customer service; warehousing and distribution; billing and collections; and sales and inventory reporting. PGW charges publishers fees for these services. PGW markets and sells these books and related products to a wide variety of retail and wholesale trade accounts, including major national chains, wholesalers, local bookstores and certain gift, gourmet and special sales accounts.

11. In addition to these two primary lines of business, AMS's APG division repackages and independently publishes various book titles on its own. Many of the titles distributed by APG were initially published and distributed by a third-party publisher, and APG subsequently repackages them for redistribution and exclusive sale by its warehouse club customers. APG creates and/or publishes the rest of its titles through its own imprints, which include Thunder Bay, Laurel Glen, Silver Dolphin and Portable Press. The self-published titles are typically sold to both warehouse club customers and independent and chain bookstore customers.

12. As of the date hereof, the Debtors serve approximately 1,078 membership warehouse locations in the United States. AMS's headquarters are located in San Diego, California, and the Debtors also maintain offices in Berkeley, California and commercial space in Ashland Oregon and New York, New York. The Debtors operate three U.S. distribution centers located in Baltimore, Maryland, Woodland, California, and Indianapolis, Indiana. The

Debtors' operations employ approximately 808 people, of whom approximately 50 are employed on a part-time basis. Like other book distributors and wholesalers, the Debtors' sales are subject to seasonal fluctuations – approximately 30% of the Debtors' annual sales occur in the third fiscal quarter (October 1 through December 31). As a result of this seasonality, additional employees are typically added during the peak holiday season. The Debtors' corporate office staff consists of approximately 165 employees who are responsible for executive and general operational, management, merchandising, advertising, finance, accounting, human resources, legal and administrative matters.

13. The Debtors lease all of the real property upon which they conduct their operations, including three U.S. distribution centers, executive offices in San Diego, California, office space in Berkeley, California, and commercial space in Ashland Oregon and New York, New York.

### **C. Corporate Structure**

14. The stock of AMS is held by approximately 400 beneficial shareholders, including institutional investors and certain of the Debtors' founders. Until June 14, 2006, AMS was required to file periodic reports with the SEC pursuant to section 13 of the Securities Exchange Act of 1934. PGI is wholly owned by AMS, and PGW in turn is wholly owned by PGI. PGI is a holding company that conducts no operations, but it and PGW are borrowers under the Senior Facility (defined below).

15. In addition to its domestic operations, AMS conducts book wholesaling and distributing operations through wholly owned subsidiaries in a number of foreign countries, including Mexico, the United Kingdom, Australia, New Zealand and Singapore, and through an affiliate in Canada. All of these subsidiaries are wholly owned by AMS. While none of these subsidiaries are guarantors under the Senior Facility, AMS has pledged 66% of its ownership interest in each as collateral.

**D. Principal Indebtedness**

16. AMS, PGW and PGI, as borrowers, the lenders party thereto (the “Senior Lenders”) and Foothill, as agent, are parties to that certain Loan and Security Agreement, dated as of April 27, 2004 (as amended from time to time, the “Senior Facility”). As described in more detail below, the Debtors’ obligations under the Senior Facility are secured by a lien on substantially all of their assets. The Senior Facility is an asset-based lending agreement that provides for a revolving line of credit (the “Revolving Loans”) up to a maximum commitment level of \$90 million. Availability under the Senior Facility is determined by a borrowing base formula based upon the Debtors’ accounts receivable and inventory, subject to adjustments and reserves established by Foothill and the Senior Lenders. The Senior Lenders assert that as of the Petition Date, the Debtors were obligated to the Senior Lenders for the principal amount drawn on the Revolving Loans plus accrued and unpaid interest and certain additional unpaid fees and expenses totaling \$41,514,347.58 (collectively, the “Senior Indebtedness”).

17. The Senior Facility is secured by a first priority security interest on substantially all of the Debtors’ assets, including substantially all of the Debtors’ personal and real property, fixtures, accounts, general intangibles, goods, inventory, intellectual property, equipment, chattel paper, instruments, documents, deposit accounts, letters of credit, banker’s acceptances, commercial tort claims, life insurance policies, receivables, books, records, all products and proceeds of the foregoing, and all cash proceeds and all other cash equivalents and cash collateral (together with all cash, negotiable instruments, documents of title, securities, deposit accounts and other cash equivalents, the “Cash Collateral”). AMS, PGW, PGI and certain of their subsidiaries (collectively, the “Obligors”) and Foothill, as agent, are parties to that certain Intercompany Subordination Agreement dated as of April 27, 2004 (the “Subordination Agreement”). The Subordination Agreement purports to subordinate the payment of all indebtedness, liabilities and other obligations of each Obligor owing to any other Obligor to the payment of the Senior Indebtedness.

18. The Senior Facility imposes numerous restrictions on the Debtors' ability to access their cash. Prior to the Petition Date, virtually all of the Debtors' cash from operations was swept daily into an account controlled by Foothill and applied to the loans outstanding, then readvanced as loans in accordance with the borrowing base formula as established and adjusted by Foothill from time to time. As of the Petition Date the borrowing base formula under the Senior Facility totaled \$64,764,447.31. In contrast, the Senior Lenders are secured by approximately \$147,500,000 in accounts receivable, approximately \$72,500,000 in inventory, as well as other valuable collateral including AMS's interests in foreign subsidiaries, fixed assets and intellectual property.

**E. Government Investigations and Restatement**

19. On July 23, 2003, AMS was served with a grand jury document subpoena by the United States District Court for the Southern District of California and a related search warrant in connection with an investigation being conducted by the Office of the United States Attorney for the Southern District of California (the "U.S. Attorney's Investigation") related to AMS's cooperative advertising practices and AMS's financial reporting in connection with such practices. On September 29, 2003, AMS received a copy of an Order Directing Private Investigation that had been issued by the Securities and Exchange Commission ("SEC") on September 23, 2003, and thereafter it was served with subpoenas for documents and testimony. AMS believes the SEC's investigation (the "SEC Investigation") involves the same or related matters as those involved in the U.S. Attorney's Investigation and other matters.

20. As a result of internal reviews regarding cooperative advertising and related reporting, on January 14, 2004, AMS publicly announced that it intended to restate its financial statements for the five-fiscal year period ended March 31, 2003. AMS has been working with its independent auditors, Deloitte & Touche LLP, since that time, but to date Deloitte & Touche LLP has not completed its audit of AMS's financial statements for the fiscal years ended March 31, 2004, 2003 and 2002, and AMS has not filed its annual reports on form 10-K or its quarterly

reports for fiscal years ending March 31, 2004, March 31, 2005, March 31, 2006 or March 31, 2007.

21. Following AMS's announcement that it intended to restate its financial statements, a number of purported derivative actions and class actions were commenced against AMS and a number of its current and former officers and directors. Between May and November 2006, AMS entered into settlements of all of the actions and a separate action commenced by AMS against its former directors' and officers' liability insurance carriers. The settlements, to the extent necessary, have been approved by the various courts where such litigation was pending.

22. AMS has incurred significant legal costs in connection with the U.S. Attorney's Investigation and the SEC Investigation and the purported derivative and class actions described above. AMS has also incurred significant legal and accounting costs in connection with the restatement. For the fiscal year ended March 31, 2005, such legal and accounting expenses were approximately \$14,270,953, and for the fiscal year ended March 31, 2006, such expenses were approximately \$6,108,012.

**F. Events Leading to the Debtors' Chapter 11 Filings**

23. Although AMS has now resolved its civil litigation and has substantially reduced its expenses related to the government investigations, these matters have imposed more than a direct monetary toll. The failure to complete the fiscal year 2004 audit and file fiscal year 2004 periodic reports with the SEC constituted a default under the Senior Facility. While earlier amendments of the Senior Facility granted AMS an extension to complete its restatement and file its fiscal year 2004 periodic reports by July 31, 2006, AMS has been unable to satisfy this covenant and Foothill has since declined to grant further extensions or waivers concerning the filing.

24. As a result of the ongoing default, the Debtors entered into a Forbearance Agreement with Foothill dated as of July 31, 2006 (the "Forbearance Agreement"). Pursuant to the Forbearance Agreement, in exchange for forbearance fees of approximately \$2,400,000,



Foothill temporarily agreed to modify borrowing base requirements and agreed to forbear for 90 days from exercising remedies under the Senior Facility. The Debtors were unable to refinance the Senior Facility during that period. On October 31, 2006, the Debtors and Foothill entered into an amendment to the Forbearance Agreement (the "Forbearance Amendment"), pursuant to which the Debtors paid forbearance fees of approximately \$1,500,000 to extend the forbearance until December 27, 2006, which forbearance was extended for an additional day on December 27, 2006.

25. In an effort to address their liquidity and other issues arising from the restatement effort, the Debtors, aided by their professional advisors, including Jefferies, have been seeking to recapitalize their businesses through a strategic transaction. Since on or about July 13, 2006, AMS has engaged in discussions with various parties with respect to recapitalization of their businesses, including through refinancing the Senior Facility, obtaining additional debt or equity financing for the Debtors, and/or selling their business or assets to a strategic or financial investor. The Debtors have received substantial investor interest, with multiple third parties executing non-disclosure agreements and conducting diligence. Despite the Debtors' progress toward recapitalizing their businesses, the Debtors were unable to obtain further forbearances relating to their defaults under the Senior Facility, and no other sources of financing were reasonably available.

26. Accordingly, the Debtors have commenced these chapter 11 cases to pursue a recapitalization or strategic transaction while preserving the going-concern value of their estates with the continued access to capital available under their debtor in possession financing facility. The Debtors believe that consummation of a strategic transaction or recapitalization through the chapter 11 process will provide certain advantages, particularly with respect to contingent liabilities and other matters related to the restatement. Accordingly, the Debtors intend to continue their sale and refinancing efforts under the protection of chapter 11.

## **II. FIRST-DAY MOTIONS**

27. The Debtors have requested various types of relief in “first-day” motions (collectively, the “First Day Motions”) in order to minimize the adverse effects of the commencement of their chapter 11 cases on their business. I believe that a critical and necessary element in successfully reorganizing the Debtors is the approval of the Debtors’ First Day Motions. The factual background and support of each First Day Motion is set forth below.

**A. Motion of Debtors and Debtors in Possession for an Order Directing Joint Administration of Related Chapter 11 Cases**

28. I am informed by counsel that the joint administration of the Debtors’ cases will facilitate and promote an economically efficient administration of these cases, permit the Clerk of the Court to utilize a single general docket for these cases, and combine notices to creditors of the Debtors’ respective estates and other parties in interest which will result in savings to the estates.

29. I am further informed by counsel that, if joint administration is ordered, the Debtors, the Court, creditors and other parties in interest will be able to avoid incurring considerable unnecessary time and expense in connection with, among other things, the need to file duplicative motions, enter duplicative orders, and forward duplicative notices to creditors and other parties in interest.

30. Additionally, I am informed by counsel that joint administration will further enable parties in interest in these chapter 11 cases to be aware of the various matters before the Court in all of the Debtors’ cases.

31. Consequently, I believe and submit that the joint administration of these chapter 11 cases is in the best interest of the Debtors, the Debtors’ estates, their creditors and other parties in interest.

**B. Motion of the Debtors and Debtors in Possession For Interim and Final Orders Pursuant to Sections 361, 362, 363 and 364 of the Bankruptcy Code, Bankruptcy Rules 4001(b) and (c), and Local Rule 4001-2, (A) Authorizing Debtors to Incur Postpetition Indebtedness, (B) Granting Security Interests and Superpriority Expense Claims and (C) Authorizing Use of Cash Collateral**

32. By this Motion, the Debtors seek entry of the Interim Order authorizing, on an interim basis and final basis, (A) incurrence of postpetition indebtedness, (b) granting security interests and superpriority administrative expenses and (C) authorizing the use of Cash Collateral, all pursuant to the terms and conditions of a debtor in possession credit facility (as defined in the Motion, the “DIP Loan Facility”) as set forth in that certain Amended And Restated Loan And Security Agreement (Debtor In Possession) by and among AMS, PGI and PGW as borrowers (collectively, the “Borrowers”), Foothill, as agent, and the Senior Lenders, as lenders (as amended from time to time, the “DIP Loan Agreement,” a form of which (without exhibits and schedules) is attached to the Motion as Exhibit B).<sup>2</sup> The Debtors have obtained the express consent of the Senior Lenders to use Cash Collateral in connection with the DIP Loan Facility and subject to the terms summarized in the Motion and as more particularly set forth in the Order submitted in connection with the Motion.

33. Under the DIP Loan Facility attached to the Motion, the Debtors will obtain from Foothill and the Senior Lenders cash advances and other extensions of credit in an aggregate principal amount of up to \$75 million. Attached as Exhibit B-1 to DIP Credit Agreement is a budget related to the DIP Loan Facility (the “Budget”). The Budget runs through March 30, 2007. I participated in the preparation of the Budget in conjunction with personnel from Capstone Advisory Group, LLC (“Capstone”), a financial advisor to AMS. This Budget sets forth the expenditures that the Debtors critically need to make in order to allow them to continue to operate as a viable going concern.

34. In filing these bankruptcy cases, the Debtors intend to continue to operate their businesses and provide services to their customers in the ordinary course. To achieve this

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<sup>2</sup> The Debtors are seeking approval of the DIP Loan Agreement in substantially the form attached hereto.

goal and preserve their estates, the Debtors need continued access to their lines of credit postpetition.

35. The Senior Lenders provide liquidity necessary for the Debtors' operations, and thus continued access to their lines of credit is essential for the Debtors' continued operations. The Debtors have operated under the Senior Facility since April 2004. The Senior Lenders have agreed to continue to provide liquidity through the DIP Loan Facility. The Debtors will bring these cases with limited cash and will have substantial expenses associated with purchases of inventory and related shipping costs in the first weeks of the case. See Budget, attached as Exhibit B-1 to the DIP Credit Agreement.

36. The DIP Loan Facility carries forward many of the terms of the Debtors' prepetition facility, giving them access to sufficient credit to continue operations. Absent immediate and continued availability of credit, the Debtors' operations will be severely disrupted, and they will be forced to cease or sharply curtail operations of some or all of their businesses, which in turn will eliminate the Debtors' ability to generate operating revenue and the value of their businesses as a going concern.

37. Before agreeing to enter into the DIP Loan Facility with Foothill and the Senior Lenders, the Debtors engaged in an extensive process to refinance the Secured Facility. As part of that process, the Debtors engaged in numerous discussions concerning secured and unsecured financing, as well as equity or other infusions, with several potential investors. Despite these efforts, the Debtors received only one proposal for debtor in possession financing other than that offered by the Senior Lenders. Upon evaluation, however, the Debtors determined that the alternate proposal was not viable as it would have provided less liquidity and it would have required a consensual priming of the Senior Lenders' liens.

38. The Debtors believe the DIP Loan Facility provides the only and best reasonably available and viable financing package available to the Debtors at this time, based upon Foothill's familiarity with the Debtors' operations and collateral, the ability to enter into the DIP Loan Facility on short notice, and other factors. In addition to the affirmative reasons

supporting obtaining debtor in possession financing with the Senior Lenders, no other prospective lender was willing to provide debtor in possession financing without at least the type of protections afforded the Senior Lenders under the DIP Loan Facility.

39. As negotiated, the DIP Loan Facility will enable the Debtors to pay operating expenses, compensate their employees, purchase inventory and otherwise maximize the going concern value of their estates. The Debtors' ability to maximize their value is dependent upon their ability to obtain post-petition credit for these purposes, and the DIP Loan Facility is the best alternative available to them.

40. The Debtors negotiated the terms of the DIP Loan Facility with Foothill and the Senior Lenders at arms' length and in good faith, and all parties were represented by counsel. The Debtors believe that the negotiated terms are fair and reasonable under the circumstances.

**C. Motion of the Debtors and the Debtors in Possession for an Order Authorizing the Debtors to Satisfy Prepetition Claims of Certain Common Carriers Pursuant to Section 105(a) of the Bankruptcy Code**

41. By this Motion, the Debtors seek entry of an order that authorizes, but does not direct, the Debtors to pay in their sole discretion the valid prepetition claims or any portion thereof of certain reputable domestic and international common carriers, shippers, freight forwarders and truckers (collectively, the "Common Carriers") that the Debtors use in the ordinary course of business shipment, transport and delivery of goods.

42. The Debtors receive goods through various forms of shipment, and much of the Debtors' pricing policies, marketing strategies and fundamental business operations rely on their ability to obtain and sell goods at competitive prices. The distribution and sale of books, other media, related accessories, and other items (the "Merchandise") is the essence of the Debtors' business.

43. The Debtors' ability to timely receive, distribute and fulfill sales depends on the maintenance of a successful and efficient system of transportation, and any disruption of the delivery or return of Merchandise would have an immediate and devastating impact on the

Debtors' operations. Likewise, any disruption in the Debtors' ability to sell Merchandise would have an equally immediate and devastating impact on the Debtors' operations. Thus, the maintenance of the Debtors' business operations and the preservation of their going-concern value depend on the maintenance of reliable and efficient transportation and sale processing systems for Merchandise, and these two related and important systems involve the use of the Common Carriers.

44. The Debtors must ensure that their chapter 11 cases do not cause third parties such as the Common Carriers to cease performing timely services because the Debtors are in many cases dependent on the services of such third parties. If the Debtors are unable to ship, receive and sell deliveries of Merchandise on a timely and uninterrupted basis, their operations will be immediately and substantially impeded and their business will suffer irreparable damage.

45. The Debtors' choice of Common Carriers is based upon selecting the most efficient vendor in any market. The use of substitute vendors in any market would not only increase the vendors' shipping costs materially, but it would also jeopardize the availability of shippers in certain markets. The Debtors have identified the Common Carriers necessary to the continued efficient operation of their businesses that consist of, without limitation, the entities listed on Exhibit A attached hereto. The Debtors have determined that each of the Common Carriers is absolutely necessary to the continued shipping, delivery and return of goods used or sold in the ordinary course of the Debtors' business.

46. Prior to the Petition Date, the Debtors performed an analysis of (i) the Merchandise that was in transit or needed to be shipped by the Common Carriers, (ii) the anticipated amount of payments that would be necessary for the Debtors to receive the Merchandise in transit, and (iii) the anticipated amount of payments that would be necessary for the Debtors to continue receiving the services provided by the Common Carriers.

47. Merchandise valued at approximately \$16,000,000 is currently being shipped at the Debtors' expense in respect of returns to certain of the Debtors' publishers and in respect of goods purchased from certain of the Debtors' publishers. The total estimated amount

owed to all Common Carriers in respect of all prepetition services is approximately \$400,000, and the Debtors believe that the maximum amount required to obtain or deliver the Merchandise currently in transit is approximately \$170,000. Further, the Debtors intend to negotiate with the Common Carriers to obtain continued services with less than full payment of the amounts due to such Common Carriers with respect to services provided prior to the Petition Date, although they seek Court approval for payments of amounts related to the prepetition services provided by Common Carriers.

**D. Motion of the Debtors and Debtors in Possession for an Order Authorizing the Debtors and Debtors in Possession to (I) Continue all Insurance Policies and Agreements Relating Thereto, (II) Continue Certain Premium Financing Arrangements Relating Thereto, and (III) Honor Certain Obligations in Respect Thereto Pursuant to Section 105(a) and 363(b) of the Bankruptcy Code**

48. Pursuant to sections 105(a) and 363(b) of the Bankruptcy Code, the Debtors seek authorization to: (i) maintain and continue to make all postpetition payments (including postpetition fees and premiums) with respect to the Insurance Policies and the Premium Finance Agreement on an uninterrupted basis; (ii) to maintain and continue on an uninterrupted basis the Debtors' prepetition practices with respect to each policy or contract; (iii) pay any prepetition premiums related to the Insurance Policies to the extent that the Debtors determine, in their discretion, that such payment is necessary to avoid cancellation, default, alteration, assignment, attachment, lapse or any form of impairment to the coverage, benefits or proceeds provided under the Insurance Policies; and (iv) enter into new policies or assume existing policies in the ordinary course of business.

49. In connection with the operation of the Debtors' business and the management of their properties, the Debtors maintain various insurance policies through third-party insurance carriers (the "Insurance Carriers") providing coverage for general liability, worker's compensation, property, foreign liability, fiduciary liability relating to retirement plans, commercial crime, umbrella, excess liability, automobiles, directors' and officers' liability, accounts receivable, transit or cargo, terrorism, kidnap and ransom, and publishers' errors and

omissions (the “Insurance Policies”). A list of the Insurance Policies, the annual premium for each Insurance Policy, the expiration date of each Insurance Policy, and the Insurance Carrier with respect to each Insurance Policy is attached to the Motion as Exhibit A thereto.

50. The Debtors obtain certain of their Insurance Policies through Lockton Insurance Brokers, Inc. (“Lockton”) and through Carpenter Moore Insurance Services, Inc. (“Carpenter Moore”).<sup>3</sup> Pursuant to an insurance broker fee agreement dated as of September 8, 2006 among Lockton and AMS (the “Broker Fee Agreement”), AMS agreed to pay commissions to Lockton. The remaining payment to Lockton under the Broker Fee Agreement for an amount of \$25,000 is due on February 8, 2007.

51. The Insurance Policies are essential to the preservation of the Debtors’ businesses, properties and assets, and, in many cases, such insurance coverage is required by various regulations, laws and contracts that govern the Debtors’ business conduct. Since the Insurance Policies are essential to the Debtors’ businesses and restructuring, the Debtors believe it is in the best interests of their estates to permit the Debtors to honor their obligations under the current insurance contracts. Any other alternative would likely require considerable additional cash expenditures and would be detrimental to the Debtors’ reorganization efforts. In order to prevent such a scenario, the Debtors request the following authority:

**(i) Authority to Pay Insurance Policy Premiums**

52. The Debtors request the authority to pay any prepetition premiums related to the Insurance Policies to the extent that the Debtors determine, in their discretion, that such payment is necessary to avoid cancellation, default, alteration, assignment, attachment, lapse or any form of impairment to the coverage, benefits or proceeds provided under the Insurance Policies. Although the Debtors are not presently aware of any such premium obligations or the

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<sup>3</sup> The Debtors purchased certain property, general liability and automobile insurance policies from Lockton and certain of their directors’ and officers’ liability insurance policies from Carpenter Moore. While Lockton and Carpenter Moore sell and collect the premium payments on such insurance policies, actual underwriting is performed by other insurance carriers. Because these policies are provided by other carriers, the Debtors have not listed Lockton or Carpenter Moore on Exhibit A to the Motion.



necessity of such payment, the Debtors seek this authority out of an abundance of caution, in recognition of the critical necessity of keeping their insurance policies in current effect, and out of concern that if the necessity for such a payment arises in the future, the passage of time while the Debtors seek and obtain the Court's authority for such a payment may have irreversible adverse consequences for the Debtors' coverage under the Insurance Policies.

53. The Debtors request the authority to continue to pay the premiums due under the Insurance Policies in the ordinary course of business. This will ensure that (a) the insurance coverage provided under the Insurance Policies is not interrupted and (b) the Debtors are not forced to procure hastily-arranged replacement insurance coverage on less favorable terms and conditions. The Insurance Policies provide the Debtors with essential insurance coverage. Any interruption in such coverage would expose the Debtors to serious risks, including: (a) the possible incurrence of direct liability for the payment of claims that otherwise would have been payable by the insurance carrier under the Insurance Policies; (b) the possible incurrence of material costs and other losses that otherwise would have been reimbursed by the Insurance Carrier under the Insurance Policies; (c) the possible loss of good-standing certification to conduct business in states that require the Debtors to maintain certain types and levels of insurance coverage; (d) the possible inability to obtain similar types and levels of insurance coverage; and (e) the possible incurrence of higher costs for re-establishing lapsed policies or obtaining new insurance coverage. Insurance premiums with respect to the Debtors' property and general liability, transit or cargo, commercial crime, terrorism, kidnap and ransom, publishers' error and omissions, umbrella, excess liability, foreign liability, fiduciary liability relating to retirement plans and automobile policies are financed with AFCO Acceptance Corporation ("AFCO").

**(ii) Authority to Maintain the Premium Finance Agreement**

54. To maintain their insurance coverage, the Debtors often are required to prepay the full premiums for the applicable coverage period. Prepaying the full premiums imposes a significant financial burden on the Debtors. To lessen this burden, prior to the Petition

Date, the Debtors entered into a premium financing agreement with AFCO to finance the premiums of certain of their Insurance Policies (collectively, the “Financed Insurance Policies”).<sup>4</sup>

55. Under that certain Premium Finance Agreement dated as of November 21, 2006, by and among AFCO and AMS (the “Premium Finance Agreement”), AFCO pays the premiums due under the Financed Insurance Policies, and the Debtors are then obligated to repay the amount financed through periodic installments over the term of the Premium Finance Agreement. The current installment payments are approximately \$35,469 per month. The final installment pursuant to the Premium Finance Agreement is due in August 2007.

56. The Debtors must be permitted to maintain the Premium Finance Agreement. If the Financed Insurance Policies are allowed to lapse and the Debtors experience a corresponding lapse in the Financed Insurance Policies as a result, the Debtors could be exposed to substantial liability for damages to persons or property or for losses incurred by the Debtors and others. I am informed by counsel that this would also cause the Debtors to violate the guidelines of the Office of the United States Trustee, which require the Debtors to maintain the Insurance Policies.

57. Moreover, if postpetition installment payments under the Premium Finance Agreement are not paid as they come due, AFCO may seek relief from the automatic stay to terminate the Financed Insurance Policies.<sup>5</sup> If AFCO succeeds in such a request, the Debtors would be forced to seek replacement insurance coverage. Even if the Debtors were able to purchase replacement insurance coverage, it is doubtful that the Debtors would be able to do so on terms and conditions as favorable as those presently in place under the Financed Insurance Policies. Given the current circumstances, there is no assurance that the Debtors would be able

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<sup>4</sup> The Financed Insurance Policies include certain policies providing coverage to certain of the Debtors’ foreign affiliates. The Debtors intend to seek reimbursement from such foreign affiliates for any premiums in respect of these policies.

<sup>5</sup> Pursuant to the Premium Finance Agreement, the Debtors assigned to AFCO all sums payable with reference to the Insurance Policies as security for payment of the Premium Finance Agreements.

to obtain replacement insurance quickly enough to prevent a lapse in coverage. A portion of the annual premiums have been paid on the underlying Financed Insurance Policies. Granting the Motion will permit the remaining premium to be satisfied and policies to remain in place.

58. Accordingly, the Court should permit the Debtors to continue their premium financing arrangements. The Debtors also request permission to enter into any new premium financing agreements in the ordinary course of business.

**(iii) Authority to Pay Workers' Compensation Deductibles**

59. Under the laws of the various states in which the Debtors operate, the Debtors are required to maintain workers' compensation liability insurance and to provide employees with workers' compensation coverage for claims arising from or related to their employment with the Debtors. The Debtors have purchased workers' compensation policies (the "Workers' Compensation Policies"), which are issued by Liberty Mutual Insurance Company ("Liberty Mutual"). The Debtors pay estimated annual aggregate premiums of approximately \$214,303 (inclusive of certain taxes and surcharges) regardless of the number or amount of claims made under the policies. The current installment payments are approximately \$15,627 per month, and the next installment payment is due January 1, 2007. The term of the Workers' Compensation Policies is from October 1, 2006 through October 1, 2007.

60. The Debtors are also liable to Liberty Mutual for a deductible portion of the claims made against workers' compensation policies issued by Liberty Mutual for the periods from October 1, 2001 through October 1, 2003 and January 1, 2005 through the present (collectively, the "Liberty Mutual Policies"). Although the Debtors believe they are current in payments of the premiums for the Workers' Compensation Policies as of the Petition Date, the Debtors believe that it is likely they will be required to reimburse Liberty Mutual for deductible payments in respect of claims paid under the Liberty Mutual Policies.<sup>6</sup> The Debtors have

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<sup>6</sup> Deductible payments relating to the Liberty Mutual Policies for the coverage period from October 1, 2001 through October 1, 2003 are billed in April of each year, while deductible Payments relating to the Liberty Mutual Policies for the coverage period from January 1, 2005 through present are billed on the first of each month.

obtained a letter of credit in the amount of approximately \$617,000 in favor of Liberty Mutual to secure their obligations with respect to the deductibles for all claims made under the Liberty Mutual Policies. The Debtors do not believe that the aggregate amount of deductibles for claims accruing prepetition will exceed the amount of the letter of credit, which secures claims accruing through October 1, 2007.

61. Additionally, the Debtors are liable for a deductible portion of claims made under workers' compensation policies issued by St. Paul Fire and Marine Insurance Co. ("St. Paul") for the period from October 1, 2003 through January 1, 2005 (collectively, the "St. Paul Policies"). The Debtors believe that it is likely they will be required to reimburse St. Paul for deductible payments in respect of claims paid under the St. Paul Policies.<sup>7</sup> The Debtors have obtained a letter of credit in the amount of approximately \$374,000 in favor of St. Paul to secure their obligations with respect to the deductibles for all claim made under the St. Paul Policies. The Debtors do not believe that the aggregate amount of deductibles for claims accruing during the coverage period of the St. Paul Policies will exceed the amount of the letter of credit.

**(iv) Authority to Enter into Additional Insurance Policies**

62. Finally, because most of the remaining insurance policies expire annually, the Debtors seek authority to renew their Insurance Policies or enter into new Insurance Policies on competitive terms without further Court approval. As the time for payment and renewal of these policies arrives at different times of the year, the Debtors may not be able to renew the Insurance Policies on time and could be forced to pay higher rates and/or expend money to acquire a new provider. As the Insurance Policies must be renewed at different times, the Debtors would be forced to appear in Court continuously to renew their Insurance Policies, a procedure that would impose an extraordinary burden on the Debtors' estates and restructuring efforts.

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<sup>7</sup> Deductible payments relating to the St. Paul Policies are billed monthly.

63. Clearly, the Debtors will need to continue their Insurance Policies throughout the duration of these chapter 11 cases. The Debtors respectfully suggest that the renewal or negotiation of these Insurance Policies falls squarely within their ordinary course of business and, counsel informs me that, but for the constraints of section 363 of the Bankruptcy Code, the Debtors would not need the Court's prior approval to enter into insurance policies. To reduce the administrative burden of these chapter 11 cases, as well as the expense of operating as debtors in possession, the Debtors seek the Court's authority now to renew their Insurance Policies or enter into new Insurance Policies at the conclusion of the term of the current Insurance Policies including the entry into any premium financing arrangements therefor.

**E. Motion of the Debtors and Debtors in Possession for an Order Authorizing the Debtors to Pay Prepetition Wages, Compensation and Employee Benefits Pursuant to Sections 105(a) and 363(b) of the Bankruptcy Code**

64. By this Motion, the Debtors seek entry of an order that (i) authorizes but does not direct the Debtors to pay Employee Obligations, Employee Deductions and Employee Expenses (as defined herein), (ii) authorizes but does not direct the Debtors to continue their practices, programs and policies in effect as of the Petition Date with respect to all Employee Obligations (including allowing Employees (as defined herein) to use paid time off accrued, but unused, as of the Petition Date), Employee Deductions and Employee Expenses and (iii) authorizes and directs the bank at which the Debtors maintain an account from which the Debtors' payroll obligations are disbursed and all other banks or lending institutions maintaining payroll and employee benefits accounts to honor and pay all prepetition and postpetition checks issued or to be issued and fund transfers requested or to be requested by the Debtors in respect of the Employee Obligations, Employee Deductions and Employee Expenses. The Debtors also seek authority to issue new postpetition checks or fund transfer requests with respect to prepetition obligations that may have been dishonored by the banks in respect of the Employee Obligations, Employee Deductions and Employee Expenses, if necessary.

(i) **Salaries and Wages**

65. The incremental employee expenses will be modest as described in the Motion. The Debtors employ in the aggregate approximately 808 employees, of whom approximately 758 are full time and 50 are part-time (collectively, the “Employees”). Counsel informs me that, as a result of the commencement of the Debtors’ chapter 11 cases, and in the absence of an order of the Court providing otherwise, the Debtors will be prohibited from paying or otherwise satisfying their prepetition obligations to the Employees, including their obligations under various wage, salary, retirement, healthcare, and various other benefit programs (collectively, the “Employee Obligations”). In addition, counsel has informed me that checks, wire transfers and direct deposit transfers issued in respect of the Employee Obligations will be dishonored. To ensure that employees do not terminate their employment at this critical time for the Debtors, and to minimize the personal hardship the Employees would suffer if prepetition employment-related obligations are not paid or honored when due, the Debtors seek authority to honor, in their discretion, such obligations, including those described above.

66. The Debtors’ petitions for relief under chapter 11 of the Bankruptcy Code will very likely cause the Employees to question their future employment prospects with the Debtors. While the Employees have demonstrated loyalty to the Debtors despite the uncertainty during the months prior to the commencement of these cases, their search for a sense of stability with regard to compensation and benefits may lead to an epidemic of Employee departures. A significant deterioration in morale among Employees at this critical time undoubtedly would have a devastating impact on the Debtors, their customers, the value of their assets and business and their ability to maximize value.

67. The Employees are essential to the success of the Debtors’ business. The cost of replacing and then retraining Employees will outweigh the cost of honoring the prepetition Employee Obligations. Any significant number of Employee departures or deterioration in morale at this time will substantially and adversely impact the Debtors’ businesses and result in immediate and irreparable harm to the creditors and estates.

Consequently, it is critical that the Debtors continue in the ordinary course the personnel policies, programs and procedures that were in effect prior to the Petition Date. If the checks issued and fund transfers requested in payment of the Employee Obligations are dishonored, or if such accrued obligations are not timely honored postpetition, the Employees will suffer extreme hardship and may be unable to pay their daily living expenses. Likewise, it would be inequitable to require the Employees to bear personally any business expenses that were incurred on behalf of the Debtors with the expectation that they would be reimbursed.

68. In the ordinary course of their businesses, the Debtors make payroll direct deposits and issue payroll checks on a bi-weekly basis. The Debtors' last payroll direct deposits and checks prior to the Petition Date relating to the two week period from December 2, 2006 through December 16, 2006 were issued on December 22, 2006 and were thus approximately six days in arrears, reflecting wages earned in the two week period up to and including the Saturday of the prior week. The next scheduled payday for Employees is January 5, 2007 and will relate to the two week pay period from December 17, 2006 through December 31, 2006 and thus includes some amounts earned prior to the Petition Date. Most of the prepetition payments were made through direct deposit as the Debtors endeavored to pay prepetition wages prior to filing; thus, the impact of payment of any remaining balances under the Motion will be minimal. The Debtors estimate that outstanding prepetition amounts for the payroll of the Employees as of the Petition Date is approximately \$1,190,066.84, or approximately \$1472.86 per Employee.<sup>8</sup>

69. The Debtors also utilize in the ordinary course of business contract labor and temporary workers (collectively, the "Contract Workers"), either on an individual basis or through various employment agencies. The greater portion of the Contract Workers are provided by employment agencies and fulfill critical operations and distribution functions during the portion of the week that the Debtors process and ship books. These Contract Workers are

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<sup>8</sup> In addition to payroll amounts accrued but unpaid prior to the Petition Date, this amount includes uncashed payroll checks for approximately \$108,259.81 issued to Employees in respect of prior pay periods, \$80,207.41 of which relates to payroll checks issued on December 22, 2006.

essential to the functioning of the Debtors' businesses, providing a significant amount of the labor necessary to operate the Debtors' distribution centers. Similarly, the Debtors also employ writers, artists and other creative personnel as Contract Workers on an individual basis in creating the works published by AMS's APG division, including APG's highly profitable "Uncle John's Bathroom Reader" series, of which several titles are currently in production. Although the Debtors endeavored to pay prepetition expenses in respect of the Contract Workers prior to filing, the Debtors estimate that, as of the Petition Date, approximately \$205,000 remains outstanding in respect of approximately 400 Contract Workers. The Debtors seek permission hereunder to pay prepetition amounts to Contract Workers in the ordinary course of business as Employee Obligations.

70. In the ordinary course of business, approximately 330 Employees of AMS and PGW are eligible to participate in an incentive program (the "Corporate Incentive Program"), which compensates eligible Employees on the basis of corporate performance, business unit performance and individual performance. The Corporate Incentive Program for fiscal year 2007 is effective from April 1, 2006 through March 31, 2007, and compensation in respect of the Corporate Incentive Program is earned upon payment, which is scheduled to occur on or about May 30, 2007. The Debtors estimate that aggregate payments in respect of the Corporate Incentive Program will be between approximately \$619,352 and \$929,028, representing between 2.86% and 4.29% of eligible Employees' base salaries.

71. PGW also compensates its sales personnel in the ordinary course of business pursuant to a sales incentive program (the "Sales Incentive Program," and, together with the Corporate Incentive Program, the "Incentive Programs"). The Sales Incentive Program compensates each eligible Employee on the basis of the net sales generated by such Employee. The Sales Incentive Program is effective from April 1, 2006 through March 31, 2007, and compensation in respect of the Sales Incentive Program is earned upon payment, which is scheduled to occur on or about May 30, 2007. The Debtors estimate that aggregate payments in



respect of the Sales Incentive Program will total approximately \$123,508, representing approximately 5.6% of eligible Employees' base salaries.

72. The Incentive Programs are ordinary course business expenses, and Employees expect to receive payments pursuant to the Incentive Programs as a portion of their salaries. The Debtors seek authorization, but not direction, to continue and modify the Incentive Programs to provide appropriate incentives for Employee management and sales performance during these cases.<sup>9</sup>

73. The Debtors seek authority to continue with their payroll schedule in the ordinary course of business and consequently pay all Employees' prepetition compensation as well, which costs are relatively minimal compared with the size of the Debtors' estates and the damage to the Debtors' chapter 11 cases that would ensue if Employee morale were disrupted by the Debtors' failure to meet the payroll portion of their Employee Obligations.

**(ii) Time-Off Days**

74. The Debtors also seek authority, but not direction, to permit Employees to use paid time off, holidays and bereavement leave, whether accrued before or after the Petition Date (collectively, "Time Off Days"), in accordance with the Debtors' prepetition policies. Regular full-time Employees accrue paid time off, which includes sick days ("Paid Time Off") based on their length of employment.

75. Paid Time Off for qualifying regular full-time distribution center

Employees of AMS accrues as follows:

0 to 4.99 years of service	-	136 annual hours Paid Time Off
5 to 9.99 years of service	-	176 annual hours Paid Time Off
10 or more years of service	-	216 annual hours Paid Time Off

76. Paid Time Off for qualifying full-time Employees of PGW, various

corporate Employees and certain exempt distribution center Employees accrues as follows:

0 to 4.99 years of service	-	160 annual hours Paid Time Off
5 to 9.99 years of service	-	200 annual hours Paid Time Off

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<sup>9</sup> Although the Debtors do not believe that payments under the Incentive Programs are prohibited by the automatic stay, out of an abundance of caution, the Debtors describe the Incentive Programs here and request approval of payment of obligations under the Incentive Programs as Employee Obligations.

10 or more years of service - 240 annual hours Paid Time Off

77. Paid Time Off for qualifying part-time distribution center Employees of

AMS working more than 20 hours per week accrues as follows:

0 to 4.99 years of service - 80 annual hours Paid Time Off  
5 to 9.99 years of service - 104 annual hours Paid Time Off  
10 or more years of service - 128 annual hours Paid Time Off

78. Employees may carry over accrued but unused Paid Time Off hours from year to year in an amount of up to two times their annual accrual of Paid Time Off hours.

However, once Employees have accrued two times their annual accrual of Paid Time Off hours, they will cease accruing Paid Time Off hours until they have used some of the Paid Time Off hours. The Debtors' vacation policy requires that requests for vacation be approved by each Employee's supervisor at least five working days in advance.

79. Prior to the Petition Date, the Debtors' policy was to pay an Employee, upon termination, all accrued unpaid vacation at his/her final rate of pay. As of the Petition Date, Employees had accrued unpaid vacation in amount equal to approximately \$2,086,822, which represents an average of approximately \$2,583 per Employee. The Debtors are not seeking permission hereunder to pay Employees for prepetition unpaid accrued vacation upon termination but, rather, are merely seeking authority to permit Employees to use Paid Time Off accrued prior to the Petition Date in accordance with the Debtors' prepetition policies.

80. Eligible full-time Employees are entitled to nine paid holidays per calendar year and are paid their regular base salary or hourly rate of pay for the number of hours they are regularly scheduled to work in a day. Part-time Employees normally scheduled to work the day of a holiday observed by the Debtors are paid for the holiday.

81. In addition, Employees are entitled to up three consecutive days of paid bereavement leave per calendar year for use in the event of a death of an immediate family member. Unused bereavement leave days do not carry forward from one calendar year to the next. Upon termination, Employees do not receive payment for bereavement leave days not taken in that calendar year.

82. Employees are also entitled to up to 80 hours of paid jury duty leave per calendar year for time spent serving on a jury. Unused jury duty leave hours will not carry forward from one calendar year to the next. Upon termination, Employees do not receive payment for jury duty leave hours not taken in that calendar year.

**(iii) Employee Benefits**

83. As part of the Debtors' Employee Obligations, the Debtors have also established a variety of benefit plans and programs (the "Employee Benefits") designed to assist their Employees and the Employees' eligible dependents in meeting certain financial burdens, including those that arise from illness, disability and death. The Debtors believe that all amounts and obligations related to Employee Benefits accrued prior to the Petition Date have been paid in full except as otherwise noted herein. However, out of an abundance of caution, the Debtors seek authorization, but not direction, to pay or otherwise honor these Employee Benefits.

**(a) Health Plan Benefits**

84. The Debtors have established several health plans. Regular full-time Employees are offered medical benefits through a choice of a health maintenance organization plan administered by CIGNA Healthcare (the "CIGNA HMO Plan"), a point-of-service open access plan administered by CIGNA Healthcare (the "CIGNA POS Plan"), or a participating provider option plan administered by CIGNA Healthcare (the "CIGNA PPO Plan"), and certain PGW Employees are offered a health maintenance organization plan administered by Kaiser Foundation Health Plan, Inc. (the "Kaiser HMO Plan"). Included in the plans are hospitalization, ambulance service, and lab/X-ray treatment. Regular full-time Employees are offered dental benefits through a dental participating-provider option plan administered by Connecticut General Life Insurance Company (the "CIGNA Dental Plan"). Prior to health plan enrollment, an Employee may elect to cover eligible dependents. AMS encourages covered Employees to choose their doctors and hospitals from the CIGNA HMO Plan, the CIGNA POS Plan, the CIGNA PPO Plan and the Kaiser Plan networks to get the greatest benefit coverage.

85. Approximately 471 Employees participate in the CIGNA HMO plan, approximately 14 Employees participate in the CIGNA PPO Plan, approximately 61 Employees participate in the CIGNA POS plan, approximately 33 Employees participate in the Kaiser plan, and approximately 564 Employees participate in the Cigna Dental. The Debtors pay monthly premiums of approximately \$221,496 for the CIGNA HMO Plan, monthly premiums of approximately \$13,950 for the CIGNA PPO Plan, monthly premiums of approximately \$45,889 for the CIGNA POS Plan, monthly premiums of approximately \$12,663 for the Kaiser Plan, and monthly premiums of approximately \$29,304 for the CIGNA Dental Plan.

86. Employees rely on the Debtors to provide continuing medical care. Employee welfare and morale would be significantly harmed if the Debtors were to fail to pay any due amounts with respect to the health insurance plans. As noted above, the Debtors believe that all amounts and obligations related to the health insurance plans prior to the Petition Date have been paid in full. However, out of an abundance of caution, the Debtors request authority to pay any prepetition costs related to the medical insurance benefits in the ordinary course of business.

87. Furthermore, and for similar reasons, the Debtors seek to continue to perform their obligations under section 4980B of the Internal Revenue Code to provide Continuation Health Coverage (“COBRA”) (see 26 U.S.C. § 4980B) with respect to former employees. The Debtors provide their former employees with COBRA administered through TRI-AD, and former employees enrolling in COBRA pay an approximate aggregate amount of \$12,610 per month to the Debtors for COBRA benefits. The Debtors in turn then pay this amount to TRI-AD as monthly premiums for the continued health coverage of these former employees, and the Debtors pay an additional administration fee to TRI-AD in an approximate amount of \$540 per month. As noted above, the Debtors believe that all amounts and obligations related to COBRA benefits prior to the Petition Date have been paid in full. However, out of an abundance of caution, the Debtors request authority to pay any prepetition costs related to COBRA benefits in the ordinary course of business.

**(b) Employee Life and Other Insurance Benefits**

88. The Debtors provide to certain Employees premium-base group life, supplemental life, accidental death and dismemberment (“AD&D”), and other insurance coverage. The Debtors pay Life Insurance Company of North America approximately \$8,416 per month for basic life and AD&D insurance coverage premiums.

89. The Debtors pay Life Insurance Company of North America approximately \$7,123 per month in long term disability insurance coverage premiums. The Debtors also pay Life Insurance Company of North America approximately \$6,281 per month in short term disability coverage.

90. Employees can also elect to obtain vision coverage through participating in a vision plan provided by Vision Service Plan (the “VSP”). In order to participate in the VSP, Employees voluntarily elect to have the contributions deducted from their payroll checks and the Debtors submit those contributions to Vision Service Plan for the insurance coverage. This plan is 100% Employee-paid. The aggregate amount deducted from Employee payroll checks for the VSP insurance coverage on a monthly basis is approximately \$6,624.

91. As noted above, the Debtors believe that all amounts and obligations related to group life, AD&D, disability and other insurance coverage prior to the Petition Date have been paid in full. However, out of an abundance of caution, the Debtors request authority to pay any prepetition costs related to group life, AD&D, disability and other insurance coverage in the ordinary course of business.

**(c) Flexible Spending Benefits Program**

92. Employees who anticipate that they will have health care expenses that are not covered by the insurance plan may elect to participate in the Debtors’ flexible spending account (the “Flexible Spending Account”), administered by TRI-AD. Employees determine what their total annual out-of-pocket expenses will be and how much they wish to set aside for the year. This amount is divided into 26 equal pre-tax deductions for the pay periods throughout the year and is credited to the Employee’s special health care account. Because the deductions

are pre-tax, participating Employees' federal, state and social security taxable wages are reduced. As expenses are incurred, an Employee files claims with TRI-AD, and TRI-AD reimburses the Employee for qualified expenses with a check. The maximum that can be set aside each year is \$4,000. The amount designated must be used by the end of each year, as any unused portion of the amount will not be reimbursed to the Employee (as stipulated by the Internal Revenue Service (the "IRS")).

**(d) Dependent Care Accounts**

93. Employees who pay for care for children under 13, disabled family members or elderly family members are eligible to participate in a flexible spending account for dependent care. Employees who anticipate that they will have dependent care expenses that are not covered by the insurance plans provided by the Debtors may determine what the total annual out-of-pocket expenses will be and how much they wish to set aside for the year. This amount is divided into 26 equal pre-tax deductions for the pay periods throughout the year and is credited to the Employee's special health care account. Because the deductions are pre-tax, participating Employees' federal, state and social security taxable wages are reduced. As expenses are incurred, an Employee may file a claim for reimbursement with TRI-AD and a check will be sent to such Employee up to the amount contributed to their account. The maximum that can be set aside each year is \$5,000. The amount designated must be used by the end of each year, as any unused portion of the amount will not be reimbursed to the Employee (as stipulated by the IRS).

**(e) Retirement Benefits Plan**

94. Any Employee who is at least eighteen (18) years old, after 1000 hours of continuous service, will be automatically enrolled in a 401(k) Savings and Retirement Plan (the "401(k) Plan") administered by the Principal Financial Group. Employees participating in this program are permitted to contribute an unlimited amount of their salary toward their 401(k) Plan account up to the amount of the statutory cap. The Debtors also make contributions representing 50% of the first 6% contributed by each participating Employee to his or her 401(k) Plan account

(collectively, "Matching Contributions").<sup>10</sup> On average, the Debtors make Matching Contributions of approximately \$16,054 during each two-week pay period, and the Debtors expect to make Matching Contributions of approximately \$14,000 during the two-week pay period from December 17, 2006 through December 31, 2006, of which \$12,600 relates to the period prior to the Petition Date. The Debtors pay approximately \$40,000 to the Principal Financial Group per quarter for administration expenses, and the Debtors also pay approximately \$18,000 per year for auditors to review the 401(k) Plan.

95. Further, the Debtors deduct from Employees' paychecks 401(k) Plan contributions and loan payments. The Debtors issue their own payroll checks and make direct deposits through their payroll accounts with California Bank & Trust, and the Debtors forward withheld 401(k) Plan contributions and loan payments. Failure to timely forward these 401(k) deductions may be a violation of the Employee Retirement Income Security Act of 1974, as amended, resulting in potentially personal liability for the Debtors' officers for such deducted amounts. The Debtors estimate that there will be no 401(k) Plan contributions and loan payments as of the Petition Date that have been deducted but not remitted.

96. The Debtors believe that maintaining the 401(k) Plan and continuing to make Matching Contributions are critical in maintaining Employee morale. Accordingly, the Debtors seek authority to continue in their discretion the 401(k) Plan, to make Matching Contributions and to pay administrative and other related expenses to maintain the 401(k) Plan.

#### **(f) Special Programs**

97. The Debtors also offer Employees and their dependents access to an employee assistance program (the "Employee Assistance Program") managed by CIGNA Behavioral Help. Through CIGNA Behavioral Help, Employees and eligible family members may receive treatment for substance abuse, mental health problems and other life issues. The Employee Assistance Program costs the Debtors approximately \$1,622 per month. This program

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<sup>10</sup> Matching Contributions vest depending upon the participating Employee's years of service with the Debtors

provides important benefits to Employees and improves Employee morale at relatively modest cost. The Debtors request authority to pay any costs related to, and to continue with such Employee Assistance Programs and related policies in the ordinary course of business.

**(i) Prepetition Amounts Withheld from Employee Paychecks and Related Deductions and Payments**

98. The Debtors deduct from their Employees' paychecks (as applicable) (i) payroll taxes and the Employees' portion of taxes pursuant to the Federal Insurance Claims Act and unemployment taxes; (ii) Employee contributions for health and disability related benefits, and flexible spending accounts; (iii) Employee contributions to 401(k) Plans; (iv) legally ordered deductions such as wage garnishments, child support and tax levies; and (v) miscellaneous other items (collectively, the "Employee Deductions"). The Debtors forward amounts equal to the Employee Deductions from their operating accounts to appropriate third-party recipients. While the Debtors do not believe that any funds were deducted from Employee paychecks but not forwarded to the appropriate third-party recipients as of the Petition Date, out of an abundance of caution, the Debtors seek authority to forward to the appropriate parties any Employee Deductions that were not forwarded due to the commencement of these chapter 11 cases.

**(ii) Reimbursable Expenses**

99. Eligible Employees may submit certain business-related expenses to the Debtors for reimbursement (collectively, the "Employee Expenses"). These Employee Expenses include relocation, car, hotel stays, meals, parking and other travel expenses and business related costs, as well as monthly telephone and internet allowances for certain approved employees. As of the Petition Date, the Debtors estimate they owe Employees approximately \$74,000 in reimbursements for Employee Expenses.<sup>11</sup> The Debtors seek authority, but not direction, to pay these Employee Expenses and to continue to pay them postpetition in the ordinary course of business.

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<sup>11</sup> This estimate includes Employee Expenses which have not yet been submitted for approval and Employee Expenses which have been submitted but not yet approved.



**F. Motion of the Debtors and the Debtors in Possession for an Order Authorizing the Debtors to Pay Prepetition Sales, Use and Franchise Taxes Pursuant to Section 105(a) of the Bankruptcy Code**

100. By this Motion, the Debtors seek entry of an order pursuant to sections 105, 363 and 507(a) of the Bankruptcy Code that authorizes, but does not direct, the Debtors 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. To the extent that any check payable to a Taxing Authority issued prior to the Petition Date had not cleared the bank as of the Petition Date, the Debtors also seek entry of an order (i) authorizing the Debtors’ banks to honor such checks and/or any prepetition wire transfer requests and (ii) authorizing the Debtors 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.

101. On a periodic basis, the Debtors pay 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 Debtors may hold a significant balance of collected but unremitted Taxes.

102. As of the Petition Date, the Debtors’ financial records indicate that the Debtors are substantially current on their payment of Taxes to all Taxing Authorities. Therefore, the Debtors seek 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 Debtors estimate that the total amount of Taxes collected prepetition but not yet paid is approximately \$3,973.20. The Debtors also estimate that, of this amount, \$286.29 will come due in December and \$3,686.91 will be due in January. These amounts represent a very small fraction of the Debtors’ total assets. The Debtors are seeking

only to pay Taxes as they become due in the ordinary course of the Debtors' business and consistent with prepetition business practices.

103. The Debtors believe that the failure to pay the Taxes could have a material adverse impact on their ability to operate in the ordinary course of business. The Debtors operate distribution centers across the country and many disputes that could impair their ability to conduct business in a particular jurisdiction could affect the Debtors as a whole. Furthermore, the Debtors believe that many Taxing Authorities may cause the Debtors to be audited if certain of the Taxes are not paid, and such audits will unnecessarily divert the Debtors' attention from their 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. Prompt and regular payment of the Taxes will help avoid these unnecessary government actions. Given the potential harm if the Taxes are not timely paid, and the fact that the Debtors intend to pay all Taxes in full, there is no reason why the relief requested in the Motion should not be granted.

**G. Motion of the Debtors and the Debtors in Possession for an Order (A) Authorizing the Continued Use of the Debtors' Centralized Cash Management System, (B) Authorizing Maintenance of the Debtors' Existing Bank Accounts and Business Forms, and (C) Extending the Debtors' Time to Comply With Section 345 of the Bankruptcy Code**

104. By this Motion, the Debtors seek entry of an order pursuant to sections 105(a), 345(b), 363, 364(a), and 364(b) of the Bankruptcy Code and substantially in the form annexed hereto waiving the guidelines (the "U.S. Trustee Guidelines") established by the United States Trustee for the District of Delaware (the "U.S. Trustee") to the extent necessary in order to continue the use of their existing cash management system, including but not limited to the initiation and completion of any intercompany payment and any support transactions. The Debtors also respectfully seek authorization to continue using their prepetition bank accounts and business forms, including a waiver of the requirement that the legend "debtor in possession" be imprinted on any existing checks and business forms, and to continue their use of the existing

cash management system. Finally, the Debtors seek an extension of time to comply with the investment guidelines provided for in section 345(b) of the Bankruptcy Code. The Debtors seek this authorization to insure their orderly entry into bankruptcy and to help efficiently administer their business and avoid the disruptions and distractions that would inevitably divert the Debtors' attention from urgent matters during the initial stages of their bankruptcy cases.

105. I am informed by counsel that one provision of the U.S. Trustee Guidelines requires a chapter 11 debtor in possession to open new bank accounts and close all existing accounts and that the U.S. Trustee Guidelines also require that new bank accounts be opened in certain financial institutions designated as authorized depositories by the U.S. Trustee.

106. The Debtors maintain a number of bank accounts in the ordinary course of business. The bank accounts include without limitation depository, operating, payroll and distribution accounts (collectively, the "Bank Accounts"). Currently the Debtors have accounts with California Bank & Trust ("CB&T"), Comerica Bank, Bank of America, N.A., JPMorgan Chase Bank, N.A., Wells Fargo Bank, National Association ("Wells Fargo"), and Mellon Financial Corporation. A true and correct list of the Bank Account names and account numbers is attached to the Motion as Exhibit A thereto.

107. The Debtors seek a waiver of the U.S. Trustee's requirement that the Debtors close their bank accounts and open new postpetition bank accounts at depositories authorized by the U.S. Trustee. I am informed by counsel that Rule 2015-2(a) of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (as amended from time to time, the "Local Rules") provides that in a chapter 11 case where the debtor uses pre-printed checks, upon motion of the debtor, the Court may, without notice and hearing, permit the debtor to use its existing checks without the designation "debtors in possession" and to use its existing bank accounts.<sup>12</sup>

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<sup>12</sup> Each Debtor will, however, use the designation "debtor in possession" on new check stock and in connection with electronic checks and wire transfers.

108. The Debtors seek a waiver of the requirement that new bank accounts be opened to replace all of the Debtors' existing Bank Accounts because the requirement would unnecessarily disrupt the Debtors' business, impair their efforts to successfully reorganize and would not provide any significant benefit to the Debtors' estates, their creditors or parties in interest. For example, the Debtors' employees would suffer significant hardship if the Debtors were required to substitute new debtor in possession payroll accounts for the existing payroll account and would face attendant delays, confusion and disruption. It is critical to the continued operation of the Debtors' business and the preservation of the value of their assets that the existing cash management system and Bank Accounts continue to be utilized without disruption.

109. In addition, the filing of the Debtors' bankruptcy petitions will undoubtedly be publicized and place a strain on the Debtors' relationships with their customers, vendors and other creditors that are essential to the Debtors' continued operations. If the Debtors are required to substitute new debtor in possession bank accounts for their existing Bank Accounts, these relationships will be further strained by the payment delays and confusion that would result from opening the new accounts. Consequently, the Debtors believe that it is imperative that they be permitted to continue using the existing Bank Accounts to avoid such unnecessary disruption of their business, efficiently administer their bankruptcy cases and devote their efforts to a successful reorganization.

**(i) Maintenance of the Debtors' Existing Business Forms is in the Best Interests of the Estates**

110. The Debtors also request authority to continue to use all existing correspondence and business forms (including, but not limited to letterhead, purchase orders, invoices, etc.), as well as checks, without reference to their "debtor in possession" status, in order to minimize expense to the estates.

111. In the ordinary course of its business, the Debtors use many pre-printed correspondence and business forms. The nature and scope of the Debtors' business and the numerous suppliers of goods and services require that the Debtors be permitted to continue using

their existing pre-printed correspondence and business forms without alteration or modification. Changing correspondence and business forms would be unnecessary and burdensome to the estates, as well as expensive and disruptive to the Debtors' business operations. Parties doing business with the Debtors undoubtedly will be aware, as a result of the size of these cases and the integrated nature of the industry in which the Debtors operate, of the Debtors' status as debtors in possession. Further, opening new debtor in possession accounts would be a significant burden due to the number of accounts that the Debtors maintain. Accordingly, the Debtors also request authority to use their respective correspondence and business forms without placing the label "debtor in possession" on each such correspondence or form.

**(ii) Maintenance of the Debtors' Existing Cash Management System is in the Best Interests of the Estates**

112. I am informed by counsel that the Debtors are affiliates as that term is defined in section 101(2) of the Bankruptcy Code. As affiliated entities, the Debtors maintain a centralized integrated cash management system ("Cash Management System") in the operation of their businesses, as described further below and in the chart attached to the Motion as Exhibit B thereto.

113. Daily cash receipts from the Debtors' customers are initially deposited into depository accounts. The Debtors utilize AMS's depository accounts with CB&T and Wells Fargo and PGW's depository account with CB&T for such transfers. Although these accounts are at different geographic locations, they are fully integrated into the Debtors' centralized cash management system that is utilized in the operation of their business.

114. Because the Debtors have pledged their cash and accounts receivable as security under the Loan and Security Agreement, as amended, dated as of April 27, 2004 (the "Senior Facility"), by and among AMS, PGI, PGW, the lenders party thereto and Wells Fargo Foothill, Inc., as agent for the lenders ("Foothill"), concentration accounts with CB&T were established under the control of Foothill (the "Foothill-Controlled Accounts").<sup>13</sup> Prepetition, all

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<sup>13</sup> The Foothill-Controlled Accounts are CB&T account number 58-150266-70 and CB&T account number 21-201304-81.

funds from the Debtors' depository accounts as well as certain other accounts were automatically swept into or credited to the Foothill-Controlled Accounts on a daily basis.<sup>14</sup> The money swept into the Foothill-Controlled Accounts was then swept on a daily basis to a bank account owned by Foothill and applied to reduce the Debtors' amount outstanding under the Senior Facility. The Debtors' treasury personnel evaluated the Debtors' cash needs on a daily basis. Based on that analysis, the Debtors drew against funds available under the Senior Facility. Funds drawn were transmitted to an operating account at CB&T (the "Operating Account"),<sup>15</sup> and such funds were then utilized to directly pay the Debtors' purchasing and operating expenses by wire transfer or to transfer funds to various accounts that were in turn used by the Debtors to issue checks to pay for their purchases and operating expenses. The Operating Account was also utilized to fund payroll accounts at CB&T for the payment of employee wages, benefits and related costs and expenses for certain Debtors.

115. The Debtors propose to maintain these accounts and the Cash Management System under the DIP Loan Facility. As described in more detail in the DIP Loan Facility and the Motion of the Debtors and Debtors in Possession for Interim and Final Orders Under Sections 361, 362, 363, and 364 of the Bankruptcy Code, Bankruptcy Rules 4001(b) and (c), and Local Rule 4001-2, (A) Authorizing Debtors to Incur Postpetition Indebtedness, (B) Granting Security Interests and Superpriority Expense Claims, (C) Authorizing Use of Cash Collateral, and (D) Granting Other Relief, it is a condition of funding thereunder that Foothill continue to maintain cash dominion over the Debtors' cash collections. The most efficient way to achieve such dominion and to ensure the Debtors' access to credit under the DIP Loan Facility is to maintain the Debtors' prepetition Cash Management System. Moreover, the DIP Loan Facility provides for the progressive paydown of the prepetition Senior Facility to be replaced by new borrowings under the DIP Loan Facility. Foothill is accustomed to the Debtors' existing cash

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<sup>14</sup> Prior to the Petition Date, funds held in the following accounts were automatically swept into or credited to Foothill-Controlled Account number 58-150266-70 on a daily basis: CB&T account number 4134-5321-2790-35, CB&T account number 21-201304-81, and Wells Fargo account number 166023501991.

<sup>15</sup> The Operating Account is CB&T account number 21-201806-61.

management procedures, and continuing the use of such procedures will enhance the Debtors' and Foothill's ability to comply with the terms of the DIP Loan Facility.

116. In addition, certain of the funds from Operating Account are transferred to separate accounts with CB&T relating to PGW's operations and to separate accounts with CB&T, Bank of America, N.A., JP Morgan Chase Bank, N.A., and Comerica Bank relating to the various AMS distribution centers located in northern California, Baltimore, Maryland, Indianapolis, Indiana, and a former AMS distribution center located in Dallas, Texas.<sup>16</sup> These funds are then utilized to pay the purchasing, operating, and employee expenses of PGW and of the various AMS distributions centers.

117. Given the size and complexity of the Debtors' operations, as well as the need to preserve and enhance their respective going concern values, a successful reorganization of the Debtors' businesses simply cannot be accomplished if there is substantial disruption in the Debtors' cash management procedures. It is essential, therefore, that the Debtors be permitted to continue to consolidate management of their cash and transfer money from entity to entity as needed and in the amounts necessary to continue the operation of their businesses. If the relief requested herein is granted, the Debtors will not pay, and each of their banks where the Bank Accounts are maintained will be instructed not to pay, any debts incurred before the Petition Date other than as specifically authorized by this Court.

118. The Cash Management System described herein constitutes the Debtors' ordinary, usual and essential business practices. The Cash Management System is similar to those commonly employed by corporate enterprises comparable to the Debtors in size and complexity. The widespread use of such systems is attributable to the numerous benefits they provide, including the ability to: (a) tightly control corporate funds; (b) insure cash availability; and (c) reduce administrative expenses by facilitating the movement of funds and the development of timely and accurate account balance and presentment information. These

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<sup>16</sup> AMS has closed its Dallas, Texas distribution center. AMS's account with Comerica Bank is used to pay costs associated with the remaining term on the lease for the Dallas, Texas facility.

controls are particularly important here given the significant amount of cash that flows through the Debtors' Cash Management System on an annual basis.

119. In addition, given the corporate and financial structure of the Debtors, it would be difficult, if not impossible, for the Debtors to establish entirely new accounts and a new cash management system. Thus, under the circumstances, maintenance of the Debtors' Cash Management System is not only essential to the Debtors, it is also in the best interests of their respective estates and creditors (of course, the Debtors will continue to maintain strict records with respect to all transfers of cash, so that all transactions can be readily ascertained, traced and recorded properly on applicable intercompany accounts).

120. If the Debtors are not permitted to continue to use their Cash Management System in its current form (modified to the extent necessary by the debtor in possession financing arrangements), their operations will be severely and perhaps irreparably impaired. Accordingly, the Court should authorize the Debtors' continued use of their existing Cash Management System.

**(iii) Cause Exists for Extending the Time for the Debtors to Comply With the Requirements of Bankruptcy Code Section 345(a)**

121. I am informed by counsel that section 345(a) of the Bankruptcy Code authorizes deposits or investments of money of estates, such as the Debtors' cash, only in a manner that will yield the maximum reasonable net return on such funds, taking into account the safety of each deposit or investment. Counsel informs me that, if deposits or investments are not insured or guaranteed by the United States or backed by the full faith and credit of the United States, section 345(b) of the Bankruptcy Code provides that, unless the court for cause orders otherwise, the estate must require the entity with which the money is deposited or invested to obtain a bond in favor of the United States that is secured by the undertaking of an adequate corporate surety.

122. I am also informed by counsel that section 345(b) also expressly provides that the Court may modify these requirements for cause. The Debtors submit that, in the existing



circumstances, cause exists to authorize the Debtors to continue to invest excess cash in substantially the same manner as the Debtors have invested such funds prior to the Petition Date.<sup>17</sup>

**H. Motion of the Debtors and Debtors in Possession for Interim and Final Orders Under Section 366 of the Bankruptcy Code (A) Prohibiting Utility Providers from Altering, Refusing or Discontinuing Service, (B) Deeming Utilities Adequately Assured of Future Performance, and (C) Establishing Procedures for Determining Adequate Assurance of Payment**

123. In the normal course of their business, the Debtors have relationships with certain utility providers (each, a “Utility Provider” and, collectively, the “Utility Providers”) for the provision of natural gas, electricity, telephone, sewer, sanitation and other services (the “Utility Services”). The Utility Providers include, without limitation, the entities set forth on the list attached to the Motion as Exhibit A thereto.<sup>18</sup> The Utility Providers service the Debtors’ operations throughout the United States.

124. Prior to the Petition Date, the Utility Providers provided Utility Services to the Debtors at various locations, including the Debtors’ distribution centers located throughout the United States. Ordinarily, upon receipt of a monthly invoice, the Debtors pay each of the Utility Providers directly for the Utility Services provided during the immediately preceding month. To the best of their knowledge, the Debtors have not had significant defaults or arrearages with respect to their undisputed invoices for Utility Services, other than payment interruptions that may be caused by the commencement of these chapter 11 cases.

125. Because uninterrupted Utility Services are critical to the Debtors’ ongoing operations, the Debtors, by this Motion and pursuant to sections 105(a) and 366 of the Bankruptcy Code, seek entry of interim and final orders: (a) prohibiting the Utility Providers from altering, refusing, or discontinuing Utility Services on account of unpaid prepetition

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<sup>17</sup> On the Petition Date, the Debtors owned stock in certain customers, including Costco, Wal-Mart Stores, Inc., BJ’s Wholesale Club, Office Depot and Staples, Inc. with an aggregate value of approximately \$16,099. All such stock is unrestricted and publicly traded.

<sup>18</sup> The Debtors reserve the right to argue that any of the entities now or hereafter listed on Exhibit A are not “utilities” within the meaning of section 366(a) of the Bankruptcy Code.

invoices; (b) providing that the Utility Providers have “adequate assurance of payment” by virtue of a supplemental two week deposit (a “Utility Deposit”) calculated upon the basis of the average bill over the preceding twelve months; (c) establishing procedures for determining requests for additional adequate assurance of payment; (d) providing that if a Utility Provider timely requests in writing additional adequate assurance that the Debtors believe is unreasonable, then, at the request of the Utility Provider and following a reasonable period for discussion and negotiation, the Debtors shall promptly file a motion for determination of adequate assurance of payment (the “Determination Motion”) and set such motion for a hearing (the “Determination Hearing”); (e) providing that any Utility Provider that does not timely request additional adequate assurance of payment, as provided for herein, shall be deemed to have adequate assurance; and (f) providing that, in the event that a Determination Motion is filed or a Determination Hearing is scheduled, any objecting Utility Provider shall be deemed to have adequate assurance of payment without the need for payment of additional deposits or other securities until an order of the Court is entered to the contrary in connection with such Determination Motion or Determination Hearing.

**I. Motion of Debtors and Debtors in Possession for an Order Establishing Procedures for Reconciliation of Reclamation and Related Claims Pursuant to Sections 105(a), 503(b)(9) and 546(c) of the Bankruptcy Code**

126. The Debtors seek an order establishing procedures for the treatment of reclamation claims. Given the high volume of merchandise received daily by the Debtors, the Debtors anticipate that a number of vendors will attempt, pursuant to section 546(c) Bankruptcy Code, to assert their right to reclaim goods delivered to the Debtors shortly before or soon after the Petition Date and/or to seek immediate payment of an administrative claim under section 503(b)(9) of the Bankruptcy Code. The Debtors estimate that as of the Petition Date, as many as \$24,457,822 in goods may be subject to reclamation claims, and as much as \$20,753,078 in claims may be eligible for administrative priority under section 503(b)(9). As a distribution company, these goods are essential to the Debtors. Moreover, the Debtors business will be severely disrupted if vendors are allowed to exercise their rights to reclaim goods or seek

immediate administrative payment without a uniform procedure that is fair and applicable to all parties.

127. The inventory subject to reclamation is also subject to liens asserted by the Senior Lenders, which take priority. See 11 U.S.C. § 546(c)(1). Similarly, premature payment of administrative or reclamation claims could constitute an event of default under the Debtors' debtor-in-possession credit agreement. Furthermore, absent the establishment of an orderly process for the determination of reclamation or related administrative claims, the Debtors' business operations will suffer and management's attention will be diverted from important operational issues in order to deal with reclamation claims.

128. The relief requested by the Motion will facilitate the continued operation of the Debtors' businesses and should obviate any vendor's perceived need to initiate legal action to preserve or enforce its rights, thereby minimizing potential costs to the Debtors' estates in responding to such litigation. Moreover, the disruption caused by having to administer and analyze reclamation and administrative claims during the first few weeks of these bankruptcy cases would seriously distract the Debtors' management and professionals at a critical period in these cases.

129. Reclamation and administrative claims that are determined in accordance with the procedures described in this Motion to be valid reclamation or administrative claims shall be paid pursuant to the Debtors' plan of reorganization.

**J. Motion of the Debtors and Debtors in Possession For Entry of an Order Authorizing the Retention of Bankruptcy Services, LLC As Noticing, Claims, and Balloting Agent to Pursuant to Section 156(c) of the Judicial Code and Bankruptcy Rules 2002-1(f) and 2014(a)**

130. I am informed and believe that the most effective and efficient manner of noticing the creditors and parties in interest involved in Debtors' chapter 11 cases, and to transmit, receive, docket, maintain, photocopy, and scan claims, is for the Debtors to engage an independent third party to act as the Debtors' notice and claims agent. The Debtors may also require the services of an agent to administer votes regarding a plan of reorganization.

Accordingly, the Debtors seek to employ Bankruptcy Services, LLC. (“BSI”) as notice, claims, and balloting agent to assist the Debtors in distributing notices, as necessary, and to process other information pertaining to these chapter 11 cases. The Debtors believe that BSI is well-qualified to serve in this capacity and that BSI’s retention is in the best interests of the Debtors’ estates and their creditors. The Debtors chose BSI based on its reputation and the competitiveness of its fees.

### **III. ADDITIONAL MOTIONS TO BE HEARD ON REGULAR NOTICE**

#### **A. Motion of Debtors and Debtors in Possession for an Order Authorizing the Retention of Professionals Utilized in the Ordinary Course of Business Pursuant to Sections 327 and 328 of the Bankruptcy Code**

131. The Debtors seek authorization to retain professionals utilized in the ordinary course of business as of the Petition Date and thereafter as may be necessary (the “Ordinary Course Professionals”). The Debtors’ employees, in the day-to-day performance of their duties, regularly call upon certain professionals, including attorneys, accountants, and other professionals to assist them in carrying out their assigned responsibilities.

132. The Debtors seek leave to continue the employment of such Ordinary Course Professionals postpetition without the necessity of filing formal applications for employment and compensation by each professional under the Bankruptcy Code. To request each Ordinary Course Professional to apply separately for approval of their employment and compensation would be unwieldy and burdensome. The uninterrupted service of the Ordinary Course Professionals is vital to the Debtors’ continuing operations and their ability to reorganize. Accordingly, the Debtors request authority to retain, employ and pay the Ordinary Course Professionals without further order of the Court.

133. The Debtors propose that no law firm that is an Ordinary Course Professional will receive payment for postpetition services rendered until such firm files an affidavit with the Court, pursuant to section 327(e) of the Bankruptcy Code, setting forth that such Ordinary Course Professional does not represent or hold any interest adverse to the Debtors

or their estates with respect to matters for which the firm seeks retention (the “Retention Affidavit”).

134. The Debtors propose that all Retention Affidavits be served, by first-class mail, on (1) the Office of the United States Trustee for the District of Delaware; (2) counsel to Wells Fargo Foothill, Inc., as agent for the Debtors’ senior secured creditors; and (3) counsel to any official committees appointed in the case (collectively, the “Notice Parties”).

135. The Debtors also seek to reserve the right to employ Ordinary Course Professionals in addition to those listed on Exhibit A to the Motion by serving a notice of such employment upon the Notice Parties. This notice shall include the Retention Affidavit applicable to such Ordinary Course Professional. The Notice Parties shall have 20 days in which to serve an objection to such employment on the Debtors’ counsel. If none of the Notice Parties objects to the employment of the Ordinary Course Professional, such employment is authorized in accordance with the Order. If an objection is served, the parties shall attempt to resolve their differences or submit the proposed employment to the Court for consideration.

136. The Debtors reserve the right to supplement the list of Ordinary Course Professionals from time to time, as necessary. In such event, the Debtors propose to file a supplemental list with this Court and serve it on the Notice Parties.

137. Unless otherwise stated in the relevant retention application, the proposed ordinary course retention and payment procedures set forth herein will not apply to those professionals for whom the Debtors have filed separate applications for approval of employment.

138. The proposed employment of the Ordinary Course Professionals and the payment of compensation on the basis set forth above is in the best interests of the Debtors’ estates and their creditors.

**B. Motion of Debtors and Debtors in Possession for an Order Granting Extension of Time to File Schedules and Statements**

139. The Debtors are large and complex enterprises with nationwide operations. Because of (a) the substantial size and scope of the Debtors’ businesses, (b) the complexity of

their financial affairs, (c) the limited staffing available to perform the required internal review of their accounts and affairs, and (d) the press of business incident to the commencement of these chapter 11 cases, the Debtors were unable to assemble, prior to the Petition Date, all of the information necessary to complete and file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases and a statement of financial affairs (collectively, the "Schedules and Statements") which counsel informs me are required to be filed pursuant to Bankruptcy Rule 1007 and Local Rule 1007-1(b).

140. Given the urgency with which the Debtors sought chapter 11 relief and the numerous critical operational matters that the Debtors' limited staff of accounting and legal personnel must address in the early days of these cases, the Debtors will not be in a position to complete the Schedules and Statements within the time specified in Bankruptcy Rule 1007 and Local Rule 1007-1(b). Completing the Schedules and Statements for each of the three Debtors will require the collection, review and assembly of information from multiple locations throughout the United States. Nevertheless, recognizing the importance of the Schedules and Statements in these chapter 11 cases, the Debtors intend to complete the Schedules and Statements as quickly as possible under the circumstances.

141. Accordingly, the Debtors respectfully request that the Court extend by an additional 60 days, for a total of 90 days, until March 29, 2007, the date by which the Schedules and Statements must be filed, pursuant to Bankruptcy Rule 1007 and Local Rule 1007-1(b). Counsel informs me that Bankruptcy Rule 1007(c) authorizes the Court to grant an extension of the date by which the Schedules and Statements must be filed "on motion for cause shown." The substantial size, scope and complexity of these cases and the volume of material that must be compiled and reviewed by the Debtors' limited staff in order to complete the Schedules and Statements for each Debtor during the initial days of these chapter 11 cases provides ample "cause" for justifying, if not compelling, the requested extension.

C. **Motion of the Debtors for an Order Providing that Creditors' Committees are not Authorized or Required to Provide Access to Confidential Information of the Debtors or to Privileged Information**

142. By this Motion, the Debtors seek entry of an order of the Court confirming that section 1102(b)(3)(A) of the Bankruptcy Code does not authorize or require any Creditors' Committee that might be appointed in the Debtors' bankruptcy cases to provide access to the Debtors' Confidential Information<sup>19</sup> to any creditor that such Creditors' Committee represents. Furthermore, the Debtors seek entry of an order clarifying that no Creditors' Committee is authorized or required to provide access to Privileged Information<sup>20</sup> to any creditor that such Creditors' Committee represents. The relief requested in the Motion will help ensure that confidential, privileged, proprietary and/or material non-public information will not be disseminated to the detriment of the Debtors' estates and will aid a Creditors' Committee in performing its statutory function.

143. The Debtors are in a highly competitive industry. The dissemination of the Debtors' Confidential Information to parties who are not bound by any confidentiality agreement directly with the Debtors could be disastrous for the Debtors. If the Debtors' general creditors or competitors buying claims could require any Creditors' Committee which may be appointed to

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<sup>19</sup> For purposes of the Motion, the term "Confidential Information" shall mean any nonpublic information of the Debtors, including, without limitation, information concerning the Debtors' assets, liabilities, business operations, projections, analyses, compilations, studies, and other documents prepared by the Debtors or its advisors or other agents, which is furnished, disclosed, or made known to the Creditors' Committee, whether intentionally or unintentionally and in any manner, including in written form, orally, or through any electronic, facsimile or computer-related communication. Confidential Information shall include (a) any notes, summaries, compilations, memoranda, reports or any other written materials disclosing, discussing, containing or reflecting Confidential Information, whether prepared by the Debtors or the Creditors' Committee, their respective, professionals, advisors or members, or others receiving or holding the Confidential Information; (b) any written Confidential Information that is discussed or presented orally; and (c) any other Confidential Information conveyed to the Creditors' Committee orally that the Debtors or their advisors or other agents advise the Creditors' Committee should be treated as confidential. Notwithstanding the foregoing, Confidential Information shall not include any information or portions of information that: (i) is or becomes generally available to the public or is or becomes available to the Creditors' Committee on a non-confidential basis, in each case to the extent that such information became so available other than by a violation of a contractual, legal, or fiduciary obligation to the Debtors; or (ii) was in the possession of the Creditors' Committee prior to its disclosure by the Debtors and is not subject to any other duty or obligation to maintain confidentiality.

<sup>20</sup> For purposes of the Motion, the term "Privileged Information" shall mean any information that is subject to the attorney-client or other state, federal, or other jurisdictional law privilege, whether such privilege is solely controlled by the committee or is a joint privilege with the debtor or a third party.

give them access to Confidential Information in the possession of such Creditors' Committee, such information could easily become public immediately thereafter.

144. The public dissemination of the Debtors' Confidential Information likely would cause serious harm to the Debtors' estates. Among other things, the Debtors' business strategies and intended initiatives would become known to the Debtors' competitors, thereby allowing such competitors to adjust to the Debtors' plans and reduce or eliminate the value of such initiatives to the estate. In addition, other Confidential Information of the Debtors, such as compensation levels or other employee information, is of a sensitive nature, and public disclosure of such information would cause morale and similar problems for the Debtors, as well as potentially violate federal and state privacy laws.

**D. Application By the Debtors For Entry of an Order Authorizing the Employment and Retention of O'Melveny & Myers LLP As Attorneys For the Debtors**

145. The Debtors seek to employ and retain O'Melveny and Myers LLP ("OMM") as their attorneys to file and prosecute the chapter 11 cases and all related matters, effective as of the Petition Date. I believe that OMM has extensive experience and knowledge in the field of debtors' and creditors' rights and business reorganizations under chapter 11 of the Bankruptcy Code.

146. In representing the Debtors for several years on a variety of matters in addition to the preparation of the present filing, OMM has become familiar with the Debtors' businesses and affairs and many of the potential legal issues that may arise in the context of the chapter 11 cases. Accordingly, I believe that OMM is both well-qualified and uniquely able to represent the Debtors in these chapter 11 cases in an efficient and timely manner.

147. As of the Petition Date, the Debtors do not owe OMM for legal services rendered before the Petition Date. All prepetition amounts have been or will be satisfied by the classic retainer and payment disclosed in the declaration of Suzanne Uhland submitted in support of the Debtors' application to retain OMM as general bankruptcy counsel in these chapter 11 cases.



**E. Application By the Debtors For Entry of an Order Authorizing the Employment and Retention of Richards, Layton & Finger, P.A. As Attorneys For the Debtors**

148. The Debtors also have proposed to retain Richards, Layton & Finger, P.A. (“RLF”) as co-counsel in Delaware. RLF will provide additional necessary legal services to the Debtors and will advise the Debtors in connection with the Local Rules and local practice in Delaware in connection with the prosecution of the Debtors’ chapter 11 cases. OMM, the Debtors and RLF have conferred and will continue to confer to ensure that there will be no undue duplication of effort or overlap of work between and among the co-counsel, and that the estates receive the best possible value.

149. As of the Petition Date, the Debtors do not owe RLF for legal services rendered before the Petition Date. All prepetition amounts have been or will be satisfied by the retainer and payment disclosed in the affidavit attached to this motion.

**F. Motion of the Debtors and Debtors in Possession for an Administrative Order Under 11 U.S.C. §§ 105(a) and 331 Establishing Procedures for Interim Monthly Compensation and Reimbursement of Expenses of Professionals**

150. In connection with these cases, the Debtors are filing applications to retain O’Melveny & Myers LLP as their bankruptcy counsel, and Richards, Layton and Finger, P.A. With the likely involvement of additional Professionals, the professional fee application and review process could be exceptionally burdensome on the Debtors, the Professionals, and the Court. Implementation of compensation procedures will provide an efficient structure for disbursing Compensation to the Professionals and will allow all parties to these cases to monitor the monthly accrual of Compensation for each Professional.

**CONCLUSION**

151. The Debtors’ goal in the pending cases is to preserve and maximize the value of their business and successfully reorganize. I believe that, if the Court grants the relief requested in each First Day Motion, the prospect of achieving these objectives will be substantially enhanced to the benefit of the Debtors’ estates, their creditors and other parties in interest.

I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct to the best of my information, knowledge and belief.

Executed this 28<sup>th</sup> day of December, 2006 at San Diego, California



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Curtis R. Smith  
Chief Financial Officer  
Advanced Marketing Services, Inc.  
and its Debtor subsidiaries

**EXHIBIT A**

[Insert 16-Week Cash Flow]

