

#S-1

signed 12-3-2003

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

In re:

**MARK DARRELL WARRELL,
LINDA KAY WARRELL,**

DEBTORS.

**CASE NO. 02-20534-7
CHAPTER 7**

ORDER GRANTING TRUSTEE'S APPLICATION TO EMPLOY SPECIAL COUNSEL

This matter is before the Court on the Chapter 7 trustee's application to employ Douglas Lancaster as special counsel to represent the estate as the appellee in a state court appeal, and an objection filed by the appellants in that appeal. Trustee Eric C. Rajala appears in person and as attorney for the trustee. David Robbins and Mo-Kan Imports, Inc., appear by counsel Cynthia F. Grimes. The Court heard the arguments of counsel and reviewed materials submitted after that hearing, and is now ready to rule.

FACTS

The facts relevant to this dispute appear to be undisputed, although their legal significance is contested.

Until 1998, debtors Mark and Linda Warrell owned part or all of two auto salvage businesses, A-OK Auto Salvage, Inc., and Missouri-Kansas Imports, Inc. (usually referred to as "Mo-Kan Imports" in a state court lawsuit among the parties). Early in 1998, the Warrells sold both businesses in separate transactions, apparently accepting notes from the buyers for the bulk of the sale prices.

First, they sold their stock in Mo-Kan Imports to David Robbins, an employee who already owned some stock in the business. As part of the sale, Robbins and Mo-Kan Imports (collectively “Robbins”) agreed not to engage in what the state court characterized as “the domestic auto salvage business” for ten years in a specified area. A short time later, the Warrells sold A-OK Auto Salvage’s assets to Steven and Jacqueline Mitschke and their company, SWM, Inc. (collectively “the Mitschkes”). This sale included the Warrells’ agreement that neither they nor Mo-Kan Imports would compete with the Mitschkes and their company in what the state court also characterized as “the domestic auto salvage business.”

As determined by the state court, Robbins violated the non-compete agreement given to the Warrells by engaging in the domestic auto salvage business. Apparently because of this competition from Robbins, the Mitschkes stopped making payments on the promissory note they had given the Warrells. The Warrells and A-OK Auto Salvage (collectively “the Warrells”) then sued in a Kansas state court to collect on the note. The Mitschkes counterclaimed for breach of the covenant not to compete. They were represented by Douglas Lancaster, the attorney the Chapter 7 trustee now seeks to hire. Although Robbins has suggested to this Court that he and his company were brought into the state court suit by the Mitschkes as third-party defendants, on page four of the brief filed on their behalf in the state court appeal, they state instead that they were added as defendants through an amended petition filed by the Warrells. The Court notes that none of the state court journal entries submitted here grants the Mitschkes any relief directly against either Robbins or Mo-Kan Imports.

Following a trial and post-judgment proceedings, the state court ultimately granted the Mitschkes a judgment against the Warrells for about \$660,000 in damages for breach of their covenant

not to compete, after giving an offset for an amount due on the promissory note originally sued on. The court indicated these damages actually resulted from Robbins' engaging in the domestic auto salvage business. The state court granted the Warrells a judgment against Robbins for about \$679,000 in damages for breach of the covenant not to compete involved in their transaction. The court found that the Warrells were liable to the Mitschkes because of Robbins' actions, and that Robbins was liable to the Warrells because of those same actions. Robbins appealed the state court judgment, but the Warrells did not appeal or cross-appeal, and their time to do so has expired.

While the appeal was pending, the Warrells filed a Chapter 7 bankruptcy petition, and Eric Rajala was appointed as the trustee for their bankruptcy estate. A notice was sent in their case fixing a claims bar date of July 17, 2002, for non-governmental creditors.¹ The Mitschkes filed a proof of claim based on the \$660,000 judgment.² David Robbins was listed in the Warrells' schedules as an unsecured creditor owed \$4,000,³ but did not file a proof of claim. Mo-Kan Imports was not listed as a creditor and did not file a proof of claim.

With their bankruptcy filing, the Warrells' judgment against Robbins became property of the Warrells' bankruptcy estate. The trustee has applied to hire Douglas Lancaster in connection with that judgment. They have an agreement (subject to the Court's approval) calling for Lancaster to defend the appeal for the estate, which will pay his out-of-pocket expenses, and for him to be paid \$180 per hour for that work, up to a maximum of \$12,000, contingent on the estate recovering not less than

¹See Pleading no. 16.

²See Claim no. 3.

³See Pleading no. 5.

\$50,000. Lancaster would also work to collect the judgment for the estate, and would receive 25% of the gross amount of any recovery beyond that covered by the hourly-rate agreement. Robbins filed an objection to the trustee's application on the grounds that Lancaster's representation of the Mitschkes disqualifies him from representing the Warrells' bankruptcy estate because of an actual conflict of interest, that the Mitschkes are his competitors and seek confidential and proprietary information from him, and that the judgment against him is merely one for indemnity so there is no reason to deplete the estate by requiring it to pay Lancaster's out-of-pocket expenses.

The Court reviewed the pleadings that had been filed and held a hearing on this dispute. Time for the hearing was limited, and the Court directed the parties to submit any additional materials they thought would help resolve two issues the matter had raised for the Court: (1) whether the Warrells' judgment against Robbins is an indemnification judgment, and (2) whether the appeal could result in a reversal of the Mitschkes' judgment against the Warrells despite the Warrells' failure to file their own appeal. Both sides have supplied supplemental materials, which the Court has reviewed. The Court notes that at the hearing, counsel for Robbins stated that her client is not a creditor of the Warrells' bankruptcy estate.

The trustee takes the position that the Warrells' judgment against Robbins is not an indemnification judgment because none of the contracts involved in the lawsuit were indemnification contracts, the issue of indemnification was never raised before the state trial court, and the appellants' brief that Robbins filed in the appeal does not raise any issue about indemnification. Robbins, on the other hand, suggests that the judgment is one for indemnification because the Warrells' amended petition that added Robbins to the suit asked for him to be found liable to the Warrells for any damages

the Warrells might be found to owe the Mitschkas, and the state court based its damage calculations for both judgments on Robbins' activities.

On the second question, the trustee's position is that the Mitschkas' judgment against the Warrells cannot be affected by the appeal because the Warrells filed no appeal or cross-appeal. Robbins suggests that three of the five issues he has raised in the appeal could lead the appellate court to vacate the judgment granted to the Mitschkas. He argues that if his appeal is successful, it could minimize or even eliminate Lancaster's clients' claim against the bankruptcy estate. It appears Robbins means to imply that the estate should be siding with his effort to overturn the judgment.

DISCUSSION AND CONCLUSIONS

Section 327 of the Bankruptcy Code governs a Chapter 7 trustee's authority to hire an attorney. The following portions of the statute are relevant here:

(a) Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys . . . that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

. . . .

(c) In a case under chapter 7, 12, or 11 of this title, a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.

As a preliminary matter, the Court notes that Robbins probably does not have standing under §327(c) to object to Lancaster's employment because Robbins did not file a proof of claim and so is not a creditor of the Warrells' bankruptcy estate. Still, because the Court's approval of the trustee's employment of counsel is required under §327(a), if the Court were convinced that Lancaster had an

actual conflict of interest with the bankruptcy estate, the Court would likely disapprove his employment even in the absence of an objection from a creditor. The Court would also point out that Robbins' concerns about Lancaster trying to obtain confidential and proprietary information from him and his company should be raised in any collection proceedings that Lancaster may pursue, where the court involved could fashion protective relief, if appropriate.

As indicated earlier, in the Court's view, the trustee's application to employ Lancaster, Robbins' objection, and the parties' arguments at the hearing raised two significant issues: (1) whether the Warrells' judgment was one for indemnification, and (2) whether the appeal could affect the Mitschkas' judgment against the Warrells. The Court will address the questions in this order.

Robbins contends that the Warrells' judgment is one for indemnification, and his only obligation under it is to repay the Warrells to the extent the Mitschkas are able to collect their judgment from the Warrells.⁴ Although it is not clear that this assertion, if true, would create an actual conflict of interest for Lancaster, the Court will assume for purposes of this decision that Lancaster would have a conflict if the judgment were one for indemnification. The Court is convinced, though, that the Warrells' judgment is not one for indemnification. The two judgments are based on independent covenants not to compete that concern the actions of Robbins and his company. However, nothing in the state court's rulings indicates that Robbins' promise to the Warrells was simply to reimburse them in the event they should be forced to pay damages as a result of Robbins' activities. Instead, as interpreted in those

⁴*But see* Black's Law Dictionary (7th ed., Bryan A. Garner, ed.-in-chief, West 1999) (online version) (indicating "indemnity" can refer to an obligation like the one Robbins is asserting, but can also be used—at least in the phrase "indemnity against liability"—to refer to liability that arises on default even if no loss has occurred).

rulings, Robbins' promise was the broader promise to pay the Warrells for any damages they suffered if Robbins engaged in the prohibited activity, without regard to any payments the Warrells might make to any third party. On the issue of liability, the state court found that Robbins breached his independent obligation to the Warrells not to compete.

Robbins has suggested that his appeal could vacate the Mitschkes' judgment against the Warrells and reinstate the Warrells' claim against the Mitschkes for the balance due on the sale of A-OK Auto Salvage's assets to the Mitschkes. If this were true, the Warrells' bankruptcy estate would have at least some interest in supporting Robbins' appeal, and this interest would clearly conflict with the Mitschkes' interest in retaining their judgment. But the Court cannot agree with Robbins' premise. Although the damages awarded by the state court were all based on Robbins' activities in "the domestic auto salvage business," the court awarded damages to the Mitschkes on the ground that the Warrells violated their covenant not to compete with the Mitschkes by allowing Robbins (through Mo-Kan Imports) to engage in that business, and awarded damages to the Warrells on the ground that Robbins violated his separate and independent covenant not to compete with the Warrells by engaging in that business. So far as this Court can see, the state court did not hold Robbins liable to the Mitschkes, and the ultimate judgments it awarded are independent of each other. Consequently, the Mitschkes' judgment against the Warrells has become final because the Warrells did not appeal it. As the successor to the Warrells and therefore a mere appellee in the state court appeal, their bankruptcy estate is bound by the general rule of Kansas appellate procedure that an appellee who did not file a

timely cross-appeal cannot complain about adverse rulings by the trial court.⁵ The Court is convinced that to the extent Robbins has attacked in the appeal the Mitschkkes' right to recover damages, only he and his company can benefit from the attack, and the Mitschkkes' judgment against the Warrells will survive the appeal intact.

Finally, Robbins also suggests that by supporting the Warrells' judgment against him and Mo-Kan Imports, the Warrells' bankruptcy estate would be taking positions contrary to those the Warrells took before the state trial court. In other words, Lancaster's arguments at trial on behalf of the Mitschkkes were contrary to the arguments the Warrells made there. While this may be true, the Warrells' interests have changed substantially since the trial. As a result of their Chapter 7 bankruptcy discharge, the Warrells will no longer have to pay the Mitschkkes, who will collect on their judgment only to the extent the Warrells' bankruptcy estate has assets to pay them. The question before the Court is not whether the Mitschkkes and the Warrells had conflicting interests up to the time the state court entered judgment, but whether the Mitschkkes and the Warrells' bankruptcy estate now have an actual conflict of interest. As indicated above, since the Warrells gave up the right to appeal the Mitschkkes' judgment against them before they filed for bankruptcy, their bankruptcy estate has no ability to attack that judgment now. Instead, the estate's only interest in the appeal is to preserve and

⁵See *Tyler v. Employers Mutual Casualty Co.*, 274 Kan. 227, 244 (2002); see also *Johnson v. American Cyanamid Co.*, 239 Kan. 279, 290-91 (1986) (where jury found drug manufacturer 100% liable and doctor 0% liable for plaintiff's injuries, but on manufacturer's appeal, supreme court ruled as a matter of law that manufacturer was not liable, supreme court could not remand for retrial of issues between plaintiff and doctor because plaintiff did not cross-appeal).

collect its judgment against Robbins. As the largest creditor of the estate, the Mitschkes share this interest, and Lancaster's representation of them does not create a conflict of interest with the estate.

For these reasons, the Court concludes that the trustee's application to employ Lancaster should be and it is hereby approved.

IT IS SO ORDERED.

Dated at Topeka, Kansas, this ____ day of December, 2003.

DALE L. SOMERS
BANKRUPTCY JUDGE

CERTIFICATE OF SERVICE

The undersigned hereby certifies that true and correct copies of the above **ORDER GRANTING TRUSTEE'S APPLICATION TO EMPLOY SPECIAL COUNSEL** were mailed via regular U.S. mail, postage prepared, on the ____ day of December, 2003, to the following:

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