

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

JERRAL W. JONES and	:	
MICHAEL V. McCOY,	:	
	:	
Plaintiffs,	:	
	:	C.A. No. 17634
	:	
RELIANT ENERGY RESOURCES CORP., as	:	
successor-in-interest to ARKLA, INC, and	:	
OCEAN ENERGY, INC., SEAGULL ENERGY	:	
E&P, INC., ARKOMA HOLDING CORP., and	:	
CROSS TIMBERS OIL CO., as	:	
successors-in-interest to ARKOMA	:	
PRODUCTION CO., and as successors-in-	:	
interest to ARKLA EXPLORATION CO.,	:	
	:	
Defendants.	:	

MEMORANDUM OPINION

Date Submitted: September 27, 2000
Date Decided: February 2, 2001

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A. Gilchrist Sparks III, Donna L. Culver and David J. Teklits, Esquires, of MORRIS, NICHOLS, ARSHT & TUNNELL, Wilmington Delaware; Joseph L. McEntree, Britt K. Latham, Esquires, of JONES, DAY, REAVIS & POGUE, Dallas, Texas; Attorneys for Defendant Reliant Energy Resources Corp.

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JACOBS, VICE CHANCELLOR

Although they now stand on opposite sides, the parties to this lawsuit were all co-defendants in an earlier federal court action brought by a class of royalty owners having a contractual relationship with one of the defendant corporations. That earlier action involved claims of unjust enrichment and breach of an implied contractual covenant. The case was decided twice by a federal appeals court, both times against the current plaintiffs. Now the plaintiffs, who were found liable for damages in the earlier federal action, have sued their former co-defendants for equitable contribution, equitable indemnity and unjust enrichment in this Court. Those defendants have moved to dismiss this Delaware action on the grounds that (i) the doctrine of collateral estoppel bars the claims raised in the plaintiffs' Delaware complaint, and (ii) the plaintiffs have failed to state cognizable claims for relief. This is the Opinion of the Court on the defendants' motion to dismiss. For the reasons next discussed, that motion will be granted.

I. FACTS

A. Background

The plaintiffs, Jerral W. Jones and Michael V. McCoy ("Jones and McCoy" or the plaintiffs) were the founders, officers and sole shareholders of Arkoma, Inc. ("Arkoma"), a natural gas exploration, development and production company. Arkoma leased mineral rights from thousands of

landowner-lessors (the “royalty owners”). Those leases entitled the royalty owners to share in one-eighth of the proceeds from gas that Arkoma produced and sold from the royalty owners’ land. Defendant Arkla Inc. (“Arkla”) is an oil and gas pipeline company that bought gas from Arkoma under several gas purchase contracts (“GPCs”). The relevant gas purchase contract (GPC 5239) which was typical of many GPC’s, included a “take-or-pay” clause that required Arkla either to take or to pay for 75% of the daily gas deliverables from Arkoma’s wells each year at the contract prices.’

B. The Sale of Arkoma

During the mid-1980’s, the price of natural gas fell dramatically and the pipelines’ markets for gas contracted. As a consequence of these market developments, in 1985 and 1986 Arkla unilaterally reduced the amount of gas that it had agreed to take from Arkoma, but Arkla refused to pay for the resulting shortfalls. Negotiations to resolve the contractual disputes between Arkla and Arkoma ensued, but were unsuccessful. Arkla’s “take-or-pay”

¹ A “take-or-pay clause” is:

. . . [a] clause in a gas purchase contract requiring the purchaser to take, or failing to take, to pay for the minimum annual contract volume of gas under which the producer-seller has available for delivery. Under such clause the purchaser usually has the right to take gas paid for (but undelivered) in succeeding years.

Klein v. Jones, 980 F.2d 521,524 (8th Cir. 1992) (quoting Howard R. Williams and Charles J. Meyers, Oil and Gas Terms, 249 (1959) (citations omitted)).

contractual debt to Arkoma continued to mount at the rate of \$3 million per month, and eventually approached the \$35 million level.

In 1986, Arkla Exploration Company (“AEC”), a wholly-owned gas production subsidiary of Arkla,² entered into an agreement with Jones and McCoy to purchase their ownership interest in Arkoma for \$73 million. That purchase price was subject to an adjustment that would be made after a specified period of additional gas production and exploration. The price adjustment occurred three years later, on September 9, 1989, and Jones and McCoy received an additional \$100 million from the Arkla parties.³

The Arkoma purchase transaction closed on December 31, 1986. As a result of the sale, Jones and McCoy relinquished their control over Arkoma. Arkoma’s leases with its royalty owners remained unaffected, all terms of those leases continuing in effect as they did before the sale. GPC 5239 remained unaffected until February 1987, when Arkoma-now owned by Arkla, renegotiated the Arkla-Arkoma gas purchase contracts (including

² In this Opinion, Arkla and AEC are referred to collectively and without distinction, as “Arkla.”

³ The “Arkla parties” and “the defendants” collectively refer to and include Reliant Energy Resources Corp. as successor in interest to Arkla, and the successors in interest to Arkoma and AEC: Ocean Energy, Inc., Seagull Energy E&P, Inc., Arkoma Holding Corp. and Cross Timbers Oil Co.

GPC 5239) and Arkoma released Arkla from all its accrued take-or-pay liability.

The renegotiated terms of those GPCs included a lower gas price. As a result, beginning in March 1987 the royalty owners received royalty payments that were based on much lower gas prices than the prices to which the parties had agreed in the original leases.

C. The Prior Litigation

On February 23, 1990, Arkoma's Arkansas royalty owners brought suit against Arkoma in an Arkansas state court (the "Klein action"). The action was removed to the United States District Court for the Western District of Arkansas (the "District Court"). In Klein, the plaintiff royalty owners claimed that the Arkla parties' renegotiation of the GPC terms constituted a breach of their covenant, implied in every oil and gas lease, to market the gas. The royalty owners also named Jones and McCoy as defendants, claiming that Jones and McCoy were unjustly enriched because the purchase price they received for selling Arkoma to Arkla included monies attributable to the settlement of Arkoma's "take-or-pay" dispute with Arkla. The royalty owners took the position that their leases entitled them to receive a portion of those settlement proceeds.

In January 1991, Jones and McCoy moved for summary judgment in the ~~Klein~~ actions on two grounds. First, there was no basis to hold them liable for the Arkla parties' take-or-pay settlement, because (i) Jones and McCoy had sold Arkoma to Arkla in its entirety with all of Arkoma's rights and obligations unimpaired, and (ii) Jones and McCoy had no direct personal contract relationship or obligation to the royalty owners. Second, Jones and McCoy contended that the royalty owners were not legally entitled to share in the proceeds of the take-or-pay dispute settlement, because (i) the royalty owners' right to payments under their leases was contingent on the actual production of gas, and (ii) that contingency did not occur when the take-or-pay claims were settled.

The District Court denied summary judgment on the defendants' first argument that the sale of Arkoma left Arkoma's contract rights and obligations unimpaired. That Court did, however, grant Jones and McCoy's summary judgment motion on the second ground, namely, that the royalty owners had no contractual right to share in the proceeds of the take-or-pay settlement. Accordingly, Jones and McCoy were dismissed from the case, leaving the Arkla parties as the sole remaining defendants, who the plaintiff royalty owners contended had breached their implied covenant to market the

gas. After trial, the District Court dismissed the royalty owners' claim on the ground that it was time-barred.

The royalty owners appealed to the United States Court of Appeals for the Eighth Circuit (the "Eighth Circuit"), which reversed and remanded the District Court judgment. The Eighth Circuit held that as a matter of equity, the royalty owners were entitled to share in the Arkla-Arkoma take-or-pay dispute settlements, and remanded the case for further proceedings. The Eighth Circuit also reversed the District Court's determination that the royalty owners' claim against the Arkla parties was time-barred.⁴

On remand, the District Court conducted a five-day bench trial on the royalty owners' unjust enrichment claim against Jones and McCoy, and heard evidence on the issue of whether the sale of Arkoma to Arkla constituted a settlement of the take-or-pay contract. The District Court found that there had been no settlement of Arkoma's take-or-pay claim during the period that Jones and McCoy owned Arkoma. That Court further found that the sale proceeds Jones and McCoy had received were attributable solely to their ownership interest in Arkoma, and not to any settlement of Arkoma's take-or-pay claim. Finally, the District Court determined that the amendments to Arkoma's gas contracts, later agreed to

⁴ Klein v. Jones, 980 F.2d 521 (8th Cir. 1992) ("Klein I").

by the Arkla parties, did not breach Arkoma's implied covenant to market the gas. Based on those rulings, the District Court entered judgment in favor of all defendants.

The royalty owners again appealed to the Eighth Circuit, which again reversed.⁵ The Eighth Circuit found that it had previously determined as a matter of law in Klein I, that the sale of Arkoma to Arkla constituted a settlement of the take-or-pay claim. Therefore, the payment for the settlement did include an amount to which the royalty owners were entitled. The Eighth Circuit then held that the District Court must determine (again on remand) the exact amount of the so-called "settlement premium" Jones and McCoy had received, and award one-eighth of that amount to the royalty owners. Finally, the Eighth Circuit determined that Arkoma had breached its implied duty to market the gas when it "failed to retain and pay over to the royalty owners a proportionate share of the premium paid by Arkla to settle the take-or-pay claims."⁶

The Arkla parties and Jones and McCoy filed motions for rehearing and suggestions for rehearing *en banc* in the Eighth Circuit, and later, petitions for a writ of certiorari in the United States Supreme Court. These

⁵ Klein v. Arkoma Production Co., 73 F.3d 779 (8th Cir. 1996) ("Klein II").

⁶ Klein II, 73 F.3d at 788.

applications were all denied. Ultimately, on August 28, 1997, the District Court entered a final judgment directing Jones and McCoy to pay the royalty owners approximately \$10,500,000. As a result of settlement negotiations, that amount was reduced to \$8,250,000, plus interest. After the settlement was approved by the District Court, Jones and McCoy paid that amount to the royalty owners. The Arkla parties did not participate in the settlement negotiations, nor did they object to the settlement.

After the Klein litigation ended, Jones and McCoy sued the Arkla parties, to recover from them the \$8,250,000 Jones and McCoy had paid to the royalty owners. The suit was originally filed in a Texas state. Later, Jones and McCoy non-suited their Texas action, and brought this Delaware action against the Arkla parties, alleging the same claims, viz, unjust enrichment, equitable contribution and equitable indemnification. In response, the Arkla defendants moved to dismiss based on its affirmative defense of collateral estoppel, and alternatively, for failure to state a claim upon which relief may be granted.

II. THE PARTIES' CONTENTIONS AND THE APPLICABLE LAW

The plaintiffs claim that they are entitled to recover, from the Arkla parties, a portion of the monies they were required to pay to the royalty holders in Klein. Defendants argue that the plaintiffs are precluded from

asserting those claims by the doctrine of collateral estoppel, because the issue of who was legally responsible to pay the royalty owners was litigated and decided adversely to the plaintiffs in ~~Althe~~ Althe. Alternatively, the defendants argue that the plaintiffs' complaint must be dismissed because it fails to state a claim upon which relief may be granted.

Because I conclude that the collateral estoppel doctrine precludes the plaintiffs' claims, it becomes unnecessary to address the alternative contention that the plaintiffs have failed to state legally cognizable claims.

All parties agree that the Arkansas law of collateral estoppel applies to this motion. Under Arkansas law, for collateral estoppel to bar a subsequent claim, four elements must be satisfied. First, the issue sought to be precluded must be the same as that involved in the first action. Second, the issue sought to be precluded in the second action must have been "actually litigated" in the first. Third, the issue sought to be precluded must have been concluded by a valid and final judgment in the first action. Fourth, the determination of the issue sought to be precluded must have been necessary to the prior judgment.⁷

⁷ Zinger v. Terrell, 985 S.W.2d 737,741 (Ark. 1999); Crockett & Brown. P.A. v. Wilson, 864 S.W.2d 244,246 (Ark. 1993).

The parties do not dispute the third element, since they agree that Klein was concluded by a valid final judgment. i s p u t e t h e remaining collateral estoppel elements, which are next addressed.

III. ANALYSIS

A. Was The Issue Sought to Be Precluded The Same As The Issue in The Prior Action?

Whether the claims in this lawsuit are collaterally estopped depends, first, on whether the liability issue that the plaintiffs seek to litigate is the same issue that was litigated and decided in the Klein action. a i n t i f f s contend that the issue in this (Delaware) action concerns the proper allocation of damages as between the plaintiffs and the defendants, and is different from the issues that were litigated in Klein. According to plaintiffs, two issues were litigated in Klein were Jones and McCoy unjustly enriched at the royalty owners' expense by not sharing with them a portion of the Arkoma sale proceeds, and (2) was the Arkla parties' failure to share with the royalty owners the proceeds of their take-or-pay settlement a breach of the implied terms of the royalty owners' leases? The plaintiffs contend that the Eighth Circuit answered both of those questions in the affirmative, and on that basis found Jones, McCoy and the Arkla parties all liable to the royalty owners.

What was not litigated or decided in Klein, the plaintiffs argue, was the issue of how damages should be apportioned among the Klein co-defendants. Indeed, the plaintiffs point out, the royalty owners expressly argued before the Eighth Circuit that apportionment was not at issue and that “[t]o the extent that [the royalty owners’] recovery is against both Jones and McCoy and the Arkla Defendants, an equitable allocation can and should be made by the trial court upon trial of the damage issue.”⁸ But this Delaware action, plaintiffs insist, does implicate that apportionment issue. Because that issue was not litigated or decided in Klein, the plaintiffs conclude that collateral estoppel cannot bar this action.

The defendants respond that the plaintiffs mischaracterize the issue presented in this Delaware proceeding. The true issue, defendants say, is who-as among Jones, McCoy and the Arkla parties-is liable to pay the amount to which the royalty owners were found entitled. That issue, defendants-urge, was decided-twice-by the Eighth Circuit. The issue is not how damages should be allocated among parties that were previously held liable.

Specifically, the defendants argue that the Eighth Circuit determined as a matter of law that there was a settlement of the take-or-pay contracts

⁸ Royalty Owners Brief to Eighth Circuit in support of its appeal in Klein II, at 47.

and that as a result, (i) Jones and McCoy were liable to the royalty owners for unjust enrichment, and (ii) Arkoma, Jones and McCoy were liable to the royalty owners for breach of the implied covenant in their leases. Having determined that, the Eighth Circuit then decided which defendants were primarily liable by “following the money,” to the ultimate recipients-Jones and McCoy. The Eighth Circuit held Jones and McCoy solely liable, because they alone received the money to which to the royalty owners were found to be entitled.

To express it in different terms, the defendants argue that there can be no allocation of damages among parties unless those parties are found to be jointly liable. Because the plaintiffs (Jones and McCoy) were the only parties found to have been unjustly enriched in Klein, they were the only parties who could be (and were) held primarily liable. Thus, defendants conclude, this Delaware action is in reality a poorly disguised effort by the plaintiffs to relitigate the liability issue that the Eighth Circuit conclusively decided against them in Klein.

Having reviewed the record and the parties’ positions, I agree that Jones and McCoy are seeking to relitigate the question of who is liable to the royalty owners. In Klein II, the Eighth Circuit held that Jones and McCoy alone were liable to the royalty owners, based on theories of unjust

enrichment and breach of an implied covenant. Arkoma was also found liable to the royalty owners on the implied covenant claim, but the Eighth Circuit held that the liability of Jones and McCoy was primary, because “Jones and McCoy actually received the monies rightfully belonging to the . . . royalty owners.”⁹

In National Farmers Union Standard Insurance Co. v. Morgan” the Eighth Circuit held that the first element of collateral estoppel is established if the “issue in the [second] case is subsumed in the findings made in” the [first] case.¹¹ Here, the issues that Jones and McCoy seek to litigate in Delaware were subsumed within the Eighth Circuit’s findings in Klein II that Jones and McCoy had ultimately received all the settlement proceeds, had been unjustly enriched, and therefore were primarily liable to the royalty owners. Dispositive evidence is the Eighth Circuit’s direction that on remand “the district court shall determine the amount [of the settlement premium obtained by Jones and McCoy and the portion due to the royalty owners] with specificity and shall enter judgment against Jones and McCoy

⁹ Klein II, 73 F.3d at 788.

¹⁰ 966 F.2d 1250 (8th Cir. 1992).

¹¹ Id. at 1253.

in that amount.”¹² There was no direction to enter judgment against any other defendant.

Because the issue of who, as between Jones and McCoy and the Arkla parties, was liable to the royalty owners was decided in Klein, the first collateral estoppel requirement is satisfied.

B. Was That Issue “Actually Litigated?”

Jones and McCoy next argue that the defendants have failed to satisfy the second element of collateral estoppel, because the defendants have not shown that the issue of who (as among Jones, McCoy and the Arkla parties) should be primarily liable was “actually litigated” in Klein. plaintiffs point out that at the royalty owners’ request, Klein was bifurcated into liability and damages phases, and that the District Court resolved only the liability issues but never reached the damages phase. Because the parties had agreed not to litigate any issue relating to damages, Jones and McCoy urge that no occasion ever arose in Klein to litigate the question of how the damages should be apportioned among the defendants.

The defendants respond that “apportionment of damages” is not the issue on which they rest their collateral estoppel defense. Defendants claim

¹² Klein II, 73 F.3d at 787 (emphasis added).

that the issue on which they rely is “who must pay,” and that issue was actually litigated in Klein.

The Arkansas test of whether an issue was “actually litigated” in a prior action “is whether such point, question or right was distinctly put in issue, or should have been put in issue, and was directly determined by such former suit and judgment.”¹³ In Klein, the royalty owners claimed (among other things) that Jones and McCoy were unjustly enriched because they had received the proceeds from a settlement of Arkoma’s take-or-pay dispute, but did not share any of those proceeds with the royalty owners. Jones and McCoy defended by arguing that the royalty owners’ claim (if any) was against Arkoma, and not Jones and McCoy. Thus, in Klein the question of who was primarily liable to pay the royalty owners was placed directly in issue by both the royalty owners and by Jones and McCoy.

The question is whether that issue was actually litigated in Klein. If the issue was “... directly determined by a court of competent jurisdiction,” then it “cannot be disputed in a subsequent suit between the same parties or their privies.”¹⁴ I conclude that the issue was directly determined in Klein I. There, the Eighth Circuit “considered and relied upon undisputed

¹³ JoToCo Corp. v. Hailey Sales Co., 596 S.W.2d 703,706 (Ark. 1980).

¹⁴ Montana v. United States, 440 U.S. 147, 153 (1979).

documentary evidence that had been presented to the district court” and found as a matter of law that there had been a settlement of the take-or-pay claims.¹⁵ Applying the so-called “Harrell Rule,”¹⁶ the Eighth Circuit then determined that the royalty owners were lawfully entitled to a portion of the settlement proceeds that Jones and McCoy had received.” The issue of liability was “directly determined” in Klein I.

In Klein II, the Eighth Circuit again considered and determined the issue of liability. The Court stated:

We have reviewed the voluminous record in this case and can find no evidence that the royalty owners’ rights or interest were separately considered in the negotiations between Jones and McCoy and the Arkla defendants. We thus conclude that the royalty owners’ interest is subsumed within the premium that Jones and McCoy received as part of the sale.¹⁸

Based on that determination, the Eighth Circuit held that Jones and McCoy were primarily liable to the royalty owners, and that Arkoma was

¹⁵ Klein II, 73 F.3d at 789 (discussing Klein I).

¹⁶ The “Harrell Rule,” as applied by the Eighth Circuit, is that “oil and gas leases should be construed in a manner so that the lessee and lessor split all economic benefits of the land; a royalty should be due on either take-or-pay payments or settlement.” Klein II, at 783.

¹⁷ Klein I, 980 F.2d at 53 1.

¹⁸ Klein II, 73 F.3d at 786.

secondarily liable.¹⁹ It may be that in Klein the parties did not actually litigate the issue of secondary liability, but it cannot be disputed that they placed the question of primary liability directly in issue, and that that issue was directly decided by the Eighth Circuit. Because Jones and McCoy had received all the proceeds of the take-or-pay settlement, the issue of primary liability was inextricably intertwined with, subsumed within, and disposed of by, the finding of unjust enrichment. For these reasons, the second requirement of collateral estoppel is also satisfied.

**C. Was the Determination of the Issue
Essential to the Prior Judgment?**

Finally, Jones and McCoy contend that the bar of collateral estoppel does not apply because the Eighth Circuit's determination of "who should pay" was not "essential" to the judgment in Klein.²⁰ If differently, the plaintiffs argue that the issue in Klein was whether Jones, McCoy and the Arkla parties were liable to the royalty owners, and that therefore it was not necessary or essential to determine how that liability should be apportioned.

The defendants agree that the allocation of damages was not necessary to the prior Klein judgment, but argue that the point is irrelevant, because allocation of damages is not the issue in this case either. Rather, the issue in Klein was (and, in this case, **is**) "who should pay," and the determination of

¹⁹ Id. at 788.

that issue was necessary-indeed, was the crux of the holding-in Klein.
determination of who should pay was essential, the defendants argue,
because under a theory of unjust enrichment it became necessary for the
court to “follow the money.” That quest led directly-and solely—to Jones
and McCoy.

Again, the defendants are correct. The issue of who was liable to the
royalty owners was directly decided in Klein II, where the Eighth Circuit
found that Jones and McCoy were primarily liable to the royalty owners.

The various holdings of the Eighth Circuit permit no other conclusion.
That Court held, as a matter of law, that the sale of Arkoma constituted a
settlement of the take-or-pay obligation, because Jones and McCoy had
received a “premium” in that sale.²⁰ Applying the “Harrell Rule,” the Court
then determined that the royalty owners were entitled to share in the
proceeds of that settlement. Finally, the Court held that because all of the
settlement proceeds flowed to Jones and McCoy from Arkla and Arkoma,
Jones and McCoy were primarily liable to the royalty owners. That
determination was logical, because the Arkla parties had already paid the
monies to Jones and McCoy, and to hold the Arkla parties liable would
require them to pay twice.

²⁰ Klein II, 73 F.3d at 785.

For these reasons, the determination in Klein that Jones and McCoy were primarily liable to the royalty owners was essential to the judgment entered in that case.

D. The Equities

Lastly, the plaintiffs urge that even if the technical requirements of collateral estoppel are satisfied, this Court should nonetheless decline, as a matter of equity, to be bound by the Klein determination that Jones and McCoy were liable to the royalty owners. The reason, plaintiffs argue, is that the issue of their liability was not fully and fairly litigated in Klein, and that as a matter of settled doctrine, a “[r]edetermination of issues is warranted if there is reason to doubt the quality, extensiveness, or fairness of procedures followed in prior litigation.”²¹

The defendants respond that the equities favor the application of collateral estoppel, because that best serves the doctrine’s underlying policies of finality and comity. Defendants emphasize that the pertinent collateral estoppel inquiry cannot be whether the determination in the first action was right or wrong, but only whether the issue determined was actually litigated, finally decided, and essential to the judgment.,

²¹ Kremer v. Chemical Constr. Corp., 456 U.S. 461,481 (1982) (citations omitted).

I agree. The doctrine of collateral estoppel limits this Court's inquiry to whether the issue sought to be precluded was previously raised, litigated and decided. Although this Court (or any court) might have decided the issues differently as an original matter, under Arkansas law "[t]he fact that a previous decree may have been erroneous or was patently so does not lessen its binding effect."²² Jones and McCoy were granted full due process in Klein, and there "is a clearly established rule that state courts must give full faith and credit to the proceedings of federal courts."²³ For these reasons, I find that the equities support the application of collateral estoppel to bar this action.

Because the defendants have satisfied all the requirements for applying the bar of collateral estoppel, the plaintiffs cannot relitigate in this action the issue of liability among the Klein defendants. t h a t determination, it becomes unnecessary to address the defendants' alternative dismissal argument that the complaint fails to state a claim upon which relief can be granted.

²² Phelps v. Justiss Oil Co., 726 S.W.2d 662,666 (Ark. 1987).

²³ Delaware Valley Citizens' Council For Clean Air v. Pennsylvania, 755 F.2d 38, 43 (3rd Cir. 1985).

IV. CONCLUSION

For the reasons set forth above, the defendants' motion to dismiss is granted. IT IS SO ORDERED.