

Commercial Law Cases Update

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1. APPEAL FROM CONFIRMATION ORDER - - EQUITABLE MOOTNESS

In re Pacific Lumber Co., 584 F. 3d 229 (5th Cir. 2009) - - The indenture trustee and certain noteholders challenged the legality of a confirmed Chapter 11 reorganization plan, where no stay pending appeal was entered. In the brief interval between confirmation and oral argument, the plan was substantially consummated and the plan proponents moved to dismiss the appeal as equitably moot. The Fifth Circuit ruled that equitable mootness did not bar review of issues raised on appeal concerning the treatment of the noteholders' secured claims; reevaluation of whether their administrative priority claim was correctly calculated; or the plan's release clauses insulating multiple parties from liability. However, the equitable mootness doctrine did foreclose review of issues related to the treatment of impaired and unsecured classes. The court reversed in part the broad non-debtor releases in the plan. The debtors were six affiliated entities involved in the growing, harvesting and processing of redwood timber. One of the plan proponents was also a pre- and post-petition secured creditor holding a claim of \$160 million, which it contended exceeded the value of the debtors' assets at the date of filing. The noteholders were owed approximately \$740 million in principal. The plan proponents were a competitor of the debtor and the debtors' primary secured lender. Under the confirmed plan, the debtors were dissolved, intercompany debts cancelled, and assets of the debtors transferred to two new entities. The plan provided for payment to the noteholders on account of their secured claims an amount equal to the value of their collateral and to pay their \$200 million deficiency claim with a recovery estimated as "unknown." Two classes, including the class consisting of a secured creditor, voted for the plan and the noteholders voted against the plan. To effect a cramdown of the plan over the negative vote of the noteholders, the bankruptcy court was required to determine the value of the collateral securing the noteholders' claims. The bankruptcy court found that payment to the noteholders of \$513.6 million in cash, representing the value of their claims, represented the "indubitable equivalent" of their secured claim pursuant to Section 1129(b)(2)(A)(iii) of the Bankruptcy Code. Two months previously, the indenture trustee had moved for a super-priority administrative expense claim on the grounds that its collateral had diminished in value after the filing of the bankruptcy cases, but this motion was rejected. Turning to the equitable mootness argument, the appeals court noted that equitable mootness "is a kind of appellate abstention that favors the finality of reorganizations and protects the interrelated multi-party expectations on which they rest." While constitutional mootness concerns arise when a judicial ruling would have no effect, equitable mootness "applies when a judicial ruling might have too much effect on the parties to a confirmed reorganization." If an order confirming a plan has not been stayed and the plan has been substantially consummated, equitable mootness prevents review if the appellate

relief requested would affect either the rights of parties not before the court or the success of the plan. The Fifth Circuit said that it would be “especially solicitous of the rights of secured creditors following confirmation.” Another caveat to application of the equitable mootness doctrine is that it should be applied “with a scalpel rather than an axe,” with the result that the court should consider it in the context of specific claims and not entire appeals. In this case, reversal of the entire confirmation order would be inappropriate in light of substantial confirmation of the plan, which entailed dissolution of two of the debtors, transfer of their assets, funding of exit financing, payment of over \$50 million to certain creditors, retention of new management, execution of contracts with new customers, and obtaining regulatory approval from state and federal agencies for the conduct of the new business. Accordingly, the Fifth Circuit found that review of the arguments of the noteholders relating to their secured claims was appropriate. Turning to the argument that the plan did not satisfy the “fair and equitable” requirements under Section 1129(b) of the Bankruptcy Code because, among other things, the plan constituted a sale of assets while barring them from exercising rights to credit bid, the Fifth Circuit found that the transfer of assets was indeed a sale of the noteholders collateral and that under Section 1129(b)(2)(A)(ii), the noteholder should have been afforded an opportunity to credit bid if confirmation was premised solely on that section of the Bankruptcy Code. Nevertheless, the noteholders did not demonstrate that clause (ii) of Section 1129(b)(2)(A) exclusively applied to confirmation of the plan. Here, the plan satisfied clause (iii) of Section 1129(b)(2)(A) because it allowed for the realization by the noteholders of the “indubitable equivalent” of their claims by paying them the cash amount of the value of their collateral. The Fifth Circuit rejected the noteholders’ argument that, by depriving them of the right to credit bid and presumably foreclose on their collateral, the plan failed to afford them the indubitable equivalent because they were forced to forfeit the possibility of later increases in the value of the collateral. The Bankruptcy Code, however, “does not protect a secured creditor’s upside potential” but only the allowed secured claim of the creditor. The plan would have been confirmable under clause (i) of Section 1129(a)(2)(A) if it offered a stream of future payments to the noteholders yielding the present value of their collateral and then paid off the note one day after the plan was confirmed. Accordingly, they cannot complain that they were paid in cash under clause (iii). The Fifth Circuit then found that the bankruptcy court’s valuation procedures and conclusions were not clearly erroneous, and therefore that the plan’s provisions for payment to the noteholders of the allowed amount of their secured claims did not violate the absolute priority rule and was fair and equitable under Section 1129(b)(2)(A)(iii). The Fifth Circuit then turned to the appellants’ arguments of artificial impairment and gerrymandering of unsecured claims whereby general unsecured claims were put in one class (which accepted the plan) and the deficiency claims of the noteholders put in a separate class (which rejected the plan). The artificial impairment argument related to a bank’s secured claim, which the appellants contended needlessly deferred payment of approximately \$1 million in default interest in installments over the course of a year. While finding the allegations made by the appellants to be “troubling,” the Fifth Circuit nevertheless found that these impairment and classification contentions were equitably moot because the plan was substantially consummated and unsecured creditors had received payment for their claims. For the same reason, the Fifth Circuit rejected the argument that the plan discriminated unfairly between the claims of the general unsecured creditors (which received approximately 75% to 90% of their unsecured claims) and the noteholders’ deficiency claims (with a speculative return that might result in their receiving nothing). Finally, the Fifth Circuit addressed the scope of the plan releases of non-debtor parties, which included the secured creditor proponent of the plan, the competitor component of the plan, the unsecured creditor’s committee and others. Finding that the arguments relating to the releases were not equitably moot as the goal of finality sought in the equitable mootness doctrine did not outweigh the court’s duty to protect the integrity of the bankruptcy process. The Fifth Circuit found “little equitable about protecting the released non-debtors from negligent suits arising out of the reorganization,” noting that Section 524(e) of the Bankruptcy Code only contemplates releases of the debtor and not co-liable third parties. In this case, the plan release provision was not intended to release co-obligors with the debtor but merely to absolve the released parties from any negligent conduct that occurred during the course of the bankruptcy. Nevertheless, the Fifth Circuit agreed that the creditors committee

should have qualified immunity for actions within the scope of their duties. Accordingly, an exculpation provision in a plan which does not insulate them from willfulness and gross negligence was permissible.

2. GUARANTY -- TOLLING OF STATUTE OF LIMITATIONS BY PRINCIPAL'S PARTIAL PAYMENT

JSA Fin. Corp. v. Quality Kitchen Corp. of Delaware, 964 A.2d 584 (Conn. App. Ct. 2009) -- The Debtor executed a promissory note for a line of credit from the lender. The note was payable with interest on demand, but no later than July 18, 1990. The debtor made an interest payment on the note on November 19, 1996, and the lender sued the debtor and the guarantor of the note in state court on July 2, 2002. The trial court ruled in favor of the lender. On appeal, the appellate court ruled that a trier of fact could find that a partial payment on the note tolled the six year statute of limitations, as the partial payment could be found to be an unequivocal acknowledgement of the entire debt that tolled the statute of limitations. The guarantor, however, while conceding that the November 1996 payment may have tolled the statute of limitations as to the debtor, contended that he did not have knowledge of or consent to the partial payment and therefore could assert the defense. While as a general rule a payment by the maker tolls the statute of limitations only as to the maker and not a guarantor when the payment is made without the guarantor's knowledge, authorization or consent, the terms of the guaranty in this case provided that the holder could modify the terms of repayment without the consent or knowledge of the guarantor and without releasing the guarantor. Specifically, the guaranty authorized the lender at any time and upon such terms as it deemed appropriate to extend the time for payment or to change the manner or terms of payment or to accept renewals for or different evidences of the indebtedness for any advances that it may make, without notice to and without releasing the guarantor. The guaranty contained very broad language and provided that it was a "continuing" guaranty, which imposed liability upon the guarantor for a period of time as is reasonable under the circumstances. The trial court found that the guaranty remained in effect and such a finding was an implicit determination of reasonableness.

3. RECOVERY OF POST-PETITION LEGAL FEES -- EFFECT OF FORECLOSURE DECREE

In re Sun 'N Fun Waterpark LLC, 408 B.R. 361 (BAP 10th Cir. 2009) -- At issue in this case was whether a mortgagee was entitled to recover post-petition legal fees and costs when it held an oversecured claim. The debtor challenged the mortgagee's entitlement to recover such fees and expenses pursuant to Section 506(b) of the Bankruptcy Code because, prior to the commencement of bankruptcy, the mortgagee had obtained a foreclosure decree under Oklahoma law. However, because the bankruptcy had occurred before the sheriff's sale, the mortgage did not merge into the foreclosure decree and the mortgagee was entitled to its contractual mortgage rights to recover attorney's fees and costs in connection with its post-petition collection efforts.

4. SUBORDINATION AGREEMENT -- JUNIOR CREDITOR'S SUIT ON GUARANTY

Highland Park CDO I Grantor Trust, Series A v. Wells Fargo Bank, N.A., 2009 U.S. Dist. LEXIS 53272 (S.D.N.Y. 2009) -- Four individuals personally guaranteed a senior loan made by a senior lender and a subordinated loan made by a subordinated lender. An intercreditor agreement between the senior and subordinated lenders specified that, in the event of a default on the senior loan, the senior lender was entitled to receive full payment before the subordinated lender was authorized to receive any payment on account of the subordinated loan. After default, the senior lender proceeded to foreclose on its collateral and the subordinated lender sued the guarantors. The subordinated lender also filed a declaratory judgment action against the senior lender in which it sought a determination that it lawfully could prosecute the suit against the guarantors irrespective of the payment status of the senior loan. The subordinated lender argued that the payment subordination only prohibited payments by the senior borrower

(rather than payments by the guarantors) to be made before payment in full of the senior loan. Ruling for the senior lender, the district court found that, while some provisions of the intercreditor agreement specifically related to payments by the senior borrower, other provisions were more generalized in their nature and applied to block any payments on account of the subordinated loan before the senior loan was paid in full. New York law did not prohibit subordination agreements from precluding subordinated lenders from suing on separate guaranty agreements.

5. ARBITRATION - - EQUITABLE CLAIM vs. CONTRACT CLAIM

Swan Landing Dev., LLC v. Florida Capital Bank, N.A., 19 So. 3d 1068 (Fla. Dist. Ct. App. 2009) - - The bank sued for a mortgage foreclosure under Florida law against the debtor, which had defaulted on the bank's loan. In its complaint, the bank included breach of contract counts against the debtor and a guarantor. Both the debtor and a guarantor moved to compel arbitration, which was denied by the trial court. On appeal, the debtor and guarantor argued that the mortgage, note and guaranty contained mandatory arbitration provisions that required all claims to be arbitrated. The appellate court ruled that the arbitration provisions did not prohibit the bank's equitable foreclosure action on the mortgage, but permitted the bank to arbitrate the foreclosure. However, the breach of contract claims under the note and guaranty were required to be arbitrated under the plain language of the loan documents.

6. ENFORCEMENT OF GUARANTY - - PAROL EVIDENCE RULE

Wachovia Bank v. Dresdner, 52 BCD 72 (Bankr. E.D. Va. 2009) - - The bank moved for summary judgment on its claim against the guarantors of a loan in the amount of \$2.63 million. The guarantors alleged that the bank had orally promised to extend an additional loan and to execute partial releases of collateral under its mortgages securing the promissory note. They argued the affirmative defense of equitable estoppel. The bank argued that Virginia's statute of frauds prohibited the arguments raised by the guarantors. The bankruptcy court, however, found that the Virginia statute of frauds was not applicable to the assertion of an affirmative defense, such as the one raised by the guarantors. The court ruled in the bank's favor because the existence of a merger clause in the guaranty and the application of the parol evidence rule combined to foreclose introduction of oral statements allegedly made by the bank that would vary the nature of the contract by the parties.

7. CONSTRUCTIVE FRAUDULENT TRANSFER - - EFFECT OF APPROVAL OF DEBTORS' CENTRALIZED CASH MANAGEMENT SYSTEM

In re Collins & Aikman Corp., 401 B.R. 900 (Bankr. E.D. Mich. 2009) - - Motions for summary judgment were filed by defendants in adversary proceedings brought against them in which it was alleged that the defendants received constructive fraudulent transfers. The pre-petition transfers consisted of payments that were made through the debtors' centralized cash management system and from which payments were made by them to several suppliers of a non-debtor Canadian subsidiary. As part of their first day motions in their Chapter 11 cases, the debtors sought and obtained authority to continue using the centralized cash management system, which they asserted was essential to their ongoing operations. The defendant suppliers argued that they were entitled to summary judgment, in part because the doctrine of judicial estoppel barred the debtors from arguing in their first day motions that the cash management system benefitted the debtors' operations while at the same time contending that pre-petition transfers from the same system were not for reasonably equivalent value. The court found that the prior statements made by the debtors at the time of their first day motions with respect to the cash management system as a whole and its benefits to the debtors' operations related to future operations. Further, the court found that the debtors' current claims to recover pre-petition payments from a non-debtor subsidiary's suppliers were not clearly inconsistent with prior positions taken in the case by the debtors.

8. USURY - - APPLICABILITY OF EQUITABLE ESTOPPEL DOCTRINE

In re Vision Dev. Group of Broward County, LLC, 411 B.R. 768 (Bankr. S.D. Fla. 2009) - - The lender made a loan to the debtors in the amount of \$10.5 million to fund their acquisition and condominium conversion of an apartment complex in Florida. The loan documents were governed by New York law. As a condition to the financing, the lender required a favorable opinion letter from the debtors' law firm. The opinion letter that was issued in favor of the lender stated that the loan documents were legal, valid and enforceable. In reliance upon the opinion letter, the lender funded the loan. In the debtors' subsequent bankruptcy, the debtors argued, among other things, that the loan was usurious under the laws of the State of Florida. The bankruptcy court rejected their claim. First, the bankruptcy court ruled that the debtors were equitably estopped from asserting a usury claim and rejected the debtors' argument that an opinion letter cannot form the basis of an equitable estoppel defense to usury. Furthermore, the court rejected the debtors' contention that the letter was irrelevant in determining the "corrupt intent" element of usury, as the debtors were essentially using a mathematical calculation to prove intent rather than showing intent from the circumstances surrounding the entire agreement. Finally, the court noted that all of the relevant loan documents were governed by New York law and, under New York law, the usury statutes did not apply to loans exceeding \$2.5 million.

9. ARBITRATION - - UNCONSCIONABILITY

Cordova v. World Fin. Corp. of New Mexico, 208 P.3d 901 (N.M. 2009) - - In a consumer loan agreement, an arbitration clause mandated arbitration for claims brought by the borrower but gave the lender the discretion to pursue various remedies (ones, according to the court, that the lender would most likely pursue). The borrower forfeited all rights under the provision to go to any court for any reason, including disputes about the validity of the loan documents, issues relating to the contracts, claims for fraud, and claims based on federal and state consumer protection laws. Accordingly, the court found that the arbitration agreement was unconscionable and therefore unenforceable.

10. LENDER LIABILITY - - QUANTUM MERUIT

Gaymar Indus., Inc. v. Firstmerit Bank, 311 Fed. Appx. 814 (6th Cir. 2009) - - The plaintiff, a manufacturer of medical equipment, agreed to sell equipment to the debtor. To pay for the equipment, the debtor obtained lease financing from a lessor pursuant to which the lessor would buy the equipment from the plaintiff and lease it to the debtor. To finance its purchase, the lessor turned to the bank with whom it had an existing line of credit. After the equipment had been delivered to the debtor, the lessor made two draw requests on the line of credit for payment to the plaintiff for the equipment. The bank honored the draw requests and deposited the money into the lessor's account and the bank retained a security interest in the equipment. There was no contract between the bank and the plaintiff. The lessor never paid the plaintiff for the equipment and never repaid the bank for the draw request, with the result that the bank exercised its right to direct the debtor to make its lease payments directly to the bank. The plaintiff then sued the bank for quantum meruit and equitable subordination, alleging that the bank failed to follow its own lending procedures when it honored the draw request of the lessor without requiring more proof that the plaintiff, as vendor, had been paid. The district court granted the bank's motion for summary judgment and, on appeal, the judgment was affirmed. Turning to the unjust enrichment (quantum meruit) claim of the plaintiff, the court noted that such a claim arises under an equitable doctrine under which a party can be made whole when it confers a benefit upon another without receiving just compensation for the value of the services. To be actionable, however, the plaintiff's harm must be "causally connected to a substantial benefit to the defendant." Furthermore, in determining whether a defendant received an unjust benefit, the court must consider whether the defendant was the party responsible for the plaintiff's detrimental position. Where a plaintiff is responsible for his own detrimental position, there is no causal connection between the defendant's benefit

and the plaintiff's loss. Applying these rules, recovery by the plaintiff was precluded, as the plaintiff could have obtained a security interest in the equipment but failed to do so. The bank owed no duty to the plaintiff to save the plaintiff from its own lack of care, the court noting that a lender is normally not a fiduciary of the debtor or its creditors and owes them no special obligation of fidelity. Even if the bank failed to follow its own internal loan policies, the plaintiff pointed to no evidence to support the conclusion that these policies existed to protect the plaintiff.

11. ESTATE PROPERTY -- ENJOINING CREDITOR PURSUIT OF ALTER EGO CLAIMS

In re Teknek, LLC, 563 F.3d 639 (7th Cir. 2009) -- The Chapter 7 trustee sought to enjoin a judgment creditor's collection efforts against shareholders of the corporate debtor and a related holding company as the debtor's purported alter egos. The trustee sought the injunction so that the trustee could seek the same judgment for the benefit of the Chapter 7 estate. The bankruptcy court entered a preliminary injunction that prevented the judgment creditor from collecting the judgment outside the bankruptcy. The district court vacated the preliminary injunction and the trustee appealed. The Seventh Circuit ruled that the judgment creditor's alter ego claims were not estate property or related to the debtor's bankruptcy case. Accordingly, a preliminary injunction against the judgment creditor's collection efforts was improperly issued.

12. SCOPE OF SECURITY INTEREST -- PROCEEDS

In re Greg James Ventures LLC, 2008 WL 4829952 (Bankr. N.D. Cal. 2008) -- The bank lent money to an automobile dealership. The bank secured its loan with a security interest in all of the dealership's inventory. After the dealership filed for Chapter 11 protection, the dealership sold various vehicles to customers. An issue arose as to the scope of the bank's security interest in certain sale proceeds consisting of the sale of an extended warranty to the purchaser, fees paid to the debtor by the lender for arranging third-party financing, incentive payments paid by the manufacturer to the debtor, expenses incurred in preparing the vehicle for sale, and post-petition repairs to the vehicle. The bank argued that its security interest extended to all of the proceeds and revenue from the sales, but the bankruptcy court disagreed. Under UCC § 9-102(a)(64), the term "proceeds" means whatever is acquired upon the sale of the collateral. The bankruptcy court found that the repair and servicing element from repairs to a vehicle constituted proceeds of a bank's security interest, but the bank's security interest did not extend to the sale to the purchaser of an extended warranty as this was a separately charged and itemized elective item for the purchaser. In addition, the financing fees and incentive payments paid for by third-party financing arranged by the debtor was not subject to the bank's security interest. However, the portion of the sale price allocated to prepping the vehicle for delivery to the purchaser, including gas, was part of the "delivered price" and therefore subject to the bank's liens.

13. LENDER LIABILITY -- TRUST FUNDS UNDER TRUTH-IN-LEASING REGULATIONS

Owner Operator Indep. Drivers Ass'n, Inc. v. Comerica Bank, 615 F. Supp. 2d 692 (S.D. Ohio 2009) -- The plaintiffs were owner-operators of trucking equipment and an owner-operator industry association. They sued a regulated motor carrier engaged in transportation service for the return of certain maintenance escrow funds pursuant to the federal Truth-in-Leasing Regulations enacted in 1978 for the protection of owner-operator truckers. The plaintiffs also sued the carrier's bank. Pursuant to agreements with the plaintiffs, the carrier deducted \$0.09 per mile from the compensation owed to each owner-operator for purposes of repairing and maintaining the leased trucking equipment. The carrier kept track of the deductions on weekly settlement statements issued to the owner-operators. The court found that the funds were collected for the sole purpose of maintaining the leased equipment prior to an owner-operator's termination of its lease and the funds were not available to be used for any other obligation. The plaintiffs sued for some \$5,583,000 of maintenance escrow funds that had not been turned over to

them. The plaintiffs and the carrier ultimately settled, with the carrier paying only \$900,000 of the total owed. The plaintiff sought to recover the balance from the bank. The bank had entered into an asset based lending arrangement with the carrier. In connection with that facility, the carrier established three accounts with the bank - a depository/operating account into which the bank made advances; a zero-balance checking account for the writing of checks; and a cash collateral account to which customers of the carrier made their payments. Funds from time to time on deposit in the depository/operating account were available for use by the carrier, provided that the bank debited the account monthly with its interest and loan fees. Amounts received in the cash collateral account were applied to the loan balance. The bank contended that it ultimately made available 100% of accounts receivable that were collected, either in the form of advances against the accounts or additional availability resulting from the collection of the full amount of the accounts. The plaintiffs asserted that the trust attached to funds in the cash collateral account when customers made payments to that account and that the bank applied those funds (which included the escrows) directly to pay down the carrier's loans. The bank, on the other hand, argued that the trust attached only to funds in the depository/operation account when the \$0.09-per-mile was deducted from an owner-operator's compensation. Noting that there was no case law analyzing what funds were subject to a trust-in-leasing trust, the court looked to analogous provisions under the Perishable Agricultural Commodities Act and concluded that there was no requirement to trace the trust funds and that comingling of trust funds did not destroy the trust. Nevertheless, the plaintiffs were still obliged to establish that the bank received the trust funds in violation of the trust. The question ultimately turned on when the trust was created. The court noted that if the trust was created when the carrier paid owner-operators their compensation from the depository/operating account, it would be presumed that any money paid for bank fees and interest included trust assets. The court concluded that the trust was created when money was withheld from the owner-operator's compensation, which did not occur until payments were made from the depository/operating account. This conclusion was based upon language in the lease agreement stating that the owner-operator authorized the carrier to deduct from settlements \$0.09 per mile to establish the maintenance expense for the equipment. The court then observed that the bank could not be liable for receiving funds in breach of a trust unless the trustee's transfer of funds itself constituted a breach of its duties to maintain the trust. As the trust only attached to the depository/operating account, there could only be a breach of trust if either the funds deposited in that account were unlawfully encumbered or were unlawfully withdrawn. The payment of monthly interest and bank fees to the bank from the depository/operating account was not a breach of trust as long as the interest and fees were commercially reasonable. There was no dispute that the interest and fees charged by the bank were comparable to those charged to its other borrowing customers. All of the other funds in the depository/operating account, except those used to pay interest and fees to the bank, were freely available to satisfy outstanding obligations to the plaintiffs. Accordingly, the bank's motion for summary judgment was granted.

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