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UNITED STATES BANKRUPTCY COURT)	
SOUTHERN DISTRICT OF NEW YORK)	
)	
)	
In re:)	Chapter 11
)	
PATRIOT COAL CORPORATION, <i>et al.</i> ,)	Case No. 12-12900 (SCC)
)	
Debtors,)	Jointly Administered
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**LIMITED OBJECTION OF
DRUMMOND COAL SALES, INC.
TO DEBTORS' NOTICE OF REJECTION OF A CERTAIN
BULK COAL TRANSFER AND STORAGE AGREEMENT**

Drummond Coal Sales, Inc. (“**Drummond**”) hereby files this limited objection (the “**Objection**”) to the Debtors’ Notice of Rejection of a certain Bulk Coal Transfer and Storage Agreement filed on November 9, 2012 [Docket No. 1551] (the “**Notice**”). In support of the Objection, Drummond states as follows:

BACKGROUND

1. On July 9, 2012 (the “**Petition Date**”), Patriot Coal Corporation (“**Patriot**”) and certain affiliated entities (collectively, the “**Debtors**”) each filed a voluntary petition for relief under chapter 11 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq. (the “**Bankruptcy Code**”), in the United States Bankruptcy Court for the Southern District of New York (the “**Bankruptcy Court**”). Since the Petition Date, the Debtors have continued to operate

their businesses and manage their properties as debtors-in-possession pursuant to Sections 1107 and 1108 of the Bankruptcy Code.

2. Prior the Petition Date, Drummond and Patriot entered into a certain Bulk Coal Transfer and Storage Agreement dated as of June 25, 2011 (the “**Agreement**”), pursuant to which Drummond agreed to allow Patriot to ship and transport coal to and through a facility in which Drummond has certain rights and which is known as "Pier IX" and located in Newport News, Virginia (the “**Facility**”). Patriot agreed to make payments to Drummond based on the amount of coal that Patriot transported into and through the Facility, with an annual "take or pay" minimum payment.

3. The term of the Agreement consists of the period running from January 1, 2013, through and including December 31, 2014 (the “**Term**”).

4. By Letter Agreement dated July 25, 2012, Patriot agreed to treat Drummond as a "critical vendor" with respect to the services provided by Drummond to Patriot under the Agreement and a prior agreement with a term that runs through December 31, 2012 (the “**Letter Agreement**”). Pursuant to the Letter Agreement, Patriot and Drummond continued to conduct business with each other in the ordinary course of business from and after the date of the Letter Agreement.

5. On October 2, 2012, under the terms of the Agreement and consistent with the Letter Agreement, Patriot paid Drummond \$1,250,002.50, which had been due and payable as the first payment due under the Agreement (the “**October Payment**”).

6. The Notice seeks Bankruptcy Court authorization to reject the Agreement.

7. The Notice was allegedly given and filed pursuant to an Order of the Bankruptcy Court Establishing Procedures for the Rejection of Executory Contracts and Unexpired Leases, etc. issued on August 16, 2012 [Docket No. 370] (the “**Procedures Order**”). In the Procedures Order, the Bankruptcy Court approved a set of procedures pursuant to which the Debtors could reject executory contracts or unexpired leases in a streamlined and economical manner.

8. Attached to the Notice was a proposed Order which, *inter alia*, authorized the Debtors' rejection of the Agreement under Section 365(a) of the Bankruptcy Code, effective as of November 12, 2012, and, in the fifth ORDERED clause of the proposed order that is attached to the Notice (the "**Fifth Order**"), required Drummond to turn over to Patriot "any pre-payments made by the Debtors to Drummond ... before the date [of the Notice] pursuant to the contract on account of services attributable to the time period following the date [of the Notice]." This would allegedly include the October Payment.

9. The relief requested in the Fifth Order is neither specifically requested nor mentioned in the Notice. The Procedures Order similarly does not provide for the turnover of funds in the form provided in the Fifth Order.

10. Under Sections 365(a) and (g) of the Bankruptcy Code, the rejection of the Agreement results in a breach thereof, effective immediately before the Petition Date, giving rise to a claim for damages for Drummond against Patriot (the "**Rejection Claim**").

11. While we do not calculate the Rejection Claim at this point in time, and hereby reserve all rights with respect thereto, it is clear to Drummond (and to Patriot) that the amount of the Rejection Claim will greatly exceed the amount of the October Payment.

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12. While Drummond does not object generally to the proposed rejection of the Agreement by the Debtors, Drummond does object to the attempt by the Debtors to require Drummond to pay Patriot \$1,250,002.50 representing the amount of the October Payment, as set forth in the Fifth Order.

13. This request is improper from both a substantive and a procedural standpoint, and the Fifth Order should be stricken from any order that is issued by this Court pursuant to the Notice, for the reasons set forth below.

A. Any Request to Recover Money must be in the Form of an Adversary Proceeding.

14. As an initial matter, we note that the form of the Notice is insufficient and cannot support any demand that Drummond pay any money to Patriot, but can simply request that the Bankruptcy Court authorize Patriot to reject the Agreement under Section 365(a) of the Bankruptcy Code.

15. Rule 7001 of the Federal Rules of Bankruptcy Procedure (the “**Bankruptcy Rules**”) provides, in pertinent part, as follows:

An adversary proceeding is governed by the rules of this Part VII. The following are adversary proceedings: (1) a proceeding to recover money or property, other than a proceeding to compel the debtor to deliver property to the trustee, or a proceeding under §554(b) or §725 of the Code, Rule 2017, or Rule 6002.;...

16. It is clear that the Patriot's demand for a turnover of funds from Drummond, as is effectively requested in the Fifth Order, constitutes a request "to recover money or property" from Drummond, relief that can only be brought in a complaint filed in an adversary proceeding, in accordance with Article VII of the Bankruptcy Rules.

17. As the relief provided for in the Fifth Order can be provided only through an adversary proceeding, the Fifth Order may not as a procedural matter be issued under the Notice, and must be stricken from the proposed Order.

B. The Procedures Order Does Not Provide for the Debtors to Obtain a Turnover of Funds.

18. The Procedures Order sets out various streamlined procedures for the rejection of executory agreements and unexpired leases by the Debtors, and for any objections thereto.

19. Although the Notice and the proposed Order are alleged to have been filed, and the remedies therein are stated to have been requested, under and in accordance with the Procedures Order, the relief being requested in the Fifth Order (i.e., the turnover of any prepaid amounts) is beyond the scope of the Procedures Order.

20. Neither the Procedures Order nor the motion for the issuance of the Procedures Order [Docket No. 136] contains any such request or language. One reason may have been that such relief can be obtained only by the commencement of an adversary proceeding. *See A, above.*

21. Paragraph 10 of the Procedures Order notes that contract counterparties are "prohibited from setting off or otherwise utilizing any monies deposited by the Debtors" under the contract being rejected. In this case, the October Payment was not a deposit. Furthermore, Drummond has a right of recoupment in this case, which is discussed in D below, which can be distinguished from a right of setoff.

22. Accordingly, the relief provided for in the Fifth Order exceeds the authority granted to the Debtors by the Procedures Order and may not be requested in the Notice or granted by the Bankruptcy Court in the proposed Order.

C. The Debtors Do Not Request the Return of the October Payment in the Notice.

23. Further to A and B above, we note that at nowhere in the Notice, or in any other document filed therewith, do the Debtors specifically request, or set out the legal or factual basis for, the repayment of the October Payment or any similar payment, as is currently set forth (and presumably requested) in the Fifth Order.

24. The reason for this failure may be the lack of authority described in A and B above, or may be that the Debtors were hoping to "sneak in" such relief in the hope that Drummond would not notice. The Debtors simply provide for this relief without any request or basis. A court cannot grant relief that is neither requested, nor for which there is a proper basis given, in the pleadings, and the Bankruptcy Court should not permit such an attempt by the Debtors.

D. Drummond Has a Right of Recoupment.

25. Under these facts, Drummond has the right to exercise and assert the equitable right of recoupment with respect to the October Payment, reducing the Rejection Claim by the amount of the October Payment, and retaining the full amount of the October Payment and not paying it to Patriot.

26. Recoupment is "an equitable principle that allows a creditor in bankruptcy to show that because of matters arising out of a transaction sued on, he or she is not liable in full for the [debtor's] claim." *United States v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994); *In re Terry*, 687 F.3d 961, 963 (8th Cir. 2012).

27. In order for a creditor to successfully assert the right of recoupment in bankruptcy, (i) the claims of the debtor and the creditor must arise from a single transaction (e.g., the Agreement) and (ii) there must be some overpayment, whether accidentally or contractually made. *See In re Photo Mechanical Services, Inc. v. E.I. DuPont de Nemours & Co., Inc.*, 179 B.R. 604 at 613 (Bankr. D. Minn. 1995); *In re Public Service Co. of New Hampshire*, 107 B.R. 441 at 445 (Bankr. D. N.H. 1989); *also, Dewey, supra*.

28. Recoupment permits a creditor to avoid the inequitable position of being forced to pay money to a party that owes money to it, which arises out of the same transaction and is equal to or exceeds the amount that is otherwise owed. In this case, it is clear that the amounts of the potential damages to be claimed arise from the same transaction, as both relate to and arise out of the Agreement and the performance (or failure thereof) thereunder.

29. Based on the substantial size of the Rejection Damages and the losses being incurred by Drummond as a result of the rejection of the Agreement, it would be inequitable for this Court to order Drummond to pay in excess of \$1 million to Patriot under the Agreement, adding "insult to injury" and, essentially, harming Drummond more than it is already being harmed as a result of the rejection of the Agreement being requested in the Notice.

30. The October Payment was not a "deposit", as it was paid to Drummond for valuable consideration. The October Payment provided a substantial "benefit" to Patriot, and

resulted in a substantial "cost" to Drummond, requiring Drummond to keep the Facility generally available for Patriot and its coal during the month of January 2013, although the rejection of the Agreement will relieve Drummond of the obligation to maintain any such capacity for Patriot.

31. Unlike setoff, recoupment requires that the claims arise from the same transaction, as is the case here, where each of the claims arises under the Agreement. *United States v. Dewey Freight Sys., Inc.*, 31 F.3d 620, 623 (8th Cir. 1994); *In re University Medical Ctr.*, 973 F.2d 1065, 1081 (3d Cir. 1992).

32. In addition, unlike setoff, recoupment is neither governed by Section 553 of the Bankruptcy Code, nor subject to the automatic stay effected under Section 362 of the Bankruptcy Code. *In re McMahon*, 129 F.3d 93, 96 (2d Cir. 1997); *Mercy Hosp. of Watertown v. New York State Dep't of Soc. Servs.*, 171 B.R. 490, 494 (N.D.N.Y. 1994). Similarly, the requirement of pre-petition/post-petition "mutuality," which applies to setoff, does not apply to recoupment. *In re B & L Oil*, 782 F.2d 155, 158-59 (10th Cir. 1986).

33. As a result, Drummond has a right of recoupment here, reducing the amount of the Rejection Claim by the amount of the October Payment, and thereby not requiring Drummond to turn over the amount of the October Payment to Patriot as a result of the Notice and the rejection of the Agreement effected thereby.

WHEREFORE, for the foregoing reasons, Drummond respectfully requests that this Court grant the Motion in part and authorize the rejection of the Agreement in an Order that excludes the Fifth Order or any similar language that requires Drummond to return the October Payment or any portion thereof, or any amount of money, to Patriot, and to grant and direct any such other and further relief as is just and proper.

Dated: November 26, 2012

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CERTIFICATE OF SERVICE

I, Elvin Ramos, under penalty of perjury of the laws of the United States of America, this 26th day of November 2012, caused a copy of the foregoing **Limited Objection of Drummond Coal Sales, Inc. to Debtors' Notice of Rejection of a Certain Bulk Coal Transfer and Storage Agreement** to be served by operation of the Case Management/Electronic Case Filing System for the United States Bankruptcy Court for the Southern District of New York (the "CM/ECF System") upon registered users of the CM/ECF System.

Dated: November 26, 2012



Elvin Ramos