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RIGHTS OF SUBROGATION IN LETTERS OF CREDIT TRANSACTIONS

JAMES J. WHITE*

I. INTRODUCTION

The past twenty years have seen more than a dozen cases in which parties to letter of credit transactions have sought subrogation to the rights of the person they have paid or to the rights of the persons on behalf of whom they have acted.¹ The most obvious case arises when the issuer of a standby letter of credit pays a beneficiary on a debt that is owed to the beneficiary by a bankrupt applicant. Having failed to take collateral from the applicant, the issuer seeks to be subrogated to the security interest of the beneficiary. Failing subrogation, the issuer may be the lowest of the low, a general creditor in the applicant’s bankruptcy. If it is subrogated to a perfected security interest, the issuer will be a perfected secured creditor in that bankruptcy. As we will see, applicants have also sought subrogation upon reimbursement of the issuer. Sometimes even confirmers have sought subrogation to the issuer’s claim against an applicant.

These claims for subrogation have met with limited success. Although a sizable minority of these claimants has been successful, the majority has been denied subrogation. In many of the cases that deny subrogation, the courts explicitly or implicitly concede that a guarantor in the same position as the letter of credit claimant would have been entitled to subrogation. The majority opinion in Tudor Development Group makes the point as follows:

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The key distinction between letters of credit and guarantees is that the issuer's obligation under a letter of credit is primary whereas a guarantor's obligation is secondary—the guarantor is only obligated to pay if the principal defaults on the debt the principal owes. In contrast, while the issuing bank in the letter of credit situation may be secondarily liable in a temporal sense, since its obligation to pay does not arise until after its customer fails to satisfy some obligation, it is satisfying its own absolute and primary obligation to make payment rather than satisfying an obligation of its customer. Having paid its own debt, as it has contractually undertaken to do, the issuer "cannot then step into the shoes of the creditor to seek subrogation, reimbursement or contribution from the [customer]."  

So the distinction between guarantees, on the one hand, and letters of credit, on the other, is that the liability on the former is called "secondary" while the liability on the latter is described as "primary." But what does that mean? A guarantee is secondary and a letter of credit primary in the sense that the guarantor can assert the defenses of the person whose liability it guarantees, whereas the issuer of a letter of credit may not look to the underlying transaction for defenses. By issuing the letter the issuer has contracted to pay upon the presentation of proper documents even if the applicant had a defense in the underlying transaction against the beneficiary. While courts such as Tudor correctly identify an important distinction between guarantees and letters of credit, a number of commentators, other courts, and the revisers of Article 5 have concluded that these courts have drawn the wrong inference concerning subrogation from the conclusion that a letter of credit obligation is "primary" whereas the guarantee is "secondary."

This point is made in the following dissent by Judge Becker in Tudor as

2. 968 F.2d at 361.
4. See U.C.C. § 5-108(a) (1996) ("Except as otherwise provided in Section 5-109, an issuer shall honor a presentation that...appears on its face strictly to comply with the terms and conditions of the letter of credit.") and § 5-108(f)(1) (1996) ("An issuer is not responsible for the performance or nonperformance of the underlying contract, arrangement, or transaction"). Comment 1 to § 5-103 makes this point as follows:
   It is often a defense to a secondary or accessory guarantor's liability that the underlying debt has been discharged or that the debtor has other defenses to the underlying liability. In letter of credit law, on the other hand, the independence principle recognized throughout Article 5 states that the issuer's liability is independent of the underlying obligation. That the beneficiary may have breached the underlying contract and thus have given a good defense on that contract to the applicant against the beneficiary is no defense for the issuer's refusal to honor. Only staunch recognition of this principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit.

Except where specified otherwise, all references are to the 1995 version of Article 5. References to the pre-1995 law will be labeled the "old" Code.
RIGHTS OF SUBROGATION

follows:

As the issuer of a letter of credit, Dauphin Deposit had fewer defenses than would the issuer of a guaranty or performance bond, but the substance of Dauphin Deposit's obligation was nevertheless essentially similar to that of a guarantor or surety. There can be no doubt that all three parties considered Dauphin Deposit as a de facto surety and the letter of credit as a substitute for a performance bond. Quite clearly, the parties intended the letter to serve the same economic role as a performance bond would have: "to guarantee the proper completion of the improvements required by the Ordinance."

Guarantors and sureties pay their own legal obligations, yet they are still entitled to seek equitable subrogation as well as contractual subrogation. That is because in meeting their own "primary" obligations, guarantors and sureties are also "secondarily" liable to pay others' debts. So far as the common law is concerned, the same logic should apply to issuers of letters of credit such as Dauphin Deposit.5

Persuaded by the logic of Judge Becker's argument and by that in other cases and from other commentators, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") and the American Law Institute ("ALI") have adopted revised Article 5 that contains Section 5-117.6 The section explicitly puts an issuer who has paid on a letter of credit, an applicant who has paid an issuer, and certain nominated persons (such as confirmers) in the same position as if those persons were guarantors.7 Section 5-117—as a matter of state law—overrules holdings such as those by the majority in Tudor Development.8 If a guarantor who had done the same thing as an issuer, applicant or nominated person would have had a right to subrogation, Section 5-117 grants the same right of subrogation to the party to the letter of credit transaction as a matter of state statutory law.9

II. THE RELATIONSHIP BETWEEN SECTION 5-117 AND OTHER LAW

Common Law Rights of Guarantors

Section 5-117 of revised Article 5 merely grants the party in a letter of credit transaction a right of subrogation where a guarantor in its shoes would have one; it does not otherwise establish rights of subrogation.10 To

5. 968 F.2d at 365 (emphasis added).
8. Id. See Tudor Development, 968 F.2d 357.
10. Id. SUBROGATION OF ISSUER, APPLICANT, AND NOMINATED PERSON.
(a) An issuer that honors a beneficiary's presentation is subrogated to the rights of the
understand where those rights might exist and to see their limits, consider Sections 27 and 28 of the recently adopted Restatement (Third) Suretyship and Guaranty. Section 27(1) reads in full as follows:

(1) Upon total satisfaction of the underlying obligation, the secondary obligor is subrogated to all rights of the obligee with respect to the underlying obligation to the extent that performance of the secondary obligation contributed to the satisfaction.11

The only obvious exception to the general right of an issuer who has paid the beneficiary to be subrogated to the beneficiary’s right that jumps out from § 27 is the case in which the payment did not “totally” satisfy the obligation. Assume a beneficiary has a $1,000,000 claim against an applicant; assume payment under the letter of credit of only $500,000. There would be no right of subrogation under Section 27 by a guarantor of the beneficiary and so none by the issuer. Doubtless there are other exceptions to be teased out of the comments to Section 27, but we need not concern ourselves with them here.12

A guarantor’s rights of subrogation are further elaborated by a list in Section 28:

(1) To the extent that the secondary obligor is subrogated to the rights of the obligee, the secondary obligor may enforce, for its benefit, the rights of the obligee as though the underlying obligation had not been satisfied:

(a) against the principal obligor pursuant to the underlying obligation;

beneficiary to the same extent as if the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as if the issuer were the secondary obligor of the underlying obligation owed to the applicant.

(b) An applicant that reimburses an issuer is subrogated to the rights of the issuer against any beneficiary, presenter, or nominated person to the same extent as if the applicant were the secondary obligor of the obligations owed to the issuer and has the rights of subrogation of the issuer to the rights of the beneficiary stated in subsection (a).

(c) A nominated person who pays or gives value against a draft or demand presented under a letter of credit is subrogated to the rights of: (1) the issuer against the applicant to the same extent as if the nominated person were a secondary obligor of the obligation owed to the issuer by the applicant; (2) the beneficiary to the same extent as if the nominated person were a secondary obligor of the underlying obligation owed to the beneficiary; and (3) the applicant to same extent as if the nominated person were a secondary obligor of the underlying obligation owed to the applicant.

(d) Notwithstanding any agreement or term to the contrary, the rights of subrogation stated in subsections (a) and (b) do not arise until the issuer honors the letter of credit or otherwise pays and the rights in subsection (c) do not arise until the nominated person pays or otherwise gives value. Until then, the issuer, nominated person, and the applicant do not derive under this section present or prospective rights forming the basis of a claim, defense, or excuse.


12. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27(1) (1996) is explained by extensive comments in the Appendix.
(b) against any other secondary obligor for the same underlying obligation, unless the other secondary obligor is a subsurety for the subrogated secondary obligor;

(c) against any interest in property securing either the obligation of the principal obligor or that of any other secondary obligor against whom the rights of the obligee may be enforced; and

(d) against any other persons whose conduct has made them liable to the obligee with respect to the default on the underlying obligation.

(2) Recovery under this section is limited as follows:

(a) the total recovery of the secondary obligor pursuant to subsection (1) may not exceed the secondary obligor's cost of performance of the secondary obligation;

(b) the enforcement of the obligee's rights against a cosurety, and against any interest in property securing performance of the obligation of a cosurety, is limited to the amount that will satisfy the cosurety's duty of contribution (§ 55).13

Claims to subrogation in letter of credit cases will usually be those listed in Section 28 (1)(a) and (1)(c), against the beneficiary's debtor and against the collateral given to secure the debtor's promise to the beneficiary.

As we will see, there may be some questions about the nature of the "rights of the obligee with respect to the underlying obligation ...."14 In some cases where an issuer has paid the beneficiary, where an applicant reimburses an issuer and where Section 5-117 gives them rights "as though" they were guarantors, there may be a question about which obligation is the "underlying obligation" or which obligation is so closely associated with the underlying obligation that a person making payment is subrogated to it. As we will demonstrate by discussion of the cases, the issuer or applicant who has been granted the rights of a guarantor by Section 5-117 may still have many bridges to cross, for there are defenses, exceptions to and limitations upon a guarantor's subrogation rights and Section 5-117 does not carry the issuer or applicant across those bridges.

III. SECTION 509 OF THE BANKRUPTCY CODE

A. Judicial Application of Section 509

When the "debtor" (usually "applicant-debtor") is in bankruptcy, Section 509 of the Bankruptcy Code poses a second obstacle to subrogation.15

14. Id. § 27(1).
Because many of the claims of subrogation were made in bankruptcy court after an applicant declared bankruptcy, some courts applied Section 509(a) to determine the parties' rights. Invariably the trustee will confront the issuer or applicant with a version of the argument from Tudor that is quoted above. Specifically, the trustee will argue that the issuer is neither a "codebtor" (as the title to Section 509 requires) nor is he "liable with the debtor" on the debt, as the text of Section 509 requires. Citing the independence principle, the trustee will argue that the issuer is independently and "primarily" liable on a debt and so fails to qualify as a "codebtor" or as one "liable with" the debtor.

Of course, the enactment of Section 5-117 by a state legislature cannot overrule federal law to the contrary. Does that mean that Section 5-117's enactment will not change the bankruptcy cases? Its enactment will change these cases.

First, Section 509 does not have to be interpreted as I have suggested; there is nothing in Section 509 or in any other part of the Bankruptcy Code that would require a court to exclude the issuer of a letter of credit from the definition of "codebtor" or from recognition as a person "liable with the debtor." In fact, a number of courts have granted subrogation to issuers (and applicants who have reimbursed their issuer) to the rights of a creditor whose debtor declared bankruptcy.

Second, the language of Section 5-117 itself should be construed to make an issuer and the other parties there mentioned "codebtors" as that term is used in Section 509. Codebtor is not defined in Section 101 of the Bankruptcy Code nor is there any other provision in the Code that would exclude an issuer or an applicant from coverage in Section 509(a) as a matter of federal law. The policy that an issuer is entitled to subrogation, enunciated by the National Conference of Commissioners, the ALI and many state legislatures, should be considered carefully by bankruptcy courts when they interpret Section 509.

Most important is the possibility that "codebtor" and "liable with" are state law concepts subject to definition by state legislatures. The Bankruptcy

Section 509. Claims of codebtors.
  (a) Except as provided in subsection (b) or (c) of this section, an entity that is liable with the debtor on, or that has secured, a claim of a creditor against the debtor, and that pays such claim, is subrogated to the rights of such creditor to the extent of such payment.

17. See supra notes 2-3 and accompanying text.
Code is replete with such internally undefined state law terms.\textsuperscript{20} Although Section 5-117 does not explicitly define an issuer as a “codebtor” and despite the fact Article 5 retains the independence principle, the drafters of Article 5 would say—for this purpose—the issuer and others to be subrogated should be recognized as “codebtors” and as “liable with” the debtor.

To summarize, it is appropriate for courts interpreting Section 509 to find that the term “codebtor” and the classification “liable with” include issuer, applicant and others from Section 5-117 either because this term and classification are matters of state law and Section 5-117 implies that they should include parties to a letter of credit transaction, or because one interpreting federal law should give deference to the positions of the states, the

\textsuperscript{20} Consider, for example, § 544 of the Bankruptcy Code that relies on state law definitions of lien creditors as follows:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.


The same is true of § 546(c):

(c) Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of this title . . . are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent, but—

(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods—

(A) before 10 days after receipt of such goods by the debtor; or

(B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and

(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—

(A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title . . . ; or

(B) secures such claim by a lien.

ALI and NCCUSL.

B. Equitable Subrogation

Even if one concludes that Section 5-117 is not capable of or has not changed the meaning of “codebtor” and “liable with” in Section 509(a), issuers and applicants are still entitled to subrogation in bankruptcy. That is because Section 509(a) is not the exclusive statement of the right to subrogation of a guarantor in bankruptcy. Many bankruptcy cases recognize an “equitable” right to subrogation apart from the right specified in Section 509(a). By its granting of the rights of guarantors to issuers, applicants and others, Section 5-117 has made those rights of subrogation available as a matter of state law where they would be available to guarantors. The right of equitable subrogation as applied in bankruptcy is not based on any Bankruptcy Code section; it is a right of state law. More clearly than the rights in Section 509(a), these rights are within the province of the state legislatures to adjust as they deem appropriate.

State courts universally recognize a guarantor’s common law right to be subrogated to a creditor’s rights against a debtor whose debt the guarantor has paid. This right, aimed at preventing the unjust enrichment of the debtor at the guarantor’s expense, is based on the equitable principle that an obligation should ultimately be satisfied by one “who in good conscience ought to pay it.” Generally, these courts apply a five-part test to determine whether a


24. See RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 cmt. a (1996); see also RESTATEMENT OF RESTITUTION, § 162 cmt. a (1937).

25. RESTATEMENT OF SECURITY § 141 cmt. a (1941); see also RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 cmt. a (1995).
surety is entitled to subrogation: the entity must pay to protect its own interest; it must not act as a volunteer; the debt must be one for which the entity was not primarily liable; the entire debt must be paid; and, subrogation must not work any injustice to the rights of others.\textsuperscript{26} An entity satisfying all five parts of this test is subrogated to every right of the creditor.\textsuperscript{27}

Many bankruptcy cases applying this test have denied subrogation to issuers, applicants and other entities involved in the letter of credit transaction because their obligations are "primary" not "secondary" like traditional guarantors' claims.\textsuperscript{28} Relying on such a classification to deny subrogation is dubious at best. However, because equitable subrogation is a creature of state law, the point is moot. Section 5-117 overrides the third part (the debt must be one for which the entity was not primarily liable) of the common law test in the letter of credit context. In so doing, it expands the availability of equitable subrogation to issuers, applicants and others in bankruptcy cases.

IV. THE CASES RECONSIDERED UNDER SECTION 5-117

Consider how Section 5-117 might change the most common subrogation cases: the issuer pays the beneficiary on a standby letter of credit and the issuer then seeks to be subrogated to the beneficiary’s collateral or to the beneficiary’s other rights (such as the right of reclamation or the rights to administrative expense treatment in bankruptcy). Cases falling within this category discussed below are \textit{In re East Texas Steel Facilities}\textsuperscript{29} and \textit{In re National Service Lines, Inc.}\textsuperscript{30}

One step removed are cases where the applicant reimburses the issuer and seeks to be subrogated to the issuer’s subrogation rights against the beneficiary’s collateral or against other rights the beneficiary holds. These cases are likely to arise only where the applicant is someone other than the debtor. \textit{In re Minnesota Kicks}\textsuperscript{31} and \textit{In re Agrownautics, Inc.}\textsuperscript{32} are examples.

Far less common are the third class of cases where the issuer seeks to be subrogated to the applicant’s rights against the beneficiary or a third party. Because a careful issuer will not have issued a letter of credit to an applicant that cannot pay (or will have taken a direct security interest from the applicant

\textsuperscript{29} 117 B.R. 235 (Bankr. N.D. Tex. 1990).
\textsuperscript{30} 80 B.R. 144 (Bankr. E.D. Mo. 1987).
\textsuperscript{31} 48 B.R. 93 (Bankr. D. Minn. 1985).
as part of the reimbursement agreement), these cases should be less common than the ones described above. Tudor Development falls into this category.³³

Finally, there are cases where the issuer fails and the confirmer pays. The only example of this kind is In re Glade Springs, Inc.³⁴ Absent the wholesale failure of American banks, we would not anticipate many cases under this category.

A. Issuer Subrogated to Beneficiary's Rights

In East Texas Steel Facilities,³⁵ the issuer, BHF, issued a letter of credit to Mannesmann, the seller (beneficiary), for $6.5 million on behalf of East Texas, the buyer (applicant).³⁶ The bank paid $1,620,871 for two shipments made after the bankruptcy proceeding of East Texas.³⁷ The bank sought subrogation on two of Mannesmann's rights.³⁸ First, it claimed Mannesmann would have had a reclamation right under Section 2-702 of the Uniform Commercial Code and Section 546(c) of the Bankruptcy Code (to the return of the goods sold).³⁹ Second—and assuming the goods stayed with the bankruptcy estate—the bank wished to present its claim as a $1,600,000 postpetition (and therefore administrative) expense claim.⁴⁰ Administrative expenses are paid in full before any payment to general creditors.⁴¹ Citing Section 509 the court declined the bank's request.⁴² The court rejected the equitable subrogation argument on the same ground as it rejected the Section 509 argument—namely that the issuer was “primarily liable.”⁴³

Section 5-117 would clearly change the equitable subrogation outcome; if one accepts the arguments that we make above concerning Section 509(a), it would also change the outcome under Section 509. By its extensive discussion of the comment to Section 5-109 of old Article 5,⁴⁴ the court intimates it would have come to the opposite conclusion about the rights of subrogation had the Uniform Commercial Code endorsed the right of subrogation.⁴⁵ Thus, I

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³³. See supra note 1.
³⁴. 826 F.2d 440 (6th Cir. 1987).
³⁷. Id.
³⁸. Id.
³⁹. Id.
⁴⁰. Id.
⁴³. Id.
⁴⁴. Comment 1 to § 5-109 (of the old Code) implicitly recognizes the right of subrogation in certain undefined transactions as follows: “the customer will normally have direct recourse against the beneficiary if performance fails, whereas the issuer will have such recourse only by assignment of or in a proper case subrogation to the rights of the customer.”
predict that the outcome in *East Texas Steel Facilities* would be changed by the adoption of Section 5-117.

Note, too, that other cases such as *National Service Lines Inc.*, have already granted administrative expense status to issuers through subrogation to their beneficiaries’ claims even under existing law. Obviously, the adoption of Section 5-117 would not change the outcome in cases like *National Service Lines*, for it merely indorses the outcome already reached there.

**B. Applicant Subrogated to Issuer’s Rights of Subrogation to Beneficiary’s Rights**

Consider a case one step removed. In *Agrownautics*, Whitney (applicant) applied for a letter of credit from Chase Manhattan on behalf of PIDA (beneficiary), a creditor to whom Agrownautics owed a debt. Whitney was apparently a principal shareholder of the debtor, Agrownautics, and so had an economic interest in its survival. When the issuer paid on the letter of credit, the applicant, Whitney, paid the issuer and then sought subrogation to the beneficiary’s claims. In *Agrownautics*, the court rejected the applicant’s claims. Like the court in *East Texas Steel*, the court cited the Uniform Commercial Code. It read the UCC as making the issuer primarily and not secondarily liable and found the issuer’s claim (here asserted by an applicant) to be outside of Section 509(a). For the reasons quoted above, the court would conclude that Section 5-117 has modified the terms in Section 5-109(a) and thus, produces a different outcome under that section.

The court also rejected the applicant’s equitable subrogation argument with the following language: “Whitney’s problem here is that the debt it paid was that of Chase, which had no secured remedy. Whitney had no obligation to PIDA to pay any debt. Its obligation was to Chase and Chase held no secured position.”

With the quoted objection in mind, consider Section 5-117(b):

(b) An applicant that reimburses an issuer is *subrogated to the rights of the issuer* against any beneficiary, presenter, or nominated person to the same extent as if the applicant were the secondary obligor of the

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46. 80 B.R. 144 (Bankr. E.D. Mo. 1987).
48. *Id.* at 351.
49. *Id.*
50. *Id.* Under § 5-117, one would regard the applicant as being subrogated to the issuer’s subrogation rights which rights would reach the collateral granted to PIDA, the beneficiary.
51. *Id.* at 353.
52. *In re Agrownautics*, 125 B.R. at 353.
53. *Id.*
54. *See supra* notes 16-21 and accompanying text.
55. 125 B.R. at 353.
obligations owed to the issuer and has the rights of subrogation of the issuer to the rights of the beneficiary stated in subsection (a).\(^\text{56}\)

In effect, Section 5-117 grants the applicant a right of subrogation to the subrogation right of Chase as though it (the applicant) guaranteed an obligation of Chase. The statute provides what the court failed to find in the common law, namely, an explicit subrogation through a two-step process of the applicant to the beneficiary's right against the collateral or otherwise in the bankruptcy estate.\(^\text{57}\) Under Section 5-117, this case should also be decided differently.\(^\text{58}\)

Finally, note that Minnesota Kicks allowed subrogation of the applicant in a similar case under the current law without the help of Section 5-117.\(^\text{59}\) The conclusion of that court will be affirmed by the adoption of this section.

C. Issuer Subrogated to Applicant's Rights

A third and less frequent case occurs when the issuer seeks to be subrogated to the applicant's rights. Representative of those cases is Tudor.\(^\text{60}\) The facts of Tudor are extraordinarily complex, but one must understand them to appreciate the legal issues. Green Hill Associates ("Associates") was the developer of a subdivision construction project.\(^\text{61}\) Associates made an agreement with the local township to complete various improvements on the subdivision such as grading, roads, driveways, parking and recreation areas.\(^\text{62}\) To guarantee performance of that obligation to the township, Associates was required to get a letter of credit or a bond.\(^\text{63}\) Dauphin Trust issued a letter of credit to fulfill that obligation in the amount of $1,880,646.\(^\text{64}\) The township was the beneficiary and Associates was the applicant. To insure that Associates would reimburse it, Dauphin Trust received a note from Tudor Development, Associates' general partner, and received an assignment of the proceeds of certain Wausau bonds that guaranteed the performance of Eastern Consolidated Utilities.\(^\text{65}\) Eastern was to construct certain internal roadways, parking areas and storm drainage systems.\(^\text{66}\)

\(^{56}\) U.C.C. § 5-117(b) (1996) (emphasis added).

\(^{57}\) Id.

\(^{58}\) Id.

\(^{59}\) I am not alone in this opinion. Neal Ossen, the lawyer for the victorious trustee in Agrownautics, was a member of the revision committee for Article 5 and conceded, with regret, that the law that he had so carefully made in the bankruptcy courts of Connecticut would be reversed by the section that the committee was adopting.

\(^{60}\) Tudor Development, 968 F.2d 357.

\(^{61}\) Id.

\(^{62}\) Id. at 358.

\(^{63}\) Id.

\(^{64}\) Id.

\(^{65}\) Tudor Development, 968 F.2d at 358.

\(^{66}\) Id. at 359.
As the developer, Associates also had a contract with the general contractor for the subdivision, Susquehanna Construction Corp., whose performance was in turn guaranteed by two USF & G bonds in the amount of $2,965,873.67 For reasons not explained, Dauphin did not take a security interest in the proceeds of the USF & G bonds.68 When the general contractor defaulted, the township drew on the letter of credit and Dauphin paid.69 Ultimately, USF & G also paid approximately $609,000 to Associates because of the general contractor's default; $594,000 of this amount was paid into court and Associates assigned a part of that to a group identified as “Investors.”70

Although Dauphin had a reimbursement agreement and, apparently, a security agreement with Associates, that agreement did not claim the proceeds of the USF & G bonds.71 Thus, it had no direct secured claim against the $594,000 fund paid into court.72 Failing a direct security claim through its applicant, Dauphin argued that it was subrogated to Associates’ rights to the fund and that its rights as subrogor were superior to Investors’ rights of assignment.73

Relying on the familiar proposition that the issuer had an independent obligation and was not like a guarantor, the majority rejected Dauphin’s rights of subrogation.74 In dissent, Judge Becker argued that the case should be sent back for a new trial.75 He maintained that Dauphin should not be foreclosed simply because it was an issuer of a letter of credit.76 If his position on that issue was accepted, he conceded that a new trial would have to be held on the question whether a guarantor would have been subrogated to this claim and, if so, whether the subrogation claim would have been superior to the assignment claims of Investors.77

Judge Becker’s dissent amply demonstrates that an issuer, applicant, or another, who is given a guarantor’s rights of subrogation still has many bridges to cross. Under Pennsylvania law, one is entitled to restitution only if restitution will not cause injustice to the rights of others;78 in this case, one might argue that Dauphin could have protected its own rights by taking a security interest originally from Associates as to all of these assets, and that equity should not help it where it failed to help itself. Section 5-117 does not

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67. *Id.* at 358.
68. *Id.* at 359.
69. *Id.*
70. *Tudor Development*, 968 F.2d at 359.
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.* at 364.
76. *Id.* at 370.
77. *Id.*
78. *Id.*
relieve a letter of credit claimant from the uncertainties of "equitable" balancing.

D. Nominated Person Subrogated to Issuer’s Rights

A final conventional, but quite uncommon case is represented by Glade Springs. In that case the applicant, Glade Springs, gave a note and deed of trust to United American Bank ("UAB"), the issuer. In return, UAB issued a letter of credit to Kanawha Valley Bank who had loaned $1,590,000 to Glade Springs. Chemical Bank confirmed the letter of credit; Glade Springs went into bankruptcy and UAB was closed after it was declared insolvent. Thereupon Chemical paid under its confirmation and sought to be subrogated to the UAB deeds of trust against the collateral of the bankruptcy estate. Ultimately, the Sixth Circuit affirmed Chemical’s right of subrogation.

Section 5-117 reaffirms that position by specifying that a nominated party (including a confirmor) has a right to subrogation when it has given value. In that case, Chemical’s paying on its confirmation would be the giving of value and under Section 5-117 the case would come out exactly the same way.

V. LIMITS ON THE RIGHT OF SUBROGATION UNDER SECTION 5-117

Section 5-117(d) bars subrogation by the issuer or applicant if the issuer does not pay and bars subrogation by nominated persons until they give value. To understand the bite of Section 5-117(d), consider the following situations.

Assume Beneficiary makes a conforming presentation and Issuer dishonors. Issuer does this because Applicant has said that the Beneficiary’s certification about Applicant’s default is inaccurate. Assume further it is unclear whether Applicant is good for the amount of the draft and thus that Issuer’s selfish interest encourages it to decline payment. If Beneficiary had no right to payment (because the conditions had not been met either in the underlying loan agreement between Applicant and Beneficiary or because, for example, Beneficiary had broken its underlying contract to deliver conforming goods), the Applicant, but not the Issuer, would have a cause of action on the underlying transaction with the Beneficiary.

May Issuer assert Applicant’s defenses when Issuer is sued for wrongful dishonor? The answer is no. Because of Section 5-117(d), Issuer’s rights of

79. 826 F.2d 440 (6th Cir. 1987).
80. Id.
81. Id.
82. Id. at 440-41
83. Id.
84. In re Glade Springs, 826 F.2d at 442.
86. Id. § 5-117(d).
subrogation have not come into being and will never come into being unless Issuer pays the beneficiary. The rule in Section 5-117(d) preserves the utility of letters of credit.\textsuperscript{87} If an issuer were permitted to assert Applicant’s defenses—as a subrogor of the applicant in wrongful dishonor cases—the independence principle would be violated and the economic utility of the letter of credit would be seriously undermined.

This condition to subrogation (payment) cannot be waived ("not withstanding any agreement to the contrary"). Doubtless the drafters did not think of every possible consequence that could be controlled by Section 5-117(d). It is important, therefore, that the courts maintain their hostility to an issuer or an applicant that seeks to be subrogated to another when the issuer has not paid.

The subrogors "do not derive... present or prospective rights" until payment or giving of value.\textsuperscript{88} This language forestalls an argument by an issuer, applicant, or the like who, in anticipation of a right to subrogation when payment is made, complains that an act of the beneficiary or other person might impair that subrogation right when and if it arises. As Comment 2 to Section 5-117(d) illustrates, the drafters intended to leave the beneficiaries and others to whose rights one might be subrogated free to act without regard to those potential rights of subrogation.\textsuperscript{89}

VI. SUBROGATION TO APPLICANT’S WARRANTY RIGHTS

Assume Issuer issues a letter of credit to Beneficiary Bank to back up a $2 million debt owed by Corporation to Beneficiary Bank. Applicant is not the Corporation, but rather a shareholder of Corporation. If Issuer were careful and conservative, it would take security from Shareholder-Applicant and would, upon payment to Beneficiary Bank, charge Applicant’s account or, if necessary, take the collateral that was given by Applicant.

For many reasons, issuers are sometimes not so careful and conservative, and occasionally they find themselves with an insolvent applicant who has not given them collateral. In the case posed, the Issuer who has paid could subrogate itself to the Beneficiary’s claim against Corporation. However, assume that Beneficiary would have only an unsecured claim in Corporation’s bankruptcy and that that claim would produce little or no recovery. Under the terms of Section 5-117, Issuer is also subrogated to the rights of Shareholder-Applicant as though Issuer were a “secondary obligor of the underlying obligation owed to the applicant.”\textsuperscript{90}

Now, assume that the letter of credit required Beneficiary Bank to certify

\textsuperscript{87} Id.  
\textsuperscript{88} Id.  
\textsuperscript{89} Id.  
\textsuperscript{90} U.C.C. § 5-117 (1996).
that Corporation had "defaulted on its obligation and remained in default for 90 days." Assume Beneficiary Bank made a proper certification under the letter of credit and Issuer paid. However, Corporation and Applicant now show that Beneficiary Bank's certification was not truthful. Assume that Corporation had not been in default for ninety days—as must be certified for a valid draw under the letter of credit and as required by the underlying agreement between Beneficiary Bank and Corporation—before Beneficiary Bank has a right to draw on the letter of credit.

In those circumstances, Beneficiary Bank's draw will have violated its warranty to Applicant under Section 5-110(a)(2). That warranty runs only to the Applicant and it specifies that Beneficiary Bank warrants "that the drawing does not violate any agreement between the Applicant and Beneficiary or any other agreement intended by them to be augmented by the letter of credit." This is not a warranty that the beneficiary's documents comply with the letter of credit; rather it is a warranty that the beneficiary has earned a right arising out of the underlying transaction between it and Corporation to draw on the letter of credit—a fact which is not true in our hypothetical case. Thus, Applicant would have a cause of action for breach of warranty against Beneficiary Bank and, in a proper case, its claim for damages might equal the entire amount of the draw. This would be the case where Beneficiary Bank had no other claim against Applicant-Shareholder and where, had there been dishonor on the letter of credit originally, Beneficiary could never have substituted an honest and conforming demand for payment.

If Applicant has no collateral and is itself incapable of satisfying Issuer's claim for reimbursement of the $2 million, does Section 5-117 subrogate Issuer to Applicant's warranty claim against Beneficiary? It is conceptually awkward to think of the issuer as guaranteeing either the duty that the beneficiary owes to the applicant (to draw only under certain circumstances, not others) or the duty that a corporate debtor owes to its applicant-shareholder (the duty to reimburse upon the shareholder-guarantor's payment). But the statute requires one to adopt this awkward conception. The statute directs us to say: assume that the issuer had said to the applicant-guarantor, I will guarantee that the beneficiary will draw on this letter of credit only in circumstances when he is entitled to do so. Alternatively, I will guarantee that the debtor corporation will reimburse you if you are called upon to pay the corporation's debt.

Once one has visualized this awkward notion of the issuer guaranteeing the beneficiary's or corporation's performance, the questions remain, what is the underlying obligation and to what rights is the issuer subrogated? One might argue that there is no obligation that meets the definition of "underlying obligation", but I do not agree. First, I would argue that either the warranty (by the beneficiary under Section 5-110) or the implicit reimbursement

91. Id. § 5-110(a)(2).
obligation (by the corporate debtor to its shareholder-guarantor) can and should be regarded as an underlying obligation for the purposes of our hypothetical subrogation. Second, I would argue that the issuer is subrogated to the applicant’s rights on the warranty and to its rights on the explicit or implicit reimbursement agreement against the corporation irrespective of which is determined to be the “underlying obligation.” Even if only one is the “underlying obligation,” I would argue that the other is a “right of the obligor with respect” to the underlying obligation as that term is used in Section 27 of the Restatement.

Note that the language of Section 5-117(a) does not merely subrogate the issuer to the rights “on the underlying obligation.” Rather, it subrogates an issuer to “rights . . . of the applicant.” It does so, at least to the extent that a guarantor in a similar circumstance would be subrogated to those rights. The general principle behind the doctrine of subrogation is stated in Comment (a) of the Restatement (Third) of Suretyship and Guaranty. By comparing subrogation rights to the rights one might acquire by assignment (from the person to whose rights one is subrogated), that comment justifies a broad

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92. One prerequisite of a guarantor’s right to equitable subrogation at common law is default by the principal obligor. By definition, in breach of warranty cases no default has occurred (i.e., the breach of warranty is the inaccuracy of the claim that the applicant has defaulted). Does this mean that an issuer that has paid a beneficiary on a standby letter of credit may not be equitably subrogated to the applicant’s breach of warranty claim against the beneficiary? The answer, based on Article 5 and equitable principles is no. Article 5 supersedes the common law default requirement for equitable subrogation in the letter of credit context. Because an issuer is not to concern itself with the underlying contract, Article 5 does not require actual default by the principal obligor. This is consistent with equitable principles. The default requirement was originally meant to exclude volunteers from acquiring subrogation rights; it would be inequitable to enforce the requirement against such an obvious non-volunteer as an issuer of a letter of credit.

93. RESTATEMENT (THIRD) OF SURETYSHIP & GUARANTY § 27 (1996). Depending on the agreements between Corporation and Shareholder-Applicant and the state of the relevant subrogation law that governs the relationship between Applicant and Corporation, Issuer might have a right of subrogation to Corporation’s claim for breach of the underlying agreement between Beneficiary and Corporation. If relevant state law regards the Shareholder-Applicant as a guarantor of the Corporation’s obligation to the Beneficiary, the Applicant (as a matter of state guarantee law) would then be subrogated to Corporation’s claim for breach of the loan agreement. As a guarantor of the guarantor under the provisions of § 5-117(a), Issuer would also be subrogated to Applicant’s claim. U.C.C. § 5-117(a) (1996). Thus, an alternative route for Issuer would be to assert that the Applicant had a right of subrogation itself and that it (Issuer) is subrogated to that right of subrogation and thus would have a claim against Beneficiary. Of course, any trustee in Corporation’s bankruptcy might challenge the right of subrogation and claim the breach of contract claim for itself.


95. Id.

rather than a narrow reading of the rights of subrogation. It states the general principle as follows:

Indeed, subrogation is often referred to as equitable assignment or an assignment by operation of law. An obligee would be economically indifferent to a choice between receiving full performance of the obligation owed to it and assigning its claim in exchange for consideration equivalent to full performance. Thus, by giving the secondary obligor the equivalent of an assignment of the obligee's rights, the law, while leaving the rights of the obligee unharmed, effectuates the goal of causing the principal obligor to bear the cost of performance.

Whether one regards the "underlying obligation" as the warranty granted by the beneficiary to the applicant or the reimbursement rights granted by the corporation to the applicant, a person who guaranteed either and who bargained for an assignment of the applicant's right surely would insist on assignment of both the right to sue the beneficiary on the warranty and to sue the corporation on the reimbursement agreement. Indeed, the warranty claim in our hypothetical case is the claim most likely to be assigned, for, by hypothesis, it would be a claim against a solvent party who has just received money from the issuer.

To paraphrase the foregoing complexity, as a matter of state law, it is sensible and fair to give to the issuer whatever rights an applicant would have—not only against persons such as the corporate debtor, but also against a beneficiary—in return for the issuer's payment for which the applicant contracted.

Finally, the grant of a right of subrogation to something other than and in addition to the underlying obligation is supported by the law of subrogation in construction bond cases and by at least one case involving a guarantor outside of the construction industry. The issuer of a payment bond pays its beneficiaries (materialmen and suppliers) amounts owed on their underlying obligation (the subcontract) with the general contractor. Routinely, that surety is subrogated not just to the rights of the beneficiaries against the general contractor (the subcontract—underlying obligation), but to the general contractor's claim against the owner for payment on the general contract. If one regards the "underlying obligation" on a payment bond to be the general contractor's obligation to the subcontractors and suppliers, this is an example where the guarantor is subrogated to a different obligation, to the general contractor's claim against the owner.

97. Id.
98. Id.
99. See, e.g., Union Indem. Co. v. Stevens, 57 F.2d 839 (5th Cir. 1932) (granting surety that paid state on bank's depository bond subrogation to bank's auditor's warrant against state).
100. See, e.g., Barrett Bros. v. St. Louis County, 206 N.W. 49 (1925) (granting surety that paid materialmen and laborers on contractor's bond subrogation to entire balance due principal.
VII. DAMAGE RECOVERY ON SUBROGATION

Because, by hypothesis, the subrogor stands in the shoes of the person to whom it is subrogated, the computation of damages or other recovery will be neither more nor less difficult than if the original party had brought the suit. Where the issuer is subrogated to the rights of a beneficiary against a debtor in a standby letter of credit transaction, the issuer asserts the routine claim of a creditor against its debtor. Subrogation may make it a secured creditor or an administrative expense claimant in bankruptcy.

Where the issuer is subrogated to the rights of the applicant, computing the claim is more complicated. In a conventional letter of credit, the issuer will be subrogated to a buyer's (applicant's) claim against a seller for breach of the contract of sale. Those rights are likely to be governed by Article 2 of the Uniform Commercial Code, or in some cases, the United Nation Convention on Contracts for the International Sale of Goods.

What if the issuer is subrogated to the rights of the applicant in a standby letter of credit? The underlying contract here is likely to be a loan. If the applicant is also the debtor, the suit will be for breach of the underlying contract (the loan agreement), but by the creditor.

If the applicant is not the debtor in the underlying transaction (assume a case like Agrownautics where the applicant is a shareholder of the debtor corporation), the issuer may wish to be subrogated to the applicant's warranty that the beneficiary makes to the applicant under Section 5-110. For several reasons, computing the damages may be quite complex and the parties' rights fairly obscure. Here, the suit would be brought under Section 5-110, a section whose remedies are not specified by Article 5.

Assume a case like Mellon Bank v. General Electric Credit Corporation. In Mellon, the beneficiary certified that the debtor had defaulted and thus that there was a right to draw on the letter of credit. Technically, there had been no default only because the beneficiary had failed to declare one; but the debtor's performance had been sufficiently deficient to have given the beneficiary a right to declare default.

If the issuer in Mellon were subrogated to the applicant-debtor's claim, what is the recovery? Absent other factors, the injury to a debtor by a premature claim of default (against one who has, in fact, defaulted or does so shortly after the claim) seems small. Unless the declaration of default somehow injures the credit standing of the debtor or otherwise renders the debtor unable to get replacement credit that would have been available, it is hard to see how the premature claim of default causes any significant damage.

102. Id. at 362.
103. Id.
Thus, in many of these cases, I would predict that the issuer’s subrogation to the applicant’s claim will be an empty right, for the issuer standing in the applicant’s shoes will not be able to prove that the applicant suffered any significant damages as a result of the premature or inappropriate declaration of default.

If one lets his imagination run wild, he can think of other scenarios where a sympathetic court might find substantial damages. In one of the most important lender liability cases, *KMC v. Irving Trust*, assume that Irving Trust’s claim against KMC had been covered by a letter of credit. Assume that Irving Trust inappropriately declared a default and drew on a $6 million line of credit issued by another bank. Further assume that as a result of the draw the issuer reimbursed itself by a charge to KMC’s account, but only to the extent of one-half of the draw. This charge, however, was sufficient to put KMC into bankruptcy.

One of the rights associated with the underlying obligation would be a right to sue the creditor for acts in connection with its declaration of default that gave liability under the lender liability rubric. Whether an issuer plaintiff, dressed in the clothes of an applicant, will stimulate a judge or jury to grant punitive damages of the kind sometimes recovered by a pitiful debtor in lender liability cases remains to be seen. If one allows subrogation to these claims, there is potential at least for large damages.

Of course, in practice these two situations, injury due to premature default and lender liability claims, will be blurred into one another, at least in the pleading stage, for the plaintiff issuer. Similarly, a debtor against whom default has been declared will always claim that untoward and uncontemplated consequences occurred as a result of the early declaration of default. In those circumstances, the issuer in the debtor’s clothes may argue that the premature default forestalled a negotiation with a replacement lender that was about to bear fruit and that would have resulted in a rebirth of the company followed by glowing financial success. I suspect that issuers asserting that claim will be even less successful than debtors have been.

Another issue is warranty damages. Are they the same as or different from the damages one would recover from subrogation to the debtor’s right on the underlying loan agreement that has been violated by the beneficiary? Assume

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104. 757 F.2d 752 (6th Cir. 1985).
105. When the issuer pushes to assert such claims as lender liability, it will be confronted not merely by the defendant beneficiary, but also by the trustee in bankruptcy or other representatives of the applicant or of the applicant’s creditors—who themselves assert a right to this asset (the lender liability claim). Either at the beginning or at the end of this law suit there will be a skirmish similar to that contemplated by Judge Becker in *Tudor Development*, where not only the issuer but also the applicant’s trustee in bankruptcy, possibly various other creditors of the applicant and perhaps even its shareholders, claim that equity grants them a higher claim to this asset (the law suit) than it grants the issuer. *Tudor Development*, 968 F.2d 357.
a beneficiary draws when it has no right to do so on the underlying agreement and so violates its warranty under Section 5-110(a)(2). Assume further that the letter of credit was soon to expire and that there would never have been a time during the life of the letter when the beneficiary could have made a truthful certification.\(^{106}\)

Are the warranty damages suffered by the applicant not equal to the full amount of the letter of credit? The answer is no. It is easy to understand how and why an issuer would so argue, but hard to see how it would prevail. It bears repeating that the issuer in a subrogation case is appearing in the applicant’s clothes. If, by hypothesis, the applicant should have no or no significant claim for damages, the issuer will have similar and no greater damages for violation of the warranty. If the applicant were solvent, it would have to pay the debt after default; the beneficiary’s behavior forces it to do no more and no less than that—even though the beneficiary is drawing improperly on a letter of credit. The premature claim of default is likely to cause the applicant little or no damage. Arguably, the issuer has suffered a loss equal to the full amount of the draw (because there was never a right to draw on the letter of credit). However, the issuer has no claim in its own right to recover from the beneficiary, at least if we assume that the draw does not rise to the level of fraud under Section 5-109.\(^{107}\)

Note that Section 5-111 on Remedies and Damages has little to say about these claims. That section covers the beneficiary’s and the applicant’s claims against the issuer, but it does not define the proper damage recovery for breach of warranty, nor does it define the appropriate damages for breach of the underlying contract, whether that contract is a loan agreement, contract for the sale of goods, or some other agreement.\(^{108}\)

**VIII. CONCLUSION**

The most direct and likely result of the adoption of Section 5-117 is the reversal of the line of cases that disallows an issuer’s or an applicant’s subrogation to the beneficiary’s security or other elevated claims in a debtor’s bankruptcy. The drafters aimed at that target and—notwithstanding quibbles that might be made under Section 509 of the Bankruptcy Code—I believe they hit it. Henceforth, I anticipate that issuers who pay beneficiaries will enjoy the

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106. This might occur, for example, where the letter required a certification that the debtor had been in default for 90 days, where the letter was about to expire or where the debtor had first fallen into default only 60 days prior to the letter’s expiration date.

107. Conceivably the issuer would have a right to restitution for money paid by mistake in those circumstances, but that right is not specified in either the new or old Article 5 and it is not clear to me whether the issuer would have such a right under the common law.

108. Comment 3 to § 5-110. The damages for breach of warranty are not specified in Section 5-111. Courts may find damage analogies in Section 2-714 in Article 2 and in warranty decisions Articles 3 and 4. *Id.*
security that has been granted to those beneficiaries and, where the payment is
of an administrative claim, administrative claim status in the debtor’s
bankruptcy.

More interesting, but also less clear, is the nature of the rights that Section
5-117 grants when the issuer does an about-face and seeks to be subrogated
down the back stairs through the applicant on a warranty or other theory.
There is little case law on this issue and, consequently, great potential for
clever application of Section 5-117.
APPENDIX

TEXT OF COMMENTS TO SECTION 27 OF THE RESTATEMENT
(THIRD) OF SURETYSHIP & GUARANTY (1996)*

a. General principle.
Subrogation is a term used by the law to describe the remedy by which, when the property of one person is used to discharge a duty of another or a security interest or lien upon property of another, under such circumstances that the other will be unjustly enriched by the retention of the benefit thus conferred, the former is placed in the position of the obligee or lienholder. Subrogation does not spring from contract although it may be confirmed or qualified by contract. Rather, it is a rule that the law adopts to compel the eventual satisfaction of an obligation by the one who ought to pay it. In the suretyship context, subrogation provides a secondary obligor who performs the secondary obligation with the obligee’s rights with respect to the underlying obligation as though that obligation had not been satisfied. See § 28. Since the underlying obligation has been satisfied, no interest of the obligee is prejudiced by permitting the secondary obligor to enforce the obligee’s rights, and the resulting benefit to the secondary obligor effectuates the rights of the secondary obligor against the principal obligor (§§ 21-26). Subrogation is often called an equitable assignment or an assignment by operation of law.

b. Necessity of complete discharge of underlying obligation.
The purpose of subrogation is to reallocate the cost of performance from the secondary obligor to the principal obligor. The mechanism by which this reallocation is accomplished should not cause any disadvantage to the obligee. The obligee would be disadvantaged, however, if the secondary obligor were subrogated to rights of the obligee before complete satisfaction of the underlying obligation. In such a case, the rights obtained by the secondary obligor through subrogation would compete with the remaining rights of the obligee pursuant to the underlying obligation, with the result that the remaining recovery of the obligee on account of the underlying obligation could be diminished. Moreover, because both the secondary obligor and the obligee would be asserting rights arising from the same undivided claim, conflicting enforcement efforts could easily result. Thus, the secondary obligor is not entitled to subrogation to the rights of the obligee until the underlying obligation is completely discharged.

This rule applies in at least three contexts. First, a secondary obligor that

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performs only part of the secondary obligation is not entitled to subrogation to
the obligee’s rights against the principal obligor.

Illustration:

1. P borrows $10,000 from C, secured by collateral worth $10,000. S is a
surety for P’s obligation to C, and P is charged with notice of S’s
obligation. Upon the default of P before paying any of the indebtedness, C
demands payment from S. S pays C $4,000. Although S is entitled to
reimbursement for the $4,000, S is not subrogated to C’s rights against P and
the collateral until such time as the remaining $6,000 is paid to C.

Second, when the secondary obligation secures only a portion of the
underlying obligation, even if the secondary obligor performs the secondary
obligation in its entirety, the secondary obligor is not entitled to subrogation to
the obligee’s rights against the principal obligor until the entire underlying
obligation is satisfied or discharged. Of course, the principal obligor will be
entitled to either reimbursement (§ 22) or restitution (§ 26). Thus, it is
sometimes in the interest of the secondary obligor to satisfy the remainder of
the underlying obligation even though it is not required to do so under the
terms of the secondary obligation.

Illustrations:

2. P borrows $10,000 from C, secured by collateral worth $10,000. S is a
surety for P’s obligation to C, up to a maximum of $8,000. P is charged with
notice of S’s obligation. Upon the default of P before paying any of the
indebtedness, C demands payment of $8,000 from S. S pays C $8,000.
Although S is entitled to reimbursement for the $8,000, S is not subrogated to
C’s rights against P and the collateral until the remaining $2,000 is paid to C.

3. P has agreed to construct a building for C. S has issued a payment
bond for P’s obligation to pay for labor and materials, subject to a maximum of
$100,000. P is charged with notice of S’s obligation. P defaults on its
obligation. The total claims for labor and materials are $120,000. S pays
$100,000 of these claims and asserts subrogation rights to $90,000 in contract
funds remaining in C’s hands. S is not entitled to subrogation because all of
the claims for labor and materials have not been satisfied. If S pays the
remaining $20,000 of claims for labor and materials, S will be entitled to
subrogation to C’s rights. If C applies $20,000 of the contract funds to the
remaining claims, S will be subrogated to the remaining contract funds.

Third, when collateral for the underlying obligation also secures other
obligations of the principal obligor to the obligee, the secondary obligor is not
entitled to subrogation to the obligee’s rights to the principal obligor’s
collateral until all obligations secured by that collateral are satisfied or


discharged.

Illustration:

4. P borrows $10,000 from C, secured by a security interest in equipment worth $10,000. S is a surety for P's obligation to C, and P is charged with notice of S's obligation. Pursuant to the security agreement, the equipment also secures two other obligations, of P to C. Upon the default of P before paying any of the indebtedness, C demands payment from S. S pays C $10,000. Although S is entitled to reimbursement for the $10,000, S is not subrogated to C's rights against the equipment until such time as the other obligations secured by the collateral are satisfied.

There is one exception to the requirement of complete discharge. A secondary obligor is discharged from the secondary obligation to the extent that the obligee's performance of an act that impairs the recourse of the secondary obligor would otherwise cause the secondary obligor a loss. See §§ 39-46. Quite often, the loss is a reduction in value of the secondary obligor's subrogation rights. It would be absurd if the effect of a partial discharge, designed to recognize the reduced value of those subrogation rights, had the effect of eliminating those rights altogether. Yet, that would be the case if, as a result of the discharge of the secondary obligor, the underlying obligation were not totally satisfied and, therefore, the secondary obligor were not eligible for subrogation. Accordingly, this section recognizes that the secondary obligor is entitled to subrogation when, but for the discharge of the secondary obligor as a result of the obligee's impairment of recourse, the underlying obligation would be totally satisfied.

Illustration:

5. P borrows $10,000 from C; S guarantees P's repayment obligation. P's obligation to C is secured by equipment worth $6,000 and investment securities worth $7,000. C neglects to perfect the security interest in the equipment. Subsequently, P borrows $20,000 from L, secured by the same items of equipment; L perfects its security interest in the equipment. P defaults on the obligations to both C and L. L's security interest in the equipment will be superior to C's interest. Thus, while P's obligation would not have been undersecured had C perfected its security interest, the failure of C to perfect the security interest in the equipment caused C to be undersecured by $3,000. Pursuant to § 42, S is discharged to the extent of $3,000. If S pays the remaining $7,000 owed pursuant to its secondary obligation, S is subrogated to C's rights with respect to the indebtedness of P.

c. Relevance of default on underlying obligation.

The secondary obligor is entitled to subrogation under this section only to
the extent that performance of the secondary obligation contributed to discharge of the underlying obligation. Performance not required by the terms of the secondary obligation does not result in subrogation rights. Accordingly, if the duty of the secondary obligor pursuant to the secondary obligation is conditioned on the default of the principal obligor on the underlying obligation, performance by the secondary obligor in the absence of default by the principal obligor will not entitle the secondary obligor to subrogation. In such a case, it could be said that, as between the principal obligor and the secondary obligor, it is the principal obligor that has the sole right to perform until default. Subrogating the secondary obligor to the rights of the obligee when the secondary obligor has performed in the absence of default would prejudice this right of the principal obligor. In a proper case, however, the principal obligor may be required to disgorge any resulting unjust enrichment to the secondary obligor.

Nonetheless, if the obligee informs the secondary obligor that the principal obligor has defaulted and demands performance by the secondary obligor, the secondary obligor should not be prejudiced if the obligee's declaration of default was inaccurate. Therefore, in such a case, it is ordinarily appropriate to treat the obligee as having contracted directly with the secondary obligor for its performance and, accordingly, to hold the obligee responsible for paying the secondary obligor for that performance.

Illustration:
6. P has agreed to construct a building for C. S has issued a performance bond for P's obligation to complete construction. Pursuant to the terms of the bond, S is not obligated to complete the construction or pay for its completion unless P defaults on its obligation to C. S, mistakenly believing that P has defaulted on the construction contract, completes the construction. S is not entitled to subrogation to C's rights to contract payments retained by C. S is entitled to recovery of any resulting unjust enrichment of P.

d. Relevance of "suretyship defenses."
Suretyship status gives the secondary obligor certain defenses with respect to the secondary obligation that are not available to the principal obligor on the underlying obligation. In addition, the contract creating the secondary obligation may give the secondary obligor additional defenses not available to the principal obligor. If the secondary obligor performs the secondary obligation despite the existence of one of these defenses, there is an unjust enrichment of a principal obligor who had no defenses to the underlying obligation, and no interests of the obligee or the principal obligor would be prejudiced by allowing subrogation. Therefore, a secondary obligor that performs the secondary obligation despite the existence of defenses available to the secondary obligor but not to the principal obligor is entitled to be
subrogated to the rights of the obligee.

**e. Principal obligor's notice of secondary obligation irrelevant.**

When the elements of this section are fulfilled, the secondary obligor is subrogated to the rights of the obligee with respect to the underlying obligation whether or not the principal obligor is charged with notice of the secondary obligation (§ 20). In either case, the principal obligor has been unjustly enriched by the secondary obligor's performance of the secondary obligation to the extent that such performance discharged the underlying obligation. Moreover, in either case, subrogating the secondary obligor to the rights of the obligee places the principal obligor in no worse position than if the obligee had not recovered from the secondary obligor and, instead, had itself sought performance of the underlying obligation.

**Illustrations:**

7. P borrows $10,000 from C, secured by collateral worth $10,000. S is a surety for P's obligation to C. P is charged with notice of the secondary obligation of S. Upon the default of P before paying any of the indebtedness, C demands payment from S. S pays C $10,000. S is subrogated to C's rights against P and the collateral.

8. Same facts as Illustration 7, except that P is not charged with notice of the secondary obligation of S. S is subrogated to C's rights against P and the collateral.

**f. Secondary obligor's knowledge of obligee's rights irrelevant.**

Subrogation is a remedy designed to prevent unjust enrichment. It is not created by contract and is not dependent on reliance. Accordingly, knowledge or lack of knowledge on the part of the secondary obligor as to the nature or extent of the obligee's rights with respect to the underlying obligation has no effect on the extent to which the secondary obligor is subrogated to the rights of the obligee. Thus, the secondary obligor's ignorance as to the existence or amount of collateral for the underlying obligation is irrelevant.

**Illustrations:**

9. P borrows $10,000 from C, and S is a surety for P's obligation to repay the loan. P's obligation to C is also secured by collateral worth $10,000, although this fact is unknown to S. Upon the default of P before paying any of the indebtedness, C demands payment from S. S pays C $10,000. S is subrogated to C's rights against P and the collateral.

10. P requests a loan of $10,000 from C, but the request is denied because P has a poor credit history and can only offer collateral with a value of $4,000. To induce C to make the loan to P, S agrees to guarantee P's repayment obligation, so long as it is secured by the collateral. After the loan is made, P
grants C a security interest in additional collateral worth $6,000. S is unaware of this additional collateral. Upon the default of P before paying any of the indebtedness, C demands payment from S. S pays C $10,000. S is subrogated to C’s rights against P and all of the collateral.

g. Obligee’s knowledge of secondary obligation irrelevant.

Subrogation is a remedy that exists to prevent the unjust enrichment of the principal obligor at the expense of the secondary obligor. Inasmuch as the remedy is normally not available unless the obligee’s claim has been fully satisfied, the obligee will be economically indifferent as to whether or not the remedy is utilized. Accordingly, there is no reason to condition the availability of the remedy on the obligee’s knowledge of the circumstances giving rise to it. Thus, if the conditions for subrogation are satisfied, it is irrelevant whether the obligee knew that the secondary obligor was a secondary obligor.

Illustration:

11. S owes C $10,000, secured by a mortgage on an item of realty. S transfers the realty to P, who assumes the liability of S to C. When P does not pay the $10,000 on the date that it is due, C, who is unaware of the transaction between P and S, demands payment from S. S pays C the $10,000. S is a secondary obligor (see §§ 1-2) and is subrogated to C’s rights against the realty.