UNITED STATES BANKRUPTCY COURT

CENTRAL DISTRICT OF CALIFORNIA

RIVERSIDE DIVISION

In re: David L. Farley, Debtor.	Case No.: 6:11-bk-12031-DS Chapter: 11 **MEMORANDUM DECISION RE MOTION FOR RECONSIDERATION OF ORDER APPROVING COMPROMISE OF CONTROVERSY BETWEEN DEBTOR AND FOAMEX INNOVATIONS OPERATING COMPANY** Date: August 25, 2011 Time: 8:30 a.m. Location: Courtroom 304 3420 Twelfth Street Riverside, CA 92501

At the above referenced date and time, the court held a hearing on the "Motion for Reconsideration of Order Approving Compromise of Controversy Between Debtor and Foamex Innovations Operating Company" (the "Motion," docket #47) filed on August 4, 2011 by Sinomax Polyurethanes (Shanghai) Co. Ltd. and Sino Century Development Ltd. (collectively, "Sinomax"). David L. Farley (the "Debtor") and Foamex Innovations Operating Company ("Foamex") oppose the Motion. Marc Winthrop of Winthrop Couchot PC and James Menke appeared on behalf of the Debtor. Ashleigh Danker of Kaye Scholer LLP appeared telephonically on behalf of Foamex. Jeffrey Cawdrey and Philip

Maltin of Gordon & Rees LLP appeared on behalf of Sinomax. All other appearances were entered on the record. After the hearing, the court took the matter under advisement.

Having considered the Motion and related pleadings, the record in this case, the evidentiary objections of the parties, and the arguments of counsel at the hearing, the court makes the following findings of fact and conclusions of law[1] pursuant to Federal Rule of Civil Procedure 52(a)(1),[2] as incorporated by Federal Rule of Bankruptcy Procedure 7052.

I. JURISDICTION

The bankruptcy court has jurisdiction over this contested matter pursuant to 28 U.S.C. §§ 157(b) and 1334(b). Sinomax's Motion is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (O). Venue is appropriate in this court. 28 U.S.C. § 1409(a).

II. INTRODUCTION

When the Debtor filed his bankruptcy case, he was the chief executive officer and sole director/shareholder of Anatomic Global, Inc. ("AGI"), a manufacturer of foam mattresses and other sleep accessories. The Debtor derived all of his personal income from compensation for services rendered to AGI. Foamex was a longstanding supplier of foam products to AGI, and as of the petition date was owed approximately $8.6 million by AGI pursuant to three separate loan and supply agreements. These obligations were secured by substantially all of AGI's assets. The Debtor also personally guaranteed AGI's obligations to Foamex and pledged his 100% ownership interest in AGI to secure his personal guaranty.

In January 2011, Foamex notified AGI and the Debtor that AGI was in default under the parties' loan and supply agreements based on AGI's failure to make certain payments. During the course of negotiations among the Debtor, AGI and Foamex, the Debtor filed his

[1] To the extent that any finding of fact is construed to be a conclusion of law, it is hereby adopted as such. To the extent that any conclusion of law is construed to be a finding of fact, it is hereby adopted as such.

[2] Unless otherwise indicated, all "Code," "chapter" and "section" references are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330 and all "Rule" references are to the Federal Rules of Bankruptcy Procedure ("FRBP") which make applicable certain Federal Rules of Civil Procedure ("FRCP").

chapter 11 petition on January 21, 2011. Foamex, asserting that the Debtor had filed his case to protect his own interest in AGI and thwart the efforts of AGI's creditors, filed an adversary proceeding in this court alleging claims for relief including breach of contract, breach of fiduciary duty and breach of the covenant of good faith and fair dealing. Foamex also filed a motion seeking the appointment of a receiver to control AGI and an injunction preventing the Debtor from transferring any assets of AGI.

Before the court issued any rulings on these matters (other than denying Foamex's application to have its receiver motion heard on shortened time), the Debtor, AGI and Foamex reached a global resolution of their disputes. The Debtor filed a Motion to Approve Compromise under Rule 9019 (the "First Compromise Motion") on March 8, 2011. After notice and a hearing, and absent any objection, the court entered an order granting the Debtor's First Compromise Motion on March 30, 2011 (the "First Compromise Order").

The transactions contemplated under the First Compromise Motion were not consummated, and on May 9, 2011, the Debtor filed a second Motion to Approve Compromise of Controversy and Sale of Certain Patents (the "Second Compromise Motion"). Under the settlement outlined in the Second Compromise Motion, the parties resolved Foamex's claims against AGI and the Debtor (including the Debtor's guaranty of AGI's obligations to Foamex) and Foamex agreed to dismiss the pending adversary proceeding and motion to appoint a receiver. The Debtor agreed to sell certain patents to Foamex for $100,000. Foamex would then form two new entities (a manufacturing entity and a sales entity) that would purchase certain AGI assets, assume certain liabilities and operate an ongoing business using these assets. The Debtor would become the CEO of the newly formed sales entity. The Second Compromise Motion was served in accordance with Local Bankruptcy Rule ("LBR") 9013-1(o) and there was no objection. After reviewing the Second Compromise Motion, the court entered an order granting the motion on May 27, 2011 (the "Second Compromise Order").

On August 4, 2011 – ten weeks after entry of the Second Compromise Order – Sinomax filed its Motion requesting that the court reconsider (i.e., vacate) the Second

Compromise Order to allow Sinomax a chance to object to the underlying terms of the settlement and argue its case at a re-hearing on approval of the compromise. Sinomax's request rested on one allegation: it never received notice of the Debtor's bankruptcy filing nor was included in any of the Debtor's bankruptcy schedules.

The parties agree that Sinomax is the plaintiff in active state court litigation against the Debtor and AGI which has been pending in California state court since August 12, 2008 (the "State Court Action"). At the hearing on the Motion, the Debtor admitted that he did not list Sinomax as a creditor in the bankruptcy case or on the master mailing matrix, did not disclose the pending litigation on the Statement of Financial Affairs and did not notify Sinomax of the bankruptcy filing when the case was filed. Indeed, the Debtor further admitted that he did not disclose the existence of his bankruptcy case for several months after the petition date, during which time he and his litigation counsel attended the Debtor's deposition in the State Court Action and negotiated for a dismissal of the State Court Action against the Debtor. It was not until June 28, 2011 – one day after Sinomax consensually dismissed the State Court Action as to the Debtor and a day before trial was to begin as to AGI – that the Debtor informed Sinomax of his bankruptcy case and the transactions effectuated by the Second Compromise Order. When the judge in the State Court Action was informed that the Debtor had failed to disclose his bankruptcy case until then, he deemed this nondisclosure "outrageous." This court agrees.

The question before this court is not simply whether the Debtor's conduct was outrageous or wrongful; it is whether the Debtor's failure to list Sinomax as a party to litigation – a failure which was at best an egregious oversight and at worst intentional misrepresentation – is cause to set aside the Second Compromise Order and unwind the transactions completed in reliance on the order by the parties to the settlement and the parties that have been conducting business with the new entities formed in connection with the compromise.

III. DISCUSSION

A. Rule 60(b)

Federal Rule of Civil Procedure 60(b),[3] made applicable to bankruptcy proceedings by Federal Rule of Bankruptcy Procedure 9024,[4] permits a court to relieve a party from a final judgment or order for, among other reasons, "fraud, misrepresentation, or misconduct by an opposing party." Fed. R. Civ. P. 60(b)(3); *DeSaracho v. Custom Food Machinery, Inc.*, 206 F.3d 874, 880 (9th Cir. 2000). To prevail, the moving party "must prove by clear and convincing evidence that the verdict was obtained through fraud, misrepresentation, or other misconduct and the conduct complained of prevented the losing party from fully and fairly presenting the defense." *DeSaracho*, 206 F.3d at 880; *Casey v. Albertson's Inc.,* 362 F.3d 1254, 1260 (9th Cir. 2004); *Jones v. Aero/Chem Corp*, 921 F.2d 875, 878–79 (9th Cir. 1990).[5]

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[3] Federal Rule of Civil Procedure 60 provides, in relevant part:

> (b) On motion and just terms, the court may relieve a party . . . from a final judgment, order, or proceeding for the following reasons:
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> (1) mistake, inadvertence, surprise or excusable neglect;
> (2) newly discovered evidence that, with reasonable diligence, could not have been discovered in time to move for a new trial under Rule 59(b);
> (3) fraud, misrepresentation, or misconduct by an opposing party;
> (4) the judgment is void;
> (5) the judge has been satisfied, released or discharged . . .;
> (6) any other reason that justifies relief.

Fed. R. Civ. P. 60(b).

[4] Federal Rule of Bankruptcy Procedure 9024 provides:

> Rule 60 F. R. Civ. P. applies in cases under the Code except that (1) a motion to reopen a case under the Code or for the reconsideration of an order allowing or disallowing a claim against the estate entered without a contest is not subject to the one year limitation prescribed in Rule 60(c), (2) a complaint to revoke a discharge in a chapter 7 liquidation case may be filed only within the time allowed by § 727(e) of the Code, and (3) a complaint to revoke an order confirming a plan may be filed only within the time allowed by § 1144, § 1230, or § 1330.

Fed. R. Bankr. P. 9024

[5] The *Jones* court expounded upon the term "misconduct" as contemplated by the rule:

> "Misconduct" does not demand proof of nefarious intent or purpose as a prerequisite to redress . . . The term can cover even accidental omissions—elsewise it would be pleonastic, because "fraud" and "misrepresentation" would likely subsume it . . . Accidents—at least avoidable ones—should not be immune from the reach of the rule.

Id. at 923

Based on the record before the court, there is little question that Sinomax can establish the existence of "misconduct" within the meaning of Rule 60(b)(3). The Debtor admits he did not list Sinomax on his schedules or statements, either as a creditor or as a party to pending litigation. The Debtor, after reviewing his petition with his bankruptcy counsel, made materially false statements to this court by omitting Sinomax from the petition. The Debtor and his litigation counsel also failed to notify Sinomax of the Debtor's bankruptcy case during pretrial discovery and negotiations in the State Court Action. The excuses made by the Debtor and his attorneys are simply not credible. It is difficult – if not impossible – to imagine that a sophisticated businessman represented by counsel would have mistakenly omitted any mention of Sinomax in his bankruptcy petition and mistakenly neglected to inform Sinomax of his bankruptcy case when the bankruptcy filing happened in the middle of discovery and negotiations in the State Court Action. Even if these omissions do not rise to the level of "fraud" or "misrepresentation" (and this court does not make any findings on this issue), they are admittedly "mistakes" and are certainly glaring failures of judgment and conduct that constitute "misconduct" under Rule 60(b)(3).

The existence of misconduct does not end the inquiry. Although Rule 60(b)(3) is "aimed at judgments which were unfairly obtained . . ." (*DeSaracho*, 206 F.3d at 880, *citing In re M/V Peacock*, 809 F.2d 1403, 1405 (9th Cir. 1987)) and that prevented the losing party from "fully and fairly presenting the defense," the movant must also demonstrate the existence of a "meritorious defense" to obtain relief from a judgment. *See DeSaracho*, 206 F.3d at 880; *Tobel v. City of Hammond*, 94 F.3d 360, 362 (7th Cir. 1996). Absent a miscarriage of justice, it would be a "fruitless gesture" to set aside a judgment if the movant/defendant has no valid defense. *Alexander v. Robertson*, 882 F.2d 421, 424 (9th Cir. 1989).

Here, the court must evaluate whether Sinomax has a meritorious argument that the compromise is not in the best interests of the estate, which in this context would amount to

a "meritorious defense." To prevail on its motion, Sinomax must show, in addition to the existence of an enumerated factor under Rule 60(b)(3), that there is "some possibility" that this court, after a hearing on the merits of an objection by Sinomax, would rule differently than it ruled when it approved the Second Compromise Order.

B. Effect of Theoretical Objection of Sinomax to the Second Compromise Motion

On May 27, 2011, having reviewed the Second Compromise Motion and related pleadings, and the record in the case, the court approved the compromise of controversy under Federal Rule of Bankruptcy Procedure 9019 and entered the Second Compromise Order.

A bankruptcy court may approve a settlement or compromise. Fed. R. Bankr. P. 9019(a). The court has great latitude in authorizing a compromise but may only approve a proposal that is "fair and equitable" to creditors. *CAM/RPC Elecs. v. Robertson* (*In re MGS Marketing*), 111 B.R. 264, 267 (9th Cir. BAP 1990) *citing Woodson v. Fireman's Fund Ins. Co.* (*In re Woodson*), 839 F.2d 610, 620 (9th Cir. 1988). The settlement should be in the best interests of the estate and "reasonable, given the particular circumstance of the case." *Martin v. Kane* (*In re A & C Properties, Inc.*), 784 F.2d 1377, 1381 (9th Cir. 1986). When determining the "fairness, reasonableness and adequacy" of the proposed compromise, the court must consider: (1) the probability of success in the litigation; (2) the difficulties, if any, to be encountered in collection; (3) the complexity of the litigation involved; and (4) the paramount interests of the creditors. *Id*.

The court – in its discretion and based on the circumstances of this case – concluded that the settlement described in the Second Compromise Motion was fair and equitable to all creditors and in the best interests of the bankruptcy estate because the settlement included a release of Foamex's claims against the Debtor and resolved highly complex, factually intense litigation (including the possible appointment of a receiver) that would significantly diminish the limited resources of the estate. The court further found that under the circumstances, the asset sale – which would bring funds into the estate for

distribution to creditors other than Foamex – was reasonable and in the best interests of the estate.

Here, although Sinomax asserts that the compromise was not fair and equitable, it offers no evidence that, if presented originally as an objection to the Second Compromise Motion, would have persuaded the court to rule differently. Sinomax is a party to litigation with several parties including the Debtor and holds at most a disputed unsecured claim against the estate. Foamex held a secured claim in excess of $8.6 million. Sinomax does not dispute the amount of the claim or its secured status. Sinomax does not dispute the evidence presented by Foamex and the Debtor showing that Foamex was substantially undersecured by several million dollars. Sinomax offers no argument or evidence that the resolution of these claims and the asset sale did not benefit the estate. In short, Sinomax has not demonstrated that, had the court known of the Debtor's pending litigation with Sinomax, the court's decision would have been different. If Sinomax had objected to the Second Compromise Motion, this court, reviewing all of the facts, would still have concluded that that the resolution of Foamex's claims and the asset sale were in the best interests of the estate, including Sinomax as an unsecured creditor. Thus, Sinomax cannot demonstrate a "meritorious defense" to the Second Compromise Order to support the granting of its Motion.

C. Equitable Mootness

Even if Sinomax had raised some "meritorious defense" demonstrating that the court would rule differently upon reconsideration, the court would still deny the Motion. Foamex notes that it has relied on the finality of the Second Compromise Order, as have third parties entering into purchase contracts with the entities formed as part of the compromise. Given these facts, the Motion must be denied based on equitable mootness. "Equitable mootness requires the court to look beyond impossibility of a remedy to 'the consequences of the remedy and the number of third parties who have changed their position in reliance on the order that is being appealed.'" *Clear Channel Outdoor, Inc. v.*

Knupfer (*In re PW, LLC*), 391 B.R. 25, 33 (9th Cir. BAP 2008), *citing In re Popp*, 323 B.R. 260, 271 (9th Cir. BAP 2005). An issue is equitably moot where the occurrence of events has caused "such a comprehensive change of circumstances to occur as to render it inequitable . . . to consider the merits of an appeal." *Focus Media, Inc. v. NBC Inc.* (*In re Focus Media, Inc.*), 378 F.3d 916, 923 (9th Cir. 2004). Implication of this doctrine includes situations where a settlement transaction is too "complex or difficult to unwind." *See Lowenschuss v. Selnick* (*In re Lowenschuss*), 170 F.3d 923, 933 (9th Cir. 1999). "Ultimately, the decision whether to unscramble the eggs turns on what is practical and equitable." *Baker & Drake, Inc. v. Pub. Serv. Comm'n* (*In re Baker & Drake, Inc.*), 35 F.3d 1348, 1352 (9th Cir.1994)

Here, Foamex described in its opposition papers the actions it has taken to effectuate the Second Compromise Order, including: (1) paying $100,000 to purchase certain patents from the Debtor; (2) forming two new wholly-owned entities (a manufacturing entity and a sales entity) to purchase certain of AGI's assets and assume certain of its liabilities; (3) withdrawing the pending motion for appointment of a receiver and dismissing the related adversary proceeding against the Debtor with prejudice; and (4) releasing the Debtor from all liability to Foamex under his guaranties of AGI's obligations. Moreover, the new businesses have been operating and entered into contracts with third parties. Because the Debtor, Foamex, AGI, and parties entering into transactions with the entities formed after the compromise have all relied on the finality of the Second Compromise Order, it would be both difficult and inequitable to unwind all the transactions. Based on these practical and equitable concerns, the court will not attempt to "unscramble the eggs" in this case.

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IV. CONCLUSION

For the reasons stated, Sinomax's Motion is denied.

The Debtor shall submit a proposed order consistent with this memorandum.

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DATED: December 15, 2011

United States Bankruptcy Judge

NOTICE OF ENTERED ORDER AND SERVICE LIST

Notice is given by the court that a judgment or order entitled **MEMORANDUM DECISION RE MOTION FOR RECONSIDERATION OF ORDER APPROVING COMPROMISE OF CONTROVERSY BETWEEN DEBTOR AND FOAMEX INNOVATIONS OPERATING COMPANY** was entered on the date indicated as "Entered" on the first page of this judgment or order and will be served in the manner indicated below:

I. SERVED BY THE COURT VIA NOTICE OF ELECTRONIC FILING ("NEF") – Pursuant to controlling General Order(s) and Local Bankruptcy Rule(s), the foregoing document was served on the following person(s) by the court via NEF and hyperlink to the judgment or order. As of 12/15/11, the following person(s) are currently on the Electronic Mail Notice List for this bankruptcy case or adversary proceeding to receive NEF transmission at the email address(es) indicated below.

- Richard J Bauer rbauer@mileslegal.com
- Jared D Bissell ecfcacb@piteduncan.com
- Jeffrey D Cawdrey jcawdrey@gordonrees.com, ebojorquez@gordonrees.com
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II. SERVED BY THE COURT VIA U.S. MAIL: A copy of this notice and a true copy of this judgment or order was sent by United States Mail, first class, postage prepaid, to the following person(s) and/or entity(ies) at the address(es) indicated below:

David L Farley
2891 Venezia Terrace
Chino Hills, CA 91709-6603

Winthrop Couchot P.C.
660 Newport Center Dr.
Suite 400
Newport Beach, CA 92660

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III. TO BE SERVED BY THE LODGING PARTY: Within 72 hours after receipt of a copy of this judgment or order which bears an "Entered" stamp, the party lodging the judgment or order will serve a complete copy bearing an "Entered" stamp by U.S. Mail, overnight mail, facsimile transmission or email and file a proof of service of the entered order on the following person(s) and/or entity(ies) at the address(es), facsimile transmission number(s), and/or email address(es) indicated below:

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