SURETY’S RIGHTS AND OBLIGATIONS UNDER SMCRA¹
AND THE BANKRUPT PRINCIPAL’S ENVIRONMENTAL OBLIGATIONS

Energy and Mineral Law Foundation
29th Mineral Law Conference
October 14-15, 2004
Lexington, Kentucky

W. Blaine Early, III
William T. Gorton III
Stites & Harbison, PLLC
250 West Main Street
Lexington, Kentucky 40507
859-226-2300

This outline is intended to accompany and supplement the panel discussion on coal company bankruptcies. It describes the nature of reclamation surety bonds, a debtor’s ongoing obligation to comply with law, and issues related to payment of costs related to reclamation.

I. SMCRA AND RECLAMATION SURETY BONDS

A. A mining permittee must furnish a bond.

1. Before a mining permit can be issued the applicant must provide a bond for performance of requirements under the laws and regulations. 30 U.S.C. § 1259(a); 30 C.F.R. § 800.11(a); KRS 350.064; 405 KAR Chapter 10.


B. A surety bond has several characteristics, including its nature as a three-party agreement that is a financial accommodation or credit transaction.

1. A reclamation surety bond is a three-party agreement among the regulatory authority (the obligee), the permittee (principal or primary obligor), and the surety (secondary obligor).

2. A surety bond is a financial accommodation or a credit transaction, and “surety bonds, issued by compensated sureties, are meant to function as credit accommodations in which the surety anticipates no loss.” Armen Shahinian, The General Agreement of Indemnity, in The Law of Suretyship 487 (Edward G. Gallagher ed. 2nd ed. 2000).


¹ 30 U.S.C. §§ 1201 et seq.
insurance.”); Meyer v. Building & Realty Service Co., 196 N.E. 250, 254 (Ind. 1935) (“We are clearly of the opinion that the contract here in question is a contract of suretyship and not an insurance policy.”). Buck Run Baptist Church, Inc. v. Cumberland Sur. Ins. Co., Inc., 983 S.W.2d 501, 504 (Ky. 1998) (“A contract of suretyship is not a contract of insurance.”).

4. Reclamation surety bonds are for the benefit of the regulatory authority and are not property of the debtor’s estate. In re Lockard, 884 F.2d 1171, 1177 (9th Cir. 1989); McLean Trucking Company v. Dept. of Industrial Relations, 74 B.R. 820, 826-28 (Bankr. W.D. N.C. 1987).

C. The surety has certain rights under SMCRA and surety law.


2. If the permittee fails to comply with law or with the terms or conditions of the permit the regulatory authority may forfeit the reclamation surety bond. 30 C.F.R. § 800.50; 405 KAR 10:050. Laws and regulations provide due process protections in the case of bond forfeiture.

3. The surety may complete the necessary reclamation in lieu of bond forfeiture. 30 C.F.R. § 800.50(a)(2); 405 KAR 10:050 § 1.

4. When the surety performs its obligations under a bond the surety has right to subrogation. Pearlman v. Reliance Ins. Co., 371 U.S. 132, 137 (1962) (‘‘A surety who pays the debts of another is entitled to all the rights of the person he paid to enforce his rights to be reimbursed.’’).

a. Surety’s subrogation right relates back to the date of the bond. Prairie State Nat’l Bank v. United States, 164 U.S. 227, 240 (1896). In re Larbar, 177 F.3d 439, 444 (6th Cir. 1999)

b. Under the equitable principle of quia timet the surety’s subrogation right exists even though it has not yet performed on the bond. Morely Const. Co. v. Maryland Cas. Co., 90 F.2d 976, 977 (8th Cir. 1937); Escrow Agents’ Fidelity Corp. v. Superior Court of Los Angeles County, 5 Cal.Rptr. 698, 699 (Calif. Ct. App. 1992).

5. Transfer of permits must be approved by the regulatory agency, and the existing surety bonds must be replaced. The law is clear that “[n]o surface coal mining permit . . . shall be transferred by sale, assignment, lease or otherwise except upon written approval by the cabinet. . . .” KRS 350.135(1); 405 KAR 8:010 § 22;
N a t u r a l R e s o u r c e s  a n d  E n v i r o n m e n t a l P r o t e c tio n  C a b in e t v .  N e a c e , 1 4 S .W .3 d 1 5 , 1 8 ( K y . 2 0 0 0 ) ; 3 0 U .S .C . § 1 2 6 1 ( b ) ; 3 0 C .F .R § 7 7 4 .1 7 .

The original permittee is not relieved of its bonded obligations until the recipient/transferee supplies a satisfactory bond and assumes “all liability for the reclamation of the area of land affected by the former permittee.” KRS 350.135(3).

II. AUTOMATIC STAY AND REGULATORY ENFORCEMENT

A. Automatic stay does not stop enforcement of environmental laws by exercise of the government’s police or regulatory power.


3. The automatic stay imposed by the Bankruptcy Code does not prevent regulatory authorities from taking enforcement actions. Ohio v. Kovacs, 469 US 274, 283 n.11 (1985) (“The automatic stay provision does not apply to suits to enforce the regulatory statutes of the State . . . ”). Penn Terra Ltd. v. Dep’t of Envtl. Resources, 733 F.2d 267, 278-79 (3rd Cir. 1984) (holding that the automatic stay was not applicable) (“injunction was meant to prevent future harm to, and to restore, the environment . . . it is clear that erosion control, backfilling, and reseeding were additionally meant to preserve the soil conditions from further deterioration . . . ”).

The recent decision of the United States District Court for the Eastern District of Kentucky in Bickford v. Lodestar Energy, Inc., 2004 U.S. Dist. LEXIS 5097, (U.S. Dist. E.D.Ky. 2004), upheld regulators’ rights to pursue regulatory remedies against debtors and specifically refused to enjoin such enforcement activity. In doing so, the District Court relied on the police power exception to the automatic stay and stated as follows:

[Title] 11 U.S.C. § 362 specifies that the automatic stay which generally precludes “the commencement or continuation … of a judicial, administrative, or other action or proceeding against the debtor” in bankruptcy does not apply to “the commencement or continuation of an action or proceeding by a governmental unit’s … police or regulatory power … other than [the enforcement of] a money judgment.” 11 U.S.C. § 362(a) and (b)(4). It is understood that “Congress clearly intended for the police power exception [codified at 11 U.S.C. § 362(b)(4)] to allow governmental agencies to remain unfettered by the bankruptcy code in the exercise of their regulatory
powers.” In re Commerce Oil Co., 847 F.2d 291, 295 (6th Cir. 1988). Thus, as a general matter, § 362 does not stay governmental proceedings to enforce statutes protecting human health and the environment. Id. At 295-97; see, e.g., Lancaster v. Tennessee, 831 F.2d 118, 1222 (6th Cir. 1987) (trustee must comply with applicable environmental law). As bankruptcy is not intended to be a safe haven from compliance with regulatory requirements generally applicable to the ongoing operations of a debtor, the compliance obligations of operating debtors include adherence to bonding and financial assurance requirements imposed by laws generally applicable to the business of the debtor.

The court held that under Chao v. Hospital Staffing Services, Inc., 270 F.3d 374, 390 (6th Cir. 2001), the regulators’ actions related primarily to protection of the public safety and were not undertaken primarily to preserve the pecuniary rights and interests of Kentucky as a potential creditor.

III. DEBTORS’ COMPLIANCE WITH LAW

A. Debtors must comply with valid state laws and regulations.

1. Title 28 U.S.C. § 959(b) provides that “a trustee . . . including a debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated . . . .”

2. Cases have applied § 959’s requirement to obligations under environmental statutes.

   In re Wall Tube and Metal Products, Co., 831 F.2d 118, 122 (6th Cir. 1987) (‘‘Wall Tube and later its trustee should have complied with the State’s hazardous substance laws’’).

   Cumberland Farms, Inc. v. Florida Dep’t of Env’tl Protection, 116 F.3d 16 19-20(1st Cir. 1997) (“it is by now abundantly clear that in state-regulated areas such as protection of the environment, a bankruptcy court must comply with the laws of the state involved. Debtors in possession . . . do not have carte blanche to ignore state and local laws protecting the environment against pollution.”) (citations omitted).

IV. LIMITATION OF ABILITY TO ABANDON PROPERTY

A. A permittee cannot simply walk away from a disturbed permit, especially when the condition of the permit presents a hazard to health and safety. Bankruptcy caselaw holds that debtors cannot abandon property in contravention of a statute or regulation
reasonably designed to protect public health or safety from identified hazards. *Midlantic Nat’l Bank v. New Jersey Dep’t of Env’t Protection*, 474 U.S. 494 (1986). In *Midlantic* the Court noted that 28 U.S.C. §959(b) requires the trustee to operate the property according to the requirements of the valid laws of the State, and more generally “that Congress did not intend for the Bankruptcy Code to pre-empt all state laws that otherwise constrain the exercise of a trustee’s powers.” *Midlantic*, 474 U.S. at 505. A bankruptcy trustee’s otherwise broad abandonment power is curtailed by laws designed to “protect the public health or safety from imminent and identifiable harm.” 474 U.S. at 507 n.9.

The Sixth Circuit applied *Midlantic* in *In re Wall Tube & Metal Products Co.*, 831 F.2d 118, 122 (6th Cir. 1987) where the court stated: “It follows that if the . . . trustee could not have abandoned the estate in contravention of the State’s environmental law, neither then should he have *maintained or possessed* the estate in continuous violation of that same law.” The court further found § 959(b) applicable to liquidating trustees and recognized that the Supreme Court “noted Congress’ intentions that the trustee’s efforts ‘to marshal and distribute the assets of the estate’ give way to the governmental interest in public health and safety.” *Id*. Finally, the Sixth Circuit addressed the impact of this requirement on creditors and stated “the protection of innocent creditors would not be furthered by a contrary holding that permits creditors to benefit from their silence while the debtor violates the law.” *In re Wall Tube*, 831 F.2d at 123 (emphasis added).

V. RESOLVING ENVIRONMENTAL RECLAMATION – RECOVERY OF COSTS AND INDIVIDUAL LIABILITY

A. The cost of reclamation and other environmental remediation may be administrative expenses necessary to preserve the bankrupt’s estate.

1. Administrative expense is defined by the Bankruptcy Code as follows:
   11 U.S.C. § 503(b)(1)(A) (“the actual, necessary costs and expenses of preserving the estate . . . .”).

2. *In re Coal Stripping, Inc.*, 222 B.R. 78 (Bankr. W.D. Pa. 1998), involved an action by a surety to recover forfeited bonds and unpaid premiums for the bonds which were related to the debtor’s mining operations. The debtor had abandoned its leasehold interest, and the court acknowledged that matter did not involve the clean up of hazardous wastes. *Id*. at 81. The court held that actual reclamation costs incurred postpetition were entitled to administrative priority even though debtor did not operate in chapter 11. The court stated as follows: “We conclude that if reclamation was performed postpetition the costs will be administrative expenses . . . .” *Id*. at 82. The court further stated that “[b]ecause this is a chapter 11 with a debtor-in-possession, to the extent [the state] expended money to perform postpetition clean-up, it would have an administrative expense. This is so, even though Debtor did not operate in the chapter 11. Its status as a debtor-in-possession carries with it certain obligations, including an ongoing duty to restore the land.” *Id*. The crucial factor for treatment as administrative expense appeared to be whether costs were incurred for actual reclamation performed post petition.
and not merely payment of the bond. Id. (“Respondents must establish actual reclamation costs incurred by [the state], and that amount . . . will be entitled to administrative priority if proven.”

The Pennsylvania DEP sought to recover funds expended to clean up and remove certain hazardous waste found at a printing facility. In re Conroy, 24 F.3d 568 (3rd Cir. 1994). Because Pennsylvania law prohibited release of hazardous substances, the court found that Conroy could not abandon the hazardous wastes on the site. Regarding the clean up costs, the court cited In re Chateaugay and In re Wall Tube & Metal Products and stated “[t]hese courts have reasoned that since the estate could not avoid such costs through abandonment, the ‘expenses to remove the threat posed by such substances are necessary to preserve the estate.”’ In re Conroy, 24 F.3d at 569-70.

In re Wall Tube & Metal Products, Co., 831 F.2d 118 (6th Cir. 1987). This matter also involved clean up of hazardous substances. The Tennessee Department of Health and Environment (“TDHE”) inspected, sampled, and analyzed the Debtor’s manufacturing site and discovered several hazardous substances there. The Sixth Circuit allowed the state’s claim as an administrative expense and stated: “The State of Tennessee, in the absence of compliance by the debtor’s estate, was entitled by its own law to expend funds to assess the gravity of the environmental hazard. We thus find those expenses to be actual and necessary, both to preserve the estate in required compliance with state law and to protect the health and safety of a potentially endangered public.” Id. at 124.

B. Costs associated with reclamation and environmental remediation may be recoverable pursuant to 11 U.S.C. § 506(c) – “surcharge of collateral.”

C. Persons involved with the permittee may be individually liable for completion of reclamation if the permittee fails to perform. For example, KRS 350.990 allows a mandatory injunction against entities and individuals to perform reclamation that the permittee has ignored. In Natural Resources & Environmental Protection Cabinet v. Neace, 14 S.W.3d 15 (Ky. 2000), the Kentucky Supreme Court reinstated the judgment of the Franklin Circuit Court that among other provisions, ordered Neace, the sole director, officer, and shareholder of the coal company/permittee, to “complete the reclamation of the entire disturbed area associated with [the permit].”