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A Study of Subrogation Mostly in Letter of Credit and Other Abstract Obligation Transactions

John F. Dolan*

I. INTRODUCTION

Sometimes issuers of abstract obligations (standby letters of credit and independent bank guarantees) find after they have paid on the obligation that

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* Professor of Law, Wayne State University Law School. This Article has its origins in a presentation to the faculty of the Molengraaff Institute for Private Law at the University of Utrecht in 1993, and the Author acknowledges the helpful comments and suggestions of the members of that faculty, especially Willem Grossheide, Arthur Harkamp, and Frans van der Velde. Special thanks also to Laura Bartell, David Gray Carlson, Eric Kades, Michael McIntyre, Cynthia Baker, and James J. White for their comments and criticism and to Matthew Engelbert, Amy Munerantz, and R. Bryan Schneider for research assistance.

1. In a classic abstract payment obligation transaction, the seller of goods or services on credit insists that the buyer obtain an abstract payment obligation to secure the buyer's obligation to pay the seller's invoice when it comes due. If the buyer does not pay, the seller draws on the abstract obligation, usually by presenting the issuer (usually the buyer's bank) with documents: a draft, a copy of the invoice, and a certificate that the invoice is unpaid. The transaction is relatively easy to illustrate.

Seller ———— Buyer
(Beneficiary) (Applicant)

Issuer

This Article uses the broader term "abstract obligation" in lieu of the term "standby letter of credit" or "independent bank guarantee" because it is now clear that standby credits are a subset of a wider category of commercial product. While much of the literature, including some by this Author, has assumed that standby letters of credit were unique abstract undertakings, it is evident that only in the United States are they the principal abstract obligation. Offshore banks have for some time been issuing independent bank guarantees, to which courts have almost universally and intentionally applied standby credit law, and which are now the subject of a United Nations Convention, the UN Convention on Independent Guarantees and Stand-by Letters of Credit, which was promulgated in 1995 (hereinafter UN CONVENTION). For cases treating the independent guarantee and the standby credit as essentially the same commercial product, see American Nat'l Bank & Trust Co. v. Hamilton Indus. Int'l, Inc., 583 F. Supp. 164 (N.D. Ill. 1984), rev'd on other grounds sub nom. Banque Paribas v. Hamilton Indus. Int'l, Inc., 767 F.2d 380 (7th Cir. 1985); Coca Cola Fin. Corp. v. Finsat Int'l Ltd., 2 Lloyd's Rep. 274 (C.A. 1996). Professor Goode has taken pains to define the general category as "abstract payment undertakings." See Roy Goode, Abstract Payment Undertakings in Essays for Patrick Atiyah (Peter Cane et al. eds., 1991); Roy Goode, Abstract Payment Undertakings in International Transactions, 22 BROOK J. INT'L
their right of reimbursement is impaired. In that case, the issuer, usually a bank, has erred; it has extended credit to a party that cannot pay. While efficiency analysis would leave the loss on the erring bank, the revised version of Article 5 of the Uniform Commercial Code ("Revised Article 5") includes a provision granting subrogation to letter of credit issuers as if they were sureties. The provision is provision article 5 of the Uniform Commercial Code ("Revised Article 5") includes a provision granting subrogation to letter of credit issuers as if they were sureties. 2 Some commentators view this statutory provision as a surefire source of subrogation for the banks.

This Article mounts an argument to the contrary. Because subrogation is an equitable remedy resting on an unjust enrichment standard, 3 this Article contends that bank issuers must make an unjust enrichment case before they can avail themselves of the subrogation remedy, even under Revised Article 5. This Article attempts to demonstrate, moreover, that the case for unjust enrichment in these transactions is difficult to make and that courts should accord banks the remedy sparingly. The arguments against subrogation also expand to cover other players in the standby letter of credit transaction, and this Article concludes that as a general principle those players should not have subrogation.

Part II explains that subrogation is a remedy, not a right, and that it is available to a plaintiff only in case of unjust enrichment. Part III argues that proper respect for subrogation's nature as a remedy and for the unjust enrichment prerequisite does not permit mechanical application of the remedy, either by granting or denying it. Part IV explains the difficulty of showing unjust enrichment in most abstract obligation settings, and it explains the damage that promiscuous granting of the remedy visits on the abstract obligation as a commercial device.

Part V analyzes Section 5-117 of Revised Article 5 and concludes that, contrary to first impressions, nothing in that section impedes the analysis offered here. Part VI suggests that while there is an argument that the Bankruptcy Code commands mechanical denial of the remedy, a fair reading can be made that the Bankruptcy Code does not interfere with the analysis this Article advances as a matter of UCC law and common law. Finally, Part VII contends that proper regard for private ordering of burdens supports limited availability of the remedy to issuers and others in abstract obligation settings unless the parties are unable to engage in that private ordering.

II. SUBROGATION AS A REMEDY


2. The provision is U.C.C. § 5-117 (1995), the last section in the letter of credit article. The appendix beginning on the last page of this Article sets out the text of the provision and of the official comments.

Much of what is advanced here rests on the often ignored fact that subrogation is an equitable remedy, not a right. Because it is a remedy, application of subrogation to any setting must abide determination that the conditions for the remedy obtain. It is an established principle of subrogation law that the purpose of subrogation is to provide restitution when the absence of restitutionary relief would yield unjust enrichment. In fact, one can say that most commentators who have considered the role of subrogation are generally

4. Dawson refers to subrogation as a “generalized remedial device.” John Dawson, Unjust Enrichment, A COMPARATIVE ANALYSIS 141 (1951); cf. John Dawson, Restitution or Damages?, 20 Ohio St. L. J. 175, 184 (1959) (referring to subrogation as one of the “restitution remedies”). Accord Lord Goff of Chieveley & Gareth Jones, The Law of Restitution 524 (3d ed. 1986); 1 George E. Palmer, The Law of Restitution 21 (1978); Restatement (First) of Security § 141 cmt. a (1941); Restatement (Third) of Suretyship and Guaranty § 27 cmt. a (1995).

5. Some of the commentary that disagrees with the conclusions of this Article refers to subrogation as a “right.” See, e.g., Carter Klein, Subrogation Rights and Letters of Credit—Get Ready, LETTERS OF CREDIT REPORT, May-June 1995, at 1; Peter Jarvis, Standby Letters of Credit-Issuers’ Subrogation and Assignment Rights, 9 U.C.C. L.J. 356 (1977) (Pt. I), 10 U.C.C. L.J. 38 (1977) (Pt. II). That characterization of subrogation preterms the unjust enrichment inquiry, which is generally a prerequisite for this remedy. The presumption, therefore, prejudices the inquiry. Both Carter and Jarvis would not grant subrogation if it weakens the abstract obligation as a commercial product. Because the characterization of subrogation as a right avoids the need to fasten on the prerequisites, these commentators may have missed the fact that subrogation does indeed impact the abstract obligation adversely.

6. “Subrogation being equitable, it follows that equitable considerations limit the right.” Laurence P. Simpson, Handbook of the Law of Suretyship 209 (1950). “Not much reflection is required for one to discover that at every point in this complex equation there are judgments of fairness and social policy, even before one faces the critical question, when is enrichment ‘unjust’?” Edward W. Spencer, The General Law of Suretyship 177 (1913) (speaking of equitable origins of subrogation).

7. “Where property of one person is used in discharging an obligation owed by another or a lien upon the property of another, under such circumstances that the other would be unjustly enriched by the retention of the benefit thus conferred, the former is entitled to be subrogated to the position of the obligee or lien-holder.” Restatement (First) of Restitution §162 (1937) (emphasis added). See also Restatement (Third) of Suretyship and Guaranty § 27 cmt. a (1996); Dan Dobbs, Law of Remedies 405 (2d ed. 1993) (hereinafter Remedies).
in agreement that unjust enrichment is the *sine qua non* of subrogation.\(^8\) Thus, in the absence of unjust enrichment the subrogation remedy is not available.

It may be sufficient to make the case against subrogation in abstract obligation transactions to rely on that historical feature of subrogation law. This Article carries the argument further, however, by contending that in the abstract obligation context, application of the subrogation remedy when unjust enrichment facts are absent produces mischievous commercial law. In short, application of the subrogation remedy without regard for unjust enrichment facts not only departs from traditional subrogation doctrine, it also generates bad law. Finally, this Article examines the role of the subrogation section in Revised Article 5 and concludes that the proper purpose of the provision is modest: to rectify the error of those who would ignore the unjust enrichment basis of the subrogation remedy.

III. PROPER APPLICATION OF THE REMEDY

**A. In the Abstract Obligation Context**

In the abstract obligation context, mechanical application of any subrogation rule prevents subrogation in virtually all cases.\(^9\) That virtually

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8. Unjust enrichment is "an indispensable element" of subrogation. 3 PALMER, *supra* note 4, at 343. Subrogation "is properly used only as a means of preventing unjust enrichment." 3 PALMER, *supra* note 4, at 344. "The test is entirely empirical. It is ... impossible to formulate any narrower principle than that the doctrine [of subrogation] will be applied only when the courts are satisfied that reason and justice demand that it should be." GOFF & JONES, *supra* note 4, at 527. Whether a surety is subrogated is a matter of "equity and good conscience." 1D SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 844 (3d ed. 1967). "Subrogation is another equitable remedy in which tracing is used to prevent unjust enrichment ...." DAN DOBBS, HANDBOOK OF THE LAW OF REMEDIES § 250 (1973) (hereinafter HANDBOOK). Equitable subrogation "is imposed by courts to prevent unjust enrichment." REMEDIES, *supra* note 7, at 405. "[S]ubrogation in this sense is to be denied when the court concludes that there is no unjust enrichment." REMEDIES, *supra* note 7, at 405. "Subrogation is a remedy that exists to prevent the unjust enrichment of the principal obligor at the expense of the secondary obligor." RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 27 cmt. g (1996). *See generally* RESTATEMENT (FIRST) OF RESTITUTION § 162 (1936).

"Subrogation, as a creature of equity, is subject to the limitation that it will not be allowed where it will prejudice creditor or be inequitable to third persons." RESTATEMENT (FIRST) OF SECURITY § 141 cmt. a (1941).

9. There are several instances when subrogation can arise in the abstract obligation setting. One commentator has identified nine of them. *See* Klein, *supra* note 5, at 1. The first three points in this Article relate to one of the most common instances on Klein's list: subrogation of the abstract obligation issuer (or the confirmer) to the rights of the beneficiary against the applicant or one related to the applicant. It is that subrogation that threatens the independence of the abstract obligation. The scope of the
complete prohibition of the subrogation remedy arises by virtue of a distinction between abstract obligations and secondary guaranties that has bedeviled much of the learning in this area.

It is classic subrogation law\textsuperscript{10} that a surety that pays the debt of its principal is subrogated to the rights of the creditor against the principal.\textsuperscript{11} Since much subrogation law comes to us from suretyship law, it is worth considering whether the differences between abstract obligations and traditional, secondary guaranties justify disparate treatment of abstract obligations or whether the differences are superficial only.

fourth point, however, extends beyond that single setting.

10. This Article describes U.S. subrogation law, which is rather generous in according the remedy. English and Canadian courts have been less generous. For a thoughtful and scholarly opinion that engages in the comparative exercise and rejects subrogation for a letter of credit issuer, see Westpac Banking Corp. v. Duke Group Ltd., [1994] O.R.3d 515. See also Paul v. Speirway Ltd., 2 All E.R. 587, 597-98 (Ch. 1976) (no subrogation when party seeking it was really an unsecured lender); Orakpo v. Manson Invs. Ltd., 3 All E.R. 1, 7 (H.L. 1977) (judgment of Lord Diplock reciting that English law does not recognize unjust enrichment as a general doctrine and still bottoms subrogation on the presumed intent of the parties).

11. In a suretyship transaction, the parties have different names. Thus, if the seller in the credit sale illustrated supra note 1 takes a surety's undertaking rather than a standby credit, the seller remains the beneficiary of the undertaking, but the buyer is no longer the applicant. The buyer is the "principal," and the issuer is the "surety." See Restatement (Third) of Suretyship and Guaranty § 27 (1996).
While a few commentators question it, the overwhelming weight of the commentary, domestic law, and international law differentiates abstract

12. Professor Cohen argues that it is “obvious” that “[s]tandby letters of credit fulfill the same economic function as secondary obligations, that is, guarantees and other suretyship devices.” Neil Cohen, Subrogation: A Further Probing, LETTERS OF CREDIT REPORT, Sept.–Oct. 1995, at 5. He argues that the commercial devices differ only in that they are governed by “different rules” and that standby letters of credit are subject to a “different legal regime.” Id. As reporter for the RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTRY (1996), he originally urged that standby letters of credit be subject to the Restatement, but in the earliest draft of the scope provision excluded the standby because the issuer of a standby “is not a secondary obligor.” RESTATEMENT (THIRD) OF THE LAW OF SURETYSHIP § 1 cmt. j (Tentative Draft 1991); cf. RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTRY § 4(2) (1996) (excluding letters of credit from the scope of the Restatement). The comment to Section 4(2) indicates that the exclusion of letters of credit from the Restatement was a consequence of the fact that they were subject to well developed law and that it would not serve any purpose to “disturb that state of affairs.” RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTRY § 2 cmt. c (1996). Professor Boss, claiming that “these letters of credit are being used interchangeably with guarantees and surety bonds,” also urged that letters of credit be subject to the Restatement. Amy Boss, Suretyship and Letters of Credit: Subrogation Revisited, 34 WM. & MARY L. REV. 1087, 1136 (1993). Professor Alces also questions the assertion that there are functional differences between letters of credit and guarantees and has expressed his dissatisfaction with the Restatement’s stated reason for the exclusion of abstract obligations from its scope. See Peter A. Alces, An Essay on Independence, Interdependence, and the Suretyship Principle, 1993 U. ILL. L. REV. 447, 479. Both he and Professor Boss would include letters of credit in the Restatement. These writers make serious arguments that merit thoughtful and thorough response. It is sufficient to say here that this Article is not the place to make that response, but that it is necessary to acknowledge that if they are correct when they argue that it is not function, but only legal rules that differentiate abstract obligations from guaranties, the thesis of this Article largely fails.


14. “Rights and obligations of an issuer to a beneficiary . . . are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises . . . .” U.C.C. § 5-103(d)(1995). “Parties to a contract may use a letter of credit to make certain that contractual disputes wend their way toward resolution
obligations (standby letters of credit and independent guarantees) from dependent obligations (secondary guaranties and suretyship obligations) in one important functional respect. The distinction rests on the notion that abstract obligations (usually standby letters of credit in the United States) are independent of the transaction out of which they arise. This independence or abstraction principle holds that the obligor on the abstract obligation (the issuer of the credit or the independent guarantor) must pay the beneficiary, notwithstanding the circumstances of the underlying transaction. Importantly, the distinction is not a product of law, for law in this instance follows commercial function. First and foremost, the distinction is one of function. In this sense, one might say that abstract obligations are primary because they are payable without regard to the failure to pay or the occurrence of a breach or other default in the underlying transaction. In short, the issuer’s liability does not derive from the liability of the debtor but from the issuer’s own undertaking.

with money in the beneficiary’s pocket rather than in the pocket of the contracting party.” Iték Corp. v. First Nat’l Bank, 730 F.2d 19, 24 (1st Cir. 1984). The premise of the guaranty is that the parties argue first and then the guarantor pays, but the premise of the abstract obligation is “pay now, argue later.” Eakin v. Continental Ill. Nat’l Bank & Trust Co., 875 F.2d 114, 116 (7th Cir. 1989).


16. The important exception to this principle is the case of fraud, where the courts and Article 5 render the credit subject to the fraud defense even though the fraud may arise in the underlying transaction. See U.C.C. § 5-109 (1995); Szetjn v. J. Henry Schroder Banking Corp., 31 N.Y.S.2d 631 (Sup. Ct. 1941). Whether that exception swallows the independence principle is the chief question on which the commentators disagree. It is fair to say that the overwhelming weight of case and academic authority supports the independence principle as a viable feature of abstract obligation law and practice, and limits it in various ways. It is beyond the scope of this Article to enter that debate. For the weight of U.S. authority, see Airline Reporting Corp. v. First Nat’l Bank, 832 F.2d 823 (4th Cir. 1987); Recon Optical, Inc. v. Israel, 816 F.2d 854 (2d Cir. 1987); Foxboro Co. v. Arabian Am. Oil Co., 805 F.2d 34 (1st Cir. 1986); Intraworld Indus., Inc. v. Girard Trust Bank, 336 A.2d 316 (Pa. 1975); Philipp Bros. v. Oil Country Specialists, Ltd., 787 S.W.2d 38 (Tex. 1990). The rule in other jurisdictions is equally protective of the abstract obligation. See, e.g., Bank of N.S. v. Angelica-Whiteware Ltd., [1987] D.L.R.4th 161; United Trading Corp. v. Allied Arab Bank Ltd., 2 Lloyd’s Rep. (C.A. 1945). For the best articulation of the opposing view, see Alces, supra note 12.

17. The standby credit issuer in the transaction illustrated supra note 1 must pay the seller even though the buyer has a contract defense to that payment, e.g., if the goods do not conform. See, e.g., Ground Air Transfer, Inc. v. Westates Airlines, Inc., 899 F.2d 1269 (1st Cir. 1990). Conversely, if the buyer does not owe the invoice price to the seller in the transaction illustrated supra note 1, the surety should not pay the seller. See Restatement of Suretyship and Guaranty § 34 (1995).
Traditional guaranties, by distinction, are first and foremost secondary to the underlying transaction. In theory and in practice, the obligor on the guaranty (the issuer of the guaranty) need not pay the guaranty beneficiary unless the circumstances of the underlying transaction dictate it. Thus, in this discussion the term “guaranty” refers to undertakings such as bonds and other suretyship arrangements whereby the party issuing the “guaranty” is obligated to pay the beneficiary of the “guaranty” only after the beneficiary establishes the fact of a loss, breach, or other default of a principal obligor.

The balance of this part addresses the question whether this distinction is merely formal, and therefore insufficient to justify denial of the subrogation remedy, or whether it supports different treatment of the two commercial devices. The overall analysis suggests that the distinction is an approximation that holds in many cases. The better reasoning concludes, however, that the distinction by itself is insufficient, and that, in any event, Revised Article 5 now interdicts it. Professor Amy Boss has provided the analytical framework.

In her article on abstract obligations and subrogation, Boss argued that the abstract obligation functions as a commercial form of guaranty and that subrogation rules in abstract obligation law should conform to subrogation rules in guaranty law. Boss proposed that the National Conference of Commissioners

18. There has been a measure of promiscuity in the use and spelling of the term “guaranty.” In international trade and in foreign banking, parties use “guarantees” that are primary undertakings. Variously referred to as “international bank guarantees [sic],” “first demand guarantees,” and “primary guarantees,” these obligations are primary in nature and are generally governed by the law of letters of credit rather than the law of suretyship, the traditional law of secondary guaranties. (Note that international bankers use the foreign spelling of the term). For cases applying abstract obligation principles to these guarantees, see, e.g., American Nat’l Bank & Trust Co. v. Hamilton Indus. Int’l, 583 F. Supp. 164 (N.D. Ill. 1984), rev’d on other grounds sub nom. Banque Paribas v. Hamilton Indus. Int’l, 767 F.2d 380 (7th Cir. 1985); Esal (Commodities) Ltd. v. Oriental Credit Ltd., 2 Lloyd’s Rep. 546 (C.A. 1985); Society of Lloyd’s v. Canadian Imperial Bank, 2 Lloyd’s Rep. 579 (Q.B. 1993). See generally Borris Kozolchyk, Bank Guarantees and Letters of Credit: Time for a Return to the Fold, 11 U. PA. J. INT’L BUS. L. 1 (1989); Omar, The Regulation of International First Demand Bonds—A Comparative Approach, 4 ARAB L.Q. 95 (1989); Jean Stoufflet, Recent Developments in the Law of International Bank Guarantees in France and Belgium, 2 ARIZ. J. INT’L & COMP. L. 48 (1987). In this Article and in most of the commentary cited here, the term guaranty (however spelled), refers to a secondary obligation generally subject to suretyship principles.

19. The Boss article examines the mechanistic analysis in the abstract obligation context. George Palmer reaches a similar conclusion in subrogation law as a general principle, criticizing mechanistic application of the primary/secondary distinction as turning “a description of one of the common instances of subrogation into a definition and in the process ignoring the reason why there is subrogation in the common instance.” 1 PALMER, supra note 4, at 252.

20. “[O]ne possible way to view letters of credit is as a mere commercial form of guaranty . . . .” Boss, supra note 12, at 1136.
on Uniform State Laws\(^2\) provide explicitly in Revised Article 5 that, post payment, subrogation be widely available for parties to the abstract obligation transaction\(^2\) and to the underlying and related transactions,\(^3\) though she urged

21. At the time she wrote, the revision of Article 5 was a project of the National Conference of Commissioners on Uniform State Laws (hereinafter "the Conference"), and Boss directed her recommendation to the Conference drafting committee to which she was an advisor. See Boss, supra note 12, at 1134-35.

22. See Boss, supra note 12, at 1090. Although Boss does not attempt to address all of them, there are a significant number of situations in which parties to the abstract obligation transaction (e.g., the applicant, the issuer, the beneficiary, the confirming bank, and the account party) may seek subrogation. To date there are no reported cases involving efforts by the issuer to subrogate itself to the rights of the applicant against the beneficiary or against third parties, but some commentators support such a claim in a proper case. See BARKLEY CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS, AND CREDIT CARDS ¶ 14.11[2][a] (rev. ed. 1995); Douglas Baird, Standby Letters of Credit in Bankruptcy, 49 U. CHI. L. REV. 130, 140 (1982); Jarvis, supra note 5; Gerald T. McLaughlin, Letters of Credit as Preferential Transfers in Bankruptcy, 50 FORDHAM L. REV. 1033, 1073 (1982). There is case law recognizing an action by the issuer to subrogate itself to the beneficiary's rights against the applicant or the applicant's property. See CCF, Inc. v. First Nat'l Bank & Trust Co. (In re Slamans), 175 B.R. 762 (N.D. Okla. 1994), rev'd, 69 F.3d 468 (10th Cir. 1995); cf. In re Valley Vue Joint Venture, 123 B.R. 199 (Bankr. E.D. Va. 1991) (subrogating applicant to rights of beneficiary). But cf. Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357 (3d Cir. 1992) (denying issuer subrogation claim to bond proceeds assigned by beneficiary to third party). Most courts have rejected subrogation of the issuer to the beneficiary on one ground or another. See, e.g., Berliner Handels-Und Frankfurter Bank v. East Tex. Steel Facilities, Inc. (In re East Tex. Steel Facilities), 117 B.R. 235 (Bankr. N.D. Tex. 1990); Bank of Am. Nat'l Trust & Sav. Ass'n v. Kaiser Steel Corp. (In re Kaiser Steel Corp.), 89 B.R. 150 (Bankr. D. Colo. 1988); In re Munzenrieder, 58 B.R. 228 (Bankr. M.D. Fla. 1986); Merchants Bank & Trust Co. v. Economic Enters., Inc. (In re Economic Enters., Inc.), 44 B.R. 230 (Bankr. D. Conn. 1984); Mead Corp. v. Dixon Paper Co., 907 P.2d 1179 (Utah 1995). There is also authority permitting the confirming bank to subrogate itself to the rights of the issuer against the applicant, see Chemical Bank v. Craig, 826 F.2d 440 (6th Cir. 1987), and to subrogate itself to the rights of the beneficiary against the applicant, see FDIC v. Liberty Nat'l Bank & Trust Co., 806 F.2d 961 (10th Cir. 1986). For authority that the applicant may subrogate itself to the rights of the beneficiary, see In re Minnesota Kicks, Inc., 48 B.R. 93 (Bankr. D. Minn. 1985). But cf. Wilkins v. Commercial Inv. Trust Corp., 153 F.3d 1273 (11th Cir. 1998) (denying subrogation to applicant seeking lien rights of parties who received credit proceeds from beneficiary); Tokyo Kogyo Shokai v. U.S. Nat'l Bank, 126 F.3d 1135 (9th Cir. 1997) (denying subrogation of applicant to issuer's rights against bank nominated to make advances under red clause credit); North Am. Foreign Trading Corp. v. Chiao Tung Bank, No. 95 Civ. 5189(LBS), 1997 WL 193197, at *1 (S.D.N.Y. Apr. 18, 1997) (denying negotiating bank's claim in nature of subrogation to beneficiary's rights against applicant in underlying transaction).

23. Professor Boss, for example, would extend subrogation benefits to the confirming bank against the applicant for the credit. See Boss, supra note 12, at 1132.
that the remedy be available only after the obligor has paid the abstract obligation. To an extent, the Conference complied.24

The Boss article made a number of telling points. Boss confronted the unhappy state in case law: Several decisions used mechanistic analysis to determine whether to apply subrogation. These cases reasoned that since an abstract obligation issuer always pays its own obligation—a characterization of the issuer’s obligation that is consistent with the independence principle that drives much of abstract obligation law—there could be no subrogation.25 The cases were telling parties that issued abstract obligations that they could not have the benefits of the independence principle without the costs. The cases reasoned that if the credit is independent, as issuers have vigorously argued,26 the issuer paying the beneficiary satisfies its own obligation, not the debtor’s obligation, and the issuer may not have subrogation.

Boss rejected this analysis, which she saw as a rhetorical distinction that did not support denial of subrogation for abstract obligations on the one hand and the application of subrogation for guaranties on the other. Much of the discussion in the cases, as Boss demonstrated, turned on two distinctions between abstract obligations27 and secondary guaranties:28 (1) the idea that the abstract obligation

Professor James J. White, the reporter for Revised Article 5, would also extend it to confirmers. See James J. White, Rights of Subrogation in Letters of Credit Transactions, 41 St. Louis U. L.J. 47, 60 (1996).

24. Under U.C.C. Section 5-117 (1995) the Conference did not directly give the issuer a right of subrogation, but it did remove from the subrogation inquiry the notion that an abstract obligation issuer may never have subrogation. For further discussion, see infra text accompanying notes 71-86.


26. See INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS arts. 3 & 4 (1993) (hereinafter “UCP 500”); INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM RULES FOR DEMAND GUARANTEES art. 2(b) (1992) (hereinafter “URDG”); INTERNATIONAL BANKING LAW AND PRACTICE, INC., INTERNATIONAL STANDBY PRACTICES rule 1.06(c) (1998) (hereinafter “ISP 98”). The first two of these is a product of the International Chamber of Commerce Banking Commission. The Commission vetted and approved the third. All three regimes support the assertion in the text. Banks are the moving force behind UCP 500 and the URDG, both of which affirm the independence of abstract undertakings.

27. Much of the Boss article and other commentary refers to standby letters of credit, which in U.S. commerce are the abstract obligation paradigm.

28. The guaranty in question is generally that of the surety industry, for it is to sureties that standby credit issuers are similar, as the title of the Boss article suggests. See Boss, supra note 12.
is independent of the underlying obligation or “primary” while the secondary guaranty is dependent on the underlying obligation or “secondary,” and (2) the parallel notion that the abstract obligation issuer satisfies its own debt when it pays the beneficiary while the guarantor satisfies the debt of another when it pays the beneficiary. In fact, the Boss article demonstrated that the two arguments are really one and that the conflated arguments do not by themselves justify the exclusion of subrogation in the abstract obligation context.

B. The Primary/Secondary Distinction

Subrogation law customarily distinguishes primary and secondary obligations and affords subrogation in the latter case but not in the former. Similarly, the banking industry distinguishes its product, the standby, from the fidelity industry’s bonds and other guaranties on the ground that the former is a primary undertaking independent of any underlying transaction while the latter are secondary, being derivative of rights in the underlying transaction.

Boss demonstrated that this distinction failed to justify a denial of subrogation to the abstract obligation issuer. She concluded that the nub of the law’s distinction between abstract obligations and secondary guaranties is one of maintaining the independence principle, the principle that the abstract obligation issuer must pay upon the beneficiary’s presentation of documents

29. While the distinction may not be persuasive in the subrogation controversy, the distinction is relevant in the bank regulatory setting. “The true test is whether an instrument is an independent rather than an accessory or suretyship undertaking.” Sue E. Auerbach, Comment of New OCC I.R. 7.1016, LETTER OF CREDIT UPDATE, Nov. 1996, at 22. Banking authorities are rightly concerned under current versions of banking law that banks engage in banking practices which fall within the scope of their charter and not insurance or fidelity company practices which do not fall within that scope. Section 24 of the National Bank Act, 12 U.S.C. § 524 (Supp. III 1997), limits nationally chartered banks to the “business of banking.” The issuance of primary undertakings, or abstract obligations, has long been the business of banking; the issuance of secondary obligations in which the bank has no interest, generally has not. See Office of the Comptroller of the Currency, Interpretive Ruling, 12 C.F.R. § 7.1016 (1998) (governing the issuance of “independent undertakings”); 12 C.F.R. § 7.1017 (1998) (limiting the issuance of secondary guaranties). By virtue of its primary nature, moreover, bank regulators treat the standby letter of credit as an unfunded loan, and insist that banks include it in their loan limit calculations. See N.Y. BANKING LAW § 103(f) (McKinney 1990); Office of the Comptroller of the Currency, Lending Limits, 12 C.F.R. § 32.2(f)(iv) (1998). Bank regulators also require bank issuers to issue abstract obligations only after proper credit analysis of the bank’s reimbursement right. See Comptroller of the Currency, Interpretive Ruling, 12 C.F.R. § 7.1016(b)(iv) (1998).

30. The Boss article generally confines analysis of subrogation in the context of the issuer’s efforts to subrogate itself to the rights of the beneficiary. The thesis of the article is broader, however, advancing subrogation generally in the abstract obligation transaction. See Boss, supra note 12, at 1128-33.
without regard to the equities of related transactions. Because that concern is a pre-payment concern and because subrogation is a post-payment adjustment, Boss concluded that the law can maintain the independence principle without regard to subrogation. From that conclusion Boss advanced the view that subrogation is good for the abstract obligation transaction if equity’s prerequisites for subrogation are satisfied, and that abstract obligations should be subject to the subrogation remedy as a matter of abstract obligation law.

It is not sufficient to conclude that there are no justifications for rejecting subrogation in the abstract obligation transaction simply because these mechanical or rhetorical justifications fail. Nor is it sufficient to conclude that absent well articulated justifications for excluding subrogation, subrogation should apply. The proper inquiry is one of determining whether subrogation fits the abstract obligation transaction, not whether current justifications are adequate or inadequate. The Boss article set out to demolish current justifications for excluding subrogation, and it accomplished that goal. But it did not set out to examine the justifications for including subrogation. It is the thesis of this Article that those who propose to include subrogation must make a case for this special remedy and further that, most of the time, they cannot make it.

31. The Boss argument that the primary/secondary distinction should not be determinative finds support from restitution scholars, who although they do not address the question of subrogation in the abstract obligation context, sharply criticize, in the words of one of them, transmuting “the description of one of the common instances of subrogation into a definition.” 1 PALMER, supra note 4, at 31; see also GOFF & JONES, supra note 4, at 527 (arguing that the narrowest principle one can advance for situations in which subrogation is apposite is the situation in which reason and justice demand it).

32. Sometimes, in abstract payment obligation transactions, though infrequently in the standby credit transaction, there is a confirmer, i.e., a second bank that “confirms” the obligation of the issuer. The confirmer’s liability runs directly to the beneficiary. See U.C.C. § 5-107(a) (1995). The illustration of the abstract payment transaction supra note 1 would be modified in the case of a confirmation as follows:

\[
\begin{array}{c|c|c|c|c|c}
\text{Seller} & \text{Buyer} & \text{Confirmer} & \text{Issuer} \\
\text{(Beneficiary)} & \text{(Applicant)} & & & \\
\end{array}
\]

Boss would give the confirming bank subrogation to the issuer’s rights against the applicant, even though the confirmer has not relied on the applicant’s credit and may not have known the applicant at the time the confirmer undertook to pay the beneficiary. See Boss, supra note 12, at 1132-33. Boss acknowledges, however, that whether subrogation should be available in all situations “may turn on” equitable distinctions that the cases have generally ignored. See Boss, supra note 12, at 1128. Boss’s article, however, does not note any instances in which she believes subrogation should be denied.
IV. LOOKING FOR UNJUST ENRICHMENT

Analysis of the abstract obligation transaction illustrates that unjust enrichment usually is not present in the abstract obligation setting. Comparison of the abstract obligation transaction’s dynamics with subrogation and its dynamics without subrogation demonstrates, moreover, that subrogation is harmful to the abstract obligation as a commercial device. This analysis concludes that there are valid commercial reasons for limiting subrogation in the abstract obligation context, namely, that subrogation (1) offends the reason for subrogation—the prevention of unjust enrichment, and (2) yields commercially harmful effects, not the least of which is a diminishing of the independence principle’s practical force.

Virtually all who have considered subrogation in the abstract obligation context agree that the law can in no event permit an abstract obligation issuer to enjoy subrogation rights before payment.33 Boss takes pains to make that point.34 The dissent in Tudor Development Group, Inc. v. United States Fidelity & Guaranty Co.,35 a leading case that an Article 5 comment indorses, makes it;36 the subrogation provision of Revised Article 5 makes it;37 the comments emphasize it;38 and Professor White, the reporter for Revised Article 5, emphasizes it.39

By making this concession, these authorities acknowledge that the existence of subrogation rights before payment could diminish the effectiveness of the abstract obligation. One court’s40 aphorism captures an essential difference between the abstract payment obligation and the guaranty, the “pay now, argue later” rule.41 This “pay now, argue later” rule explains the law’s insistence that

33. Careful parsing of the facts of cases denying subrogation may well reveal an absence of unjust enrichment and, therefore, no grounds for subrogation. In principle, then, the courts may have reached the correct result, but Boss is correct that often the opinions facially resort to the rhetorical distinction she finds unhelpful. See generally supra note 22 (citing cases).
34. See Boss, supra note 12, at 1117-19.
35. 968 F.2d 357, 368 (3d Cir. 1992).
36. Id. at 368 (Becker, J., dissenting).
39. See White, supra note 23, at 61 (“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.”).
41. Under secondary guaranty law, because payment under the guaranty depends upon underlying contract obligations, the guarantor/surety need not pay until it is clear that its principal in the underlying transaction owes the money. Hence, for guaranties,
abstract obligations maintain independence from the underlying transaction and justifies the private bargaining of commercial parties who between themselves decide whether to use the "pay now, argue later" product or the "argue now, pay later" product. In short, the authorities, the drafters of Revised Article 5, and the dissent in a leading subrogation case, seem to be saying that if subrogation weakens the independence of the abstract obligation, they would withhold it. They withhold it before payment because to grant it then weakens the independence.

Allowing pre-payment subrogation obviously weakens the independence principle. If an abstract obligation issuer receives conforming documents from the beneficiary asking for payment under the credit, the abstract obligation rules and Revised Article 5 insist that the issuer pay. The issuer may not raise defenses that arise out of the underlying transaction, usually may not assert the rule is "argue now, pay later." In the abstract obligation context, however, the obligor/issuer pays without regard to underlying transaction equities because the abstract payment obligation is independent of the underlying transaction. Only after payment do the beneficiary (the seller) and the applicant (the buyer) adjust their positions. See, e.g., Recon Optical, Inc. v. Israel., 816 F.2d 854 (2d Cir. 1987). Hence for abstract obligations, the rule is "pay now, argue later."

42. Courts generally have been mindful of the distinction. If a bank undertaking is intimately related to the underlying transaction, it strays "too far from the basic purpose of letters of credit, namely providing a means of assuring payment cheaply by eliminating the need for the issuer to police the underlying contract," and courts simply treat it as a secondary guaranty. Wichita Eagle & Beacon Publ'g Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286 (9th Cir. 1974). The issue generally arises in the context of nondocumentary conditions for payment under the obligation. Wichita holds that if the obligation is payable against nondocumentary conditions that are important to the obligation rather than incidental to it, the obligation is dependent rather than independent, and the law of abstract obligations is not suitable to it. This rule illustrates the fact that, arguably, it is not law but commercial realities that determine the abstract nature of an obligation. Accord Calumet Nat'l Bank v. First Nat'l Bank, No. 83 C 2141, 1983 LEXIS 14465 (N.D. Ill. Aug. 19, 1983); Mayhill Homes Corp. v. Family Fed. Sav. & Loan Ass'n, 324 S.E.2d 340 (S.C. Ct. App. 1984); Western Petroleum Co. v. First Bank Aberdeen, N.A., 367 N.W.2d 773 (S.D. 1985); cf. Universal Sav. Ass'n v. Kileeon Sav. & Loan Ass'n, 757 S.W.2d 72 (Tex. Ct. App. 1988) (permitting issuers to accept documentary evidence that nondocumentary condition is satisfied); Banque De L'Indochine Et De Suez S.A. v. JH Rayner Ltd., 1 Lloyd’s Rep. 228 (1983 C.A.). Revised Article 5 codifies Wichita's sensible, commercial rule. Section 5-102(a)(10) defines "letter of credit" to include only undertakings that satisfy "the requirements of Section 5-104." Section 5-104 stipulates that the obligation must be independent of underlying contracts or arrangements. See also U.C.C. § 5-102 cmt. 6 (1995).

43. See UCP 500, supra note 26, art. 9(a); URDG, supra note 26, art. 2(b); ISP 98, supra note 26, rule 2.01.

44. See U.C.C. § 5-108(a) (1995); cf. UN CONVENTION, supra note 1, art. 17(1).

45. See, e.g., Asociacion De Azucareros De Guatamala v. United States Nat'l Bank, 423 F.2d 638 (9th Cir. 1970); New York Life Ins. Co. v. Hartford Nat'l Bank &
setoff rights against the beneficiary, and often may not raise public policy issues relating to the underlying transaction. To allow the issuer to raise subrogation rights against the beneficiary before payment would be a serious departure from these concerted efforts to make the issuer pay against conforming documents. Any other rule would render the abstract obligation an "argue-now, pay later" device, that is, a secondary guaranty.

Those who support post-payment application of the subrogation remedy have taken the position that it does not affect the independence of the obligation. As a matter of courthouse practice, they may be correct, but as a matter of banking house practice, they are not. The problem with subrogation is that at any time it weakens the independence of the credit. By ignoring the dynamics of banking practice and relying on trial practice, the authorities have missed the point. While it is true that substantive legal rules can prevent bank issuers from seeking the subrogation remedy at the courthouse until the issuer pays, those rules cannot prevent the bank issuer from calculating the remedy's benefits when the issuer decides at the banking house whether to pay the beneficiary.

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46. Power Curber Int'l Ltd. v. National Bank of Kuwait S.A.K., 3 All E.R. 607 (C.A. 1981). This anti-setoff applies if the setoff arises out of a related transaction, but does not apply if the issuer is setting off a debt due the issuer from the beneficiary. See, e.g., FDIC v. Liberty Nat'l Bank & Trust Co., 806 F.2d 961 (10th Cir. 1986); Bamberger Polymers Int'l Corp. v. Citibank, N.A., 477 N.Y.S.2d 931 (Sup. Ct. 1983).


48. See, e.g., Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Corp., 968 F.2d 357, 367 (3d Cir. 1992) (Becker, J., dissenting) ("The drafters' concern about importing the law of guaranty was not about subrogation, but about eroding the independence principle (which, as I shall explain in the next section, is not compromised by allowing subrogation."). "Once the issuer had [paid the beneficiary], however, as [the issuer] has here, the purpose of the independence principle has been served: the beneficiary has the money." Id. at 368. "It is difficult to see, however, how allowing subrogation once payment has been made by the issuer or party seeking subrogation will interfere with the operation of letters of credit as swift and certain payment mechanisms." Boss, supra note 12, at 1121.

49. In a number of cases, bank issuers of letters of credit have resorted to interpleader, declaratory judgment, or other procedural devices to delay paying beneficiaries until disputes, usually arising out of the underlying transaction, are resolved. See, e.g., Unifirst Fed. Sav. Bank v. American Ins. Co., 905 F.2d 208 (8th Cir. 1990) (issuer's declaratory judgment action); Johnson v. Levy Org. Dev. Co., 789 F.2d 601 (7th Cir. 1986) (attempt by issuer to interplead). The cases are numerous and are collected at JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 11.07 (rev. ed. 1996) (hereinafter DOLAN, LETTERS OF CREDIT). Such conduct by issuers corrodes the
A. The Effect of Subrogation on the Independence of Abstract Obligations

The chief practical, commercial distinction between the abstract obligation and the secondary guaranty lies in the fact that in the former, the issuer pays before the beneficiary establishes the fact of default, while in the latter the beneficiary must establish the fact of default before the guarantor pays. In practice, when the parties to the underlying transaction dispute the question of default, the difference is critical. Under the abstract obligation, the beneficiary will litigate with the funds; under the secondary guaranty it will litigate without them. Under the abstract obligation, the beneficiary often will have the benefit of a convenient forum; under the secondary guaranty, it may lose that benefit. The distinctions are important not only in the international context where abstract obligations often operate, but also in domestic transactions. The independence of the obligation; and some courts, but only a few, have reacted with a measure of impatience. See, e.g., Eakin v. Continental Ill. Nat’l Bank & Trust Co., 875 F.2d 114 (7th Cir. 1989) (entering judgment for face amount of credit against issuer that originally sought declaratory relief and denying issuer recoupment that would have been available absent its suit); Dallas Bank & Trust Co. v. Commonwealth Dev. Corp., 686 S.W.2d 226 (Tex. Ct. App. 1984) (denying issuer’s interpleader and using interpleaded facts to enter summary judgment against issuer). Cf. Bank of Canton, Ltd. v. Republic Nat’l Bank, 636 F.2d 30 (2d Cir. 1980) ( awarding damages in the nature of penalty, even though appellant did not ask for them, against issuer that took frivolous appeal). For another case in which an issuer apparently dishonored and then used settlement negotiations to obtain an assignment from the beneficiary, see First State Bank & Trust Co. v. McIver, 893 F.2d 301 (11th Cir. 1990).

50. The standby credit, of course, covers situations in addition to those involving default, but the default model illustrates the point.

advantages, furthermore, are plain to the commercial parties, and one must assume that they structured their arrangement with regard to these advantages.\footnote{52} When the authorities contend that the subrogation remedy should apply only post-payment, they are acknowledging these practical distinctions and are making allowance for them. Yet, once the law accommodates subrogation, even post-payment, issuers and confirmers will act on that possibility, not in every case, but in some cases. The possibility of post-payment subrogation will tempt the credit issuer to dishonor even when it knows it should pay and will alter the practical pre-payment dynamics of the abstract obligation. Credit issuer dishonor, moreover, alters the structure of the abstract obligation transaction, misallocating the risks and advantages the parties have allocated by their bargain. The mere possibility of the subrogation remedy corrodes the independence of the abstract obligation, diminishes its practical benefit, and moves the obligation along the continuum from abstract obligation to secondary guaranty.

This is not to say that subrogation should never lie in abstract obligation transactions but that it should lie only after consideration of these commercial imperatives in light of the claimant’s assertion that it has unjustly enriched the defendant. Nor is it to say that subrogation will wreck the abstract obligation’s viability as a commercial device. The premier feature of the abstract obligation is not the law that supports it; it is the persistence of abstract obligation issuers’ tradition of keeping it independent. Presumably, the market will reward issuers that decline to engage in the strategic behavior that a wide application of the subrogation remedy invites.\footnote{53}

\footnote{52. \textit{Foxboro Co. v. Arabian Am. Oil Co.}, 805 F.2d 34 (1st Cir. 1986), is a classic example of court protection (ultimately) of the commercial function of a simple-demand guarantee. In \textit{Foxboro}, the guarantee permitted a foreign buyer to recover funds before the parties settled their underlying dispute. The trial court saw the buyer/beneficiary’s draw under the guarantee as an attempt to obtain strategic advantage in the settlement negotiations and, in an opinion replete with harsh language and flashes of judicial impatience, enjoined the beneficiary’s draw. \textit{Foxboro Co. v. Arabian Am. Oil Co.}, 634 F. Supp. 1226 (D. Mass.), rev’d, 805 F.2d 34 (1st Cir. 1986). The opinion of the court of appeals makes it quite clear that the court recognized (1) that, indeed, the buyer was using the guarantee to obtain an advantage in the settlement negotiations and (2) that the obvious purpose of the guarantee was to give the beneficiary such advantage. Unwilling to reallocate advantages and disadvantages agreed to by the parties, the court of appeals dissolved the injunction and reversed, the trial court’s displeasure notwithstanding. \textit{See Foxboro}, 805 F.2d at 34.}

\footnote{53. The market might save the standby as a commercial product, but it might not save the beneficiary in a multi-million dollar transaction when the applicant is insolvent.}
B. The Independence of Abstract Obligations with Subrogation

The problem with subrogation in abstract obligation transactions lies in its effect on issuer behavior. When an abstract obligation issuer receives conforming documents from the beneficiary, the issuer should pay notwithstanding the equities of the underlying transaction. There are times, of course, when the issuer would choose not to pay, usually because the applicant is insolvent or is unwilling to reimburse. In such cases, the issuer prefers to avail itself of the applicant’s defenses in the underlying transaction to the beneficiary’s claim, but the independence principle teaches that those defenses are not available to the issuer. Similarly, if the issuer dishonors, the independence principle prevents the issuer from raising defenses and from seeking subrogation.54 If the issuer refuses to pay when presented with complying documents, it is liable to the beneficiary for the face amount of the credit plus interest, attorneys’ fees, and incidental damages.55

The beneficiary will not, however, keep the money it receives under the credit from the issuer indefinitely. If there are defenses in the underlying transaction, the applicant will likely sue the beneficiary for breach of contract or other cause of action and recover all or part of the payment.56 That suit, however, should occur while the beneficiary enjoys the advantages of holding the money during litigation and may require the applicant to sue in a distant forum. In short, by virtue of the independence principle, the bank pays first and the parties argue later.

An issuer facing possible loss of reimbursement will be tempted to dishonor and raise the applicant’s defenses by way of subrogation in the ensuing litigation. It is true that these defenses are not defenses to payment under the credit and that the remedy of subrogation does not arise until the issuer pays the beneficiary, but it will take a disciplined court to deprive the issuer of subrogation when the beneficiary sues for what has the appearance of a judgment that will unjustly enrich the beneficiary. An illustration is instructive here.

On May 1, on the application of New York Seller Company (“Seller”), First National Bank (“Bank”) issued a $10,000,000 abstract obligation in favor of

54. “[A]n issuer may not dishonor and then defend its dishonor or assert a setoff on the ground that it is subrogated to another person’s rights.” U.C.C. § 5-117 cmt. 2 (1995).

55. U.C.C. § 5-111(a), (d), (e) (1995). As a general rule, in the standby context, courts do not look to the underlying transaction to determine damages. See, e.g., Bakin v. Continental Ill. Nat’l Bank & Trust Co., 875 F.2d 114 (7th Cir. 1989); Airline Reporting Corp. v. First Nat’l Bank, 832 F.2d 823 (4th Cir. 1987).

56. For cases in which applicants have sought recovery in the underlying transaction after payment by the issuer, see e.g., Kiva Constr. & Eng’g, Inc. v. International Fidelity Ins. Co., 961 F.2d 213 (5th Cir. 1992); Wood v. R.R. Donnelley & Sons Co., 888 F.2d 313 (3d Cir. 1989).

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Foreign Government Buyer ("Buyer"), a Middle Eastern governmental enterprise that was purchasing electrical generating equipment from Seller. The credit was to provide Buyer with security for return of its fifty-percent advance payment to Seller upon the occurrence of certain events specified in the sales contract. On May 2, war erupted in Buyer's country. Buyer repudiated the sales contract and made a conforming demand on Bank, arguing that the force majeure clause of the sales contract applied, terminating the contract and entitling Buyer to a full return of its advance payment. Seller argued that the force majeure clause did not cover the eventuality of war and did not obligate Seller to return the payment.

In a guaranty setting, these arguments are critical to Bank's decision to pay. A guarantor, being secondarily liable and having issued an undertaking dependent on facts in the underlying transaction, should assess these arguments before it pays or dishonors and may litigate them prior to payment. Because Buyer knew that guaranty law might force it to litigate underlying transaction issues in a New York court, it refused to accept a guaranty. Instead, Buyer insisted on the abstract obligation, assuming that it could obtain return of its advances without having to litigate in New York, 57 and Buyer used its negotiating strength with Seller to exact the agreement. Both Seller and Buyer knew that one party would hold the funds during a potential dispute and knew that one party would have to sue in a foreign jurisdiction. 58 Had the parties elected to use a secondary guaranty, Buyer would have shouldered these costs. Under the abstract obligation they selected, Seller assumed them. 59

57. Commercial parties may use abstract payment obligations, rather than guarantees, for the further reason that the abstract payment obligation usually costs less than the guaranty. The issuer of a standby credit, for example, decides whether to pay on the basis of document examination at the banking house, a quick and inexpensive process. The guarantor/surety, however, must investigate the facts of the underlying transaction, determine the amount of the obligation, and often, conduct the inquiry off premises, before it can know whether to pay. See McGUINNESS, supra note 13, ¶ 12.102.

58. An arbitration provision in the underlying transaction may select a forum for arbitration. In that case, a preliminary injunction in New York negates the forum selection clause. For a case that illustrates this unfortunate effect of interlocutory interference by the courts, see Intraworld Indus., Inc. v. Girard Trust Bank, 336 A.2d 316 (Pa. 1975). Even if the arbitration clause provides for arbitration in New York, the applicable law at the injunction hearing might differ from that in the agreement. And, in any event, the beneficiary will not hold the proceeds of the credit in injunction litigation but will hold them during the arbitration if a temporary restraining order or preliminary injunction does not issue. There is considerable authority indicating that courts are aware of this feature of independent undertakings and take steps to protect it. See, e.g., Trans Meridian Trading, Inc. v. Empresa Nacional De Comercializacion De Insumos, 829 F.2d 949 (9th Cir. 1987); Enterprise Int'l, Inc. v. Corporacion Estatal Petrolera Ecuatoriana, 762 F.2d 464 (5th Cir. 1985); American Export Group Int'l Servs., Inc. v. Salem M. AL-NISF Elec. Co., 661 F. Supp. 759 (D.D.C. 1987).

59. These disadvantages do not disappear, and someone has to bear them. The
On May 3, Seller becomes insolvent, and Bank must decide whether to pay under the credit. If subrogation is not available to Bank, it will be inclined to pay because failure to pay will make it liable for the face amount of the credit, interest, and attorneys’ fees. Bank will have no recourse, furthermore, for its failure to assess Seller’s credit adequately other than to file a claim in Seller’s insolvency proceedings.

If subrogation is available, Bank will be able to raise Seller’s underlying contract claim against Buyer. Bank will have an incentive to confront the beneficiary-Buyer because both Bank and Buyer know that Bank can eventually raise Seller’s force majeure argument. Bank might, for instance, threaten to dishonor unless the beneficiary agrees to take half of the claimed amount. This incentive disappears, however, if Bank has no opportunity to seek subrogation because the law gives it no rights against the beneficiary and will render it liable for the beneficiary’s attorneys’ fees in addition to the face amount of the credit. When subrogation is available, however, the possible addition of attorneys’ fees to the beneficiary’s damage claim, although a disincentive for Bank to dishonor, would probably not be sufficient to overcome the more powerful incentive to dishonor that is present when the subrogation remedy is available.

This same invitation to act strategically arises even if Bank calculates that a court would award judgment against it but allow Bank to sue the beneficiary later, perhaps in a different court or forum, to recover its payment of a judgment on the grounds that it unjustly enriched the beneficiary. Although it is true that bank credit issuers should not dishonor facially complying presentations (and that they are liable if they do), the potential for subrogation will provide a bank that is intent on dishonoring with comfort. The following example illustrates the way the subrogation would have to work in order to deny the dishonoring bank that comfort.

First, the beneficiary would sue the bank for wrongful dishonor. When the bank raises the applicant’s defense, the court must strike the defense as inadequate because the bank has yet to pay, and, under the universal view, subrogation is available only after payment. The court would presumably enter judgment against the defenseless bank, and the bank would then satisfy the judgment by paying the beneficiary. At that point, the bank, as subrogee of the applicant’s rights, would bring suit, perhaps in a different forum, against the beneficiary for breach or fraud in the underlying transaction. The court in that suit would enter judgment against the beneficiary and in favor of the bank, and the beneficiary would satisfy that judgment by paying the bank the same amount, perhaps with interest differentials, that the bank paid the beneficiary under the

parties can apportion them, however. By creating a contract requirement that the advance payment not be secured by any obligation, the parties would allocate the cost fully to the buyer. By securing return of the advance payment to the extent of 50%, they have allocated the costs one-half to the seller, one-half to the buyer. There are an infinite number of possible allocations, but all of this is for the commercial parties to decide when they negotiate the terms of their relationship.

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first judgment. It is hard to believe that many U.S. courts will find this circuitous litigation appealing.60

That is not to say that subrogation for the issuer will destroy abstract obligations in commerce. It will not, but it will corrode them. That fact is worth considering when an issuer seeks subrogation. Nor is it to say that the presence of a subrogation remedy will produce wide-scale dishonor by issuers. An abstract obligation issuer with an international presence may be zealous in protecting its reputation and unwilling to engage in conduct that will render its obligations less acceptable in the markets. But the presence of the subrogation remedy will corrode the independence, and even large issuers with strong reputations will succumb from time to time, as they have with other legal devices that corrode the independence of the obligation. Remedies for fraud in abstract obligation transactions are the foremost threat to the independence of these obligations, and courts have wisely fashioned strong limits on those remedies,61 as Revised Article 5 has done.62 The courts should also fashion limits for the subrogation remedy for the same reason: The subrogation remedy threatens the independence of the obligation. The unjust enrichment prerequisite for the subrogation remedy is the chief limiting device.

In short, the theory that the subrogation defense will apply only in the post-payment setting fails when a credit issuer, at its own instance or the instance of an applicant or other party, elects to use the club that subrogation grants it, be it a pre-payment or a post-payment weapon. In fact, post-payment subrogation provides an incentive for an issuer to engage in such behavior.63 Because that

60. In Chase Manhattan Bank v. Township of Bensalem, No. 96-6804, U.S. Dist. LEXIS 8217 (E.D. Pa. June 5, 1997), the issuer successfully used a breach of contract claim to justify dishonor of its own credit obligation. The beneficiary was supposed to return the credit to the issuer; instead, the beneficiary drew. A court with proper regard for the independence principle would have required the issuer to pay the beneficiary and then would have permitted the issuer to recover the payment. The Township of Bensalem court, however, granted summary judgment to the issuer in its declaratory judgment suit against the beneficiary, holding that the issuer owed the beneficiary nothing.

61. The limits include a requirement that the fraud be more than technical fraud; it must be elevated to the point that the beneficiary is attempting to take the money with no colorable right to it. See, e.g., Intraglobe, 336 A.2d at 325. Professor Ellinger characterizes the cases as requiring a showing that the beneficiary is acting "without any shred of honest belief in his rights." Edward Ellinger, Fraud in Documentary Credit Transactions, 1981 J. Bus. L. 258, 262. The courts, moreover, have fashioned serious thresholds as a matter of practice against injunctions to stop payment of an abstract obligation, not the least of which is a showing that there are no adequate remedies at law, in either the beneficiary's jurisdiction or the applicant's, and a showing of a likelihood of success on the merits. See, e.g., Trans Meridian Trading, 829 F.2d at 949 (requiring absence of adequate remedy at law); Recon Optical, Inc. v. Israel, 816 F.2d 854 (2d Cir. 1987) (requiring a showing of likelihood of success on the merits).


63. See supra note 49 (citing authority).
behavior weakens the abstract obligation as a commercial device, courts should be loath to invoke the subrogation remedy, and issuers seeking it should face a high threshold for establishing unjust enrichment.

These conclusions suggest that given the unsuitability of subrogation to most abstract obligation situations, the courts construing Revised Article 5 are best advised to limit the remedy to the narrow situation in which unjust enrichment facts are patent. That conclusion leaves itself open to the charge that there is no room for subrogation in the abstract obligation transaction. Yet, there are instances in which we know that subrogation should lie, and it is premature to declare that there are not others. We know that sometimes issuers are not in position to bargain for rights and that to deny subrogation in those cases might be unfair.\(^{64}\) An entity that issues an abstract obligation to the holders of a negotiable instrument\(^{65}\) or a negotiable bond\(^{66}\) cannot negotiate with the beneficiary before or even after the instrument is uttered. The issuer whose abstract obligation secures that note or bond does not know who the beneficiary will be and does not know what unjust enrichment facts might arise.\(^{67}\) Similarly, an issuer that issues an obligation on behalf of a pool of applicants that changes over time cannot know what unjust enrichment facts might arise in the underlying transaction. Such an issuer is not in a position to negotiate with each applicant as it joins the pool.\(^{68}\) Finally, Professor White\(^{69}\) raises a third

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64. The casualty cases and employee fidelity bond cases are examples of situations in which the surety cannot \textit{ex ante} take assignments from the parties that will benefit from its payments. For another, see American Sur. Co. v. Bethlehem Nat'l Bank, 314 U.S. 314, 318-19 (1941) (subrogation of surety to prevent windfall to claimants in failed bank's receivership).


possibility when he argues convincingly that in proper circumstances an issuer might be subrogated to the rights of the applicant under the UCC warranty rule.\textsuperscript{70} Such a claim is not one parties anticipate when they negotiate a letter of credit transaction. A breach of warranty claim in these circumstances is akin to a casualty claim, the kind of claim that traditionally is subject to the subrogation remedy.

V. THE REACH OF SECTION 5-117

At the time the National Conference on Uniform State Laws was redrafting UCC Article 5, Professor Boss chaired the ABA Uniform Commercial Code Committee, was a member of the UCC Permanent Editorial Board, and actively participated in the Conference's drafting sessions.\textsuperscript{71} Subsequent to the publication of her article, the Conference drafting committee adopted Section 5-117, which addresses subrogation in the abstract obligation context. It would be naive to think that the Boss arguments had no influence on the drafting process. In addition, the reporter for Revised Article 5, Professor James White, has written on the changes he feels Section 5-117 works on the subrogation case law. His article generally supports the Boss thesis, but with some qualifications.\textsuperscript{72}

Some may assume that Section 5-117 adopts the position that subrogation should always obtain in abstract obligation transactions.\textsuperscript{73} There are two persuasive reasons for rejecting that assumption. First, the language of the section itself does not support that reading; and second, such a reading flies in the face of the traditional prerequisite for subrogation—unjust enrichment. The section language is plain and unequivocal: In each instance that the section indorses subrogation, it invokes subrogation law. In each subsection, the provision references existing subrogation principles rather than fashioning new subrogation doctrine for abstract obligations. In short, the provision does not

\begin{itemize}
  \item \textsuperscript{69} See White, supra note 23, at 61-64.
  \item \textsuperscript{70} See U.C.C. § 5-110(a)(2) (1995).
  \item \textsuperscript{71} See U.C.C. art. 5, prefatory note (1995).
  \item \textsuperscript{72} See White, supra note 23.
  \item \textsuperscript{73} While the White article assumes that the Section will yield a different result in many cases that deny subrogation, see White, supra note 23, at 52, 56-60, the article acknowledges that Section 5-117 does not finish the inquiry. White states:
    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.
    White, supra note 23, at 51. “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.” White, supra note 23, at 59.
\end{itemize}
abrogate the unjust enrichment prerequisite; it abrogates the mechanical line of authority rejected by Boss that denied subrogation to issuers because an abstract obligation issuer’s undertaking is independent and primary. 74

Subsection (a) does not say that an abstract obligation issuer that pays the debtor’s obligation is subrogated to the rights of the beneficiary; it says that the issuer shall be subrogated “to the same extent as if the issuer were a secondary obligor of the underlying obligation.” Subsections (b) and (c) treat four additional situations and in each of them the subsections do not grant subrogation as a matter of course to the identified parties but only grant it “to the same extent as if the [party] were a secondary obligor.” 75

A Comment to the subrogation section indicates that the drafters were also influenced by the dissent in Tudor Development Group, Inc. v. United States Fidelity & Guaranty Co. 76 In fact, the Comment, perhaps going beyond the language of the statute, “indorses” that dissent. 77 In Tudor, the majority relied in part on the analysis Revised Article 5 forbids; that is, denying subrogation in part because the credit issuer paid its own debt and not the debt of the applicant. To the extent of that reasoning, the text of revised Section 5-117 implicitly overturns the majority in Tudor and the Comments explicitly indorse that point in the dissent.

The Tudor majority made three points, however. The first was the forbidden point discussed above. The second point was that because subrogation weakens the independence of the credit, the 1962 version of Article 5 implicitly

74. White says that it addresses the fact that the courts “have drawn the wrong inference concerning subrogation from the conclusion that a letter of credit obligation is ‘primary’ whereas the guarantee is ‘secondary.’” White, supra note 23, at 48.

75. Arguably, Section 5-117 fashions no new statutory law on subrogation. Commentary in the 1962 version of Article 5 reflects concern similar to that of Section 5-117 that subrogation in abstract obligation cases should not obtain unless the facts of the case satisfy traditional prerequisites for subrogation. The comments to Section 5-109 of the 1962 version of Article 5 address the possibility of subrogating the issuer to the applicant’s rights against the beneficiary. U.C.C. § 5-109 cmt. (1962). If the beneficiary of a commercial letter of credit presents complying documents to the issuer, and if the issuer pays the beneficiary, the applicant may have a cause of action against the beneficiary whose goods delivered in the underlying contract are defective. The comment addresses the possibility that the applicant fails to reimburse the issuer and suggests that in that event the issuer can make a claim against the beneficiary. Id. The comment notes, however, that the ability of the issuer to maintain the claim rests on the applicant’s assignment to the issuer of its claim against the beneficiary or “in a proper case subrogation to the rights of the [applicant].” Id. (emphasis added). The highlighted language suggests that, only if the issuer can show unjust enrichment, would it have subrogation — the precise effect of the “to the same extent as” language of Section 5-117 in Revised Article 5. U.C.C. § 5-117 (1995).

76. 968 F.2d 357 (3d Cir. 1992) (Becker, J., dissenting).


78. 968 F.2d 357 (3d Cir. 1992).
disallows it. This is redolent of the forbidden analysis, and Section 5-117 makes it clear that Revised Article 5 allows subrogation. Revised Article 5 does not say, however, that courts engaging in the unjust enrichment inquiry must ignore the effect of subrogation on the abstract obligation as a commercial product. Revised Article 5 makes a significant concession to subrogation law when it says in Section 5-117 and in the Comments that courts may not construe Revised Article 5 as a rejection of the subrogation remedy in the abstract obligation context, but Revised Article 5 does not refashion subrogation.

Thus, courts are still free to indulge subrogation law’s customary requirement that a finding of unjust enrichment must precede application of the subrogation remedy. To the extent that subrogation corrodes the independence principle, it may be one element in the unjust enrichment calculus. Revised Article 5 says only that it does not by itself require a court to deny a party subrogation. Some might be compelled to read Section 5-117’s Comment indorsing the dissent in Tudor as preventing courts from considering the effect of the remedy on the abstract obligation as a commercial device when they engage in unjust enrichment analysis. That reading of the Comment would be more persuasive if there were something in the text of the statute to support it. There isn’t.79

The third point in Tudor was the unfairness point; that is, the point that it would be unfair to permit a party to acquire rights after the fact without paying for them and to the prejudice of third parties when the party did not use its opportunities to buy those rights at the outset. The plaintiff in Tudor had acquired ex ante rights in certain bond proceeds and sought to use subrogation to obtain additional bond proceeds that had been assigned ex ante to another creditor. The trial court and the appellate court held that the plaintiff could not have those bond proceeds. The holding is consistent with unjust enrichment analysis; and, if the Comment indorsers the dissent’s rejection of that analysis, the Comment is in direct conflict with the text of Section 5-117. The section arguably disclaims any attempt to add to the rights of the party seeking subrogation,80 and the Comment explicitly disclaims any such intention.81

In summary, the drafters did not undertake to remake subrogation law; they undertook to neuter the mechanistic argument to the extent that the independence of abstract obligations from the underlying transaction rendered them invariably inhospitable to subrogation theory. Thus, the drafters validated Boss’s arguments against mechanical analysis, but they did not go beyond that point. They do not say that subrogation always obtains. They say that courts should measure the abstract obligation issuer’s subrogation claim as they measure the

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79. See infra appendix (providing full text).
80. See supra notes 71-89 (discussing the “to the same extent as” language of Section 5-117 in the text of this Article).
81. “By itself this section does not grant any right of subrogation. It grants only the right that would exist if the person seeking subrogation ‘were a secondary obligor’.” U.C.C. § 5-117 cmt. 1 (1995).
subrogation claim of a secondary party. That measure is one that turns on the presence of unjust enrichment. Thus, the UCC’s jurisprudence is consistent with traditional subrogation notions. 82

Admittedly, the dissent in Tudor is broader than this reading. The dissent attacks the mechanistic argument and goes further by arguing that post-payment subrogation does not damage the independence of the abstract obligation. 83 Subpart IV(A) of this Article assesses that contention and finds it refutable, but the fact remains that the Comment may indorse that feature of the dissent by implication.

There are two responses to that implicit indorsement. First, the Tudor dissent spent most of its time attacking the mechanistic argument, and one can read the Comment as an indorsement of only that feature of the dissent. Second, the dissent objected to the majority’s disposal of the case on summary judgment without “balancing the equities.” 84 Thus, when the Tudor majority denied subrogation, the dissent did not suggest that subrogation be granted but that the matter be remanded to see whether equity demanded subrogation. 85 To read the Comment as indorsing that result is to read it consistently with the language of Section 5-117, expressed no less than five times, that whether subrogation should be allowed depends on the law of secondary obligations where an unjust enrichment inquiry traditionally is essential. Finally, the Comment itself acknowledges that “[b]y itself this section does not grant any right of subrogation.” 86

Faithfulness to the Boss anti-mechanical, anti-rhetorical thesis, to the language of the section and the Comment, and to the Tudor dissent requires evaluation of the transaction in light of traditional subrogation law. In short, the authority does not command application of the remedy; the authority commands the inquiry: Is there unjust enrichment?

This inquiry suggests that generally there is no unfairness and that an issuer will often have a difficult time making a case for the subrogation remedy. However, an analysis of the common law and of state abstract obligation law


83. The majority opinion suggests that in its view the independence principle “is unlikely to be substantially diminished were we to allow subrogation in this situation.” Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 363 (3d Cir. 1992).

84. Id. at 371 (Becker, J., dissenting). In fact, the majority did balance the equities, affirming the lower court’s conclusion that “the equities do not favor subrogation in this case.” Id. at 363.

85. “I would hold that an issuer of a standby letter of credit may, in proper circumstances, obtain equitable subrogation to the rights of its customer.” Id. at 364 (emphasis added).


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must abide a brief digression into federal bankruptcy law, which may preterm 1it discussion of the issue.

VI. SECTION 509 OF THE BANKRUPTCY CODE

There is obviously something to be gained by fashioning subrogation rules that effect clarity for the parties as they structure the abstract obligation transaction. Some commentators suggested prior to the promulgation of Revised Article 5 that Section 5-117 would resolve the problem by making it clear that an issuer that pays the applicant’s debt is subrogated to the rights of the beneficiary against the applicant. In any event, however, Section 5-117 does not fashion a bright line test for invoking the subrogation remedy. Rather, it commands the unjust enrichment inquiry with its attendant concerns for the equities of the entire transaction. Mechanical application of the remedy is not true to unjust enrichment jurisprudence. The Bankruptcy Code, however, may command application of a mechanical rule.

Section 509 of the Bankruptcy Code deals with subrogation of “an entity that is liable with the debtor on . . . a claim of [the] creditor against the debtor” to the rights of a creditor against the debtor. In the bankruptcy setting, some courts have subrogated abstract obligation issuers to the rights of the beneficiary against the debtor applicant or its property. A majority, however, have refused


88. Neil Cohen contends, without any unjust enrichment analysis, that subrogation lies in the abstract obligation context. See Cohen, supra note 12. Professor Cohen, the reporter for the Restatement of Suretyship, was not unmindful of the unjust enrichment prerequisite, however, when he drafted the Restatement. See RESTATEMENT (THIRD) OF THE LAW OF SURETYSHIP AND GUARANTY § 27 cmt. a (1996). He assumes that whenever the issuer pays the debt of the applicant there is unjust enrichment. The rule he fashions, then, is akin to a per se rule and one easy to apply. Albert Givray suggests that parties use assignment to effect post-payment adjustments without subrogation “until the cavalry arrives in the form of UCC Section R5-117.” Albert Givray, Wrongful Honor: Post-Honor Grab for Beneficiary’s Rights without Subrogation, LETTERS OF CREDIT REPORT, July-Aug. 1995, at 6; see also Klein, supra note 5. Klein reads the proposed Section 5-117 as granting “an encompassing array of subrogation rights to the issuer,” and as eliminating the split of authority on the right of the issuer to be subrogated to the beneficiary’s rights against the applicant. Klein, supra note 5, at 1, 3. Klein also argues that Section 5-117 eliminates the split of authority on the right of the issuer to be subrogated to the beneficiary’s rights against the applicant. Klein, supra note 5, at 3. Elsewhere in the same article, however, Klein admits that the adoption of Revised Article 5 will create some uncertainty and demonstrates with clarity the way a court’s inquiry into equitable concerns can render the subrogation remedy opaque.

that relief. Some of the bankruptcy cases that deny subrogation do so on the mechanical analysis that Boss decries and that Section 5-117 prohibits, but those refusals rest on federal court interpretation of a federal statute and cannot be revised through state statutory reform. Bankruptcy, moreover, is the locus of many subrogation cases, for it is often the applicant's financial demise that prompts the issuer to seek subrogation.

In defense of the courts denying subrogation on mechanical analysis, one must acknowledge that they bottom their decisions on the language of the Bankruptcy Code itself. Section 509(a) allows subrogation to an entity that is "liable with the debtor." Because abstract obligation issuers maintain that their product is independent of the underlying transaction in which the debtor is liable to the beneficiary, the courts hold that the issuer is not liable with the debtor and that by negative implication subrogation will not lie.

One might add that bankruptcy courts arguably should not be burdened with lengthy inquiry into the equities of the broad transaction out of which the abstract obligation arises. Preterminating that broad inquiry might offend traditional subrogation principles, but fashioning a clear, bright line rule that renders the inquiry mechanical might promote bankruptcy court efficiency.


91. See, e.g., In re Slamans, 69 F.3d at 468. Professor White valiantly and ingeniously argues to the contrary that state law informs the language of Section 509. See White, supra note 23, at 51-55.

92. See, e.g., In re Slamans, 69 F.3d at 476; In re Kaiser Steel Corp., 89 B.R. at 154; cf. In re East Tex. Steel, 117 B.R. at 241 (no subrogation when issuer and applicant not jointly liable); In re Agrownautics, Inc., 125 B.R. at 353 (no subrogation when parties not codebtors).

93. It would be unfair to suggest that mechanical application of the section appears only in those cases that deny subrogation. In fact, courts that allow subrogation are guilty of mechanical analysis as well. See, e.g., In re Valley Vue Joint Venture, 123 B.R. 199 (Bankr. E.D. Va. 1991). In Valley Vue, the court rejected the majority view and criticized it for ignoring the fact that an abstract obligation works in many ways as secondary guaranties work. Id. at 212. But, the court then granted subrogation without any unjust enrichment analysis. Id. Valley Vue substitutes one brand of mechanical analysis for another, and does so in a situation that suggests there was in fact no unjust
If bankruptcy considerations are paramount, Revised Article 5 cannot displace them; and it may be that Section 5-117 only will bear on non-bankruptcy cases.\textsuperscript{95}

In some bankruptcy situations, a guarantor or issuer would be entitled to subrogation to the beneficiary’s collateral as a matter of common law. Yet, a beneficiary can defeat the issuer’s right by refusing to file a claim in the bankruptcy and then making a claim on the guarantee/abstract obligation. In such event, a guarantor/issuer of that obligation is seriously harmed. The principal/applicant is insolvent, and the guarantor/issuer has no claim against the principal’s assets. One authority suggests that the purpose of Section 509 is to protect the issuer/guarantor from that possibility.\textsuperscript{96} If that suggestion is correct, it is probably best to read Section 509 as non-exclusive, that is, as an instance of the Bankruptcy Code’s protecting the issuer’s common law remedy against strategic behavior by the beneficiary and not as a command that bankruptcy courts invoke mechanical subrogation analysis.\textsuperscript{97}

Interpreting Section 509 as non-exclusive does not undermine the position of this Article that the common law of subrogation with its unjust enrichment prerequisite governs subrogation in bankruptcy as well as elsewhere. The bankruptcy cases that engage in unjust enrichment analysis also support this reading of Section 509.\textsuperscript{98} Until there is controlling authority to the contrary, enrichment.


\textsuperscript{96} \textit{4 LAWRENCE KING, COLLIER ON BANKRUPTCY} ¶ 509.01 (15th rev. ed. 1998).

\textsuperscript{97} On the non-exclusivity question, the cases are split. \textit{See}, e.g., \textit{In re Missionary Baptist Found. of Am., Inc.}, 667 F.2d 1244, 1246 (5th Cir. 1982) (not exclusive); Creditors’ Comm. v. Commonwealth, 105 B.R. 145, 148 (Bankr. D. Mass. 1989) (Section 509, not state law, is source of subrogation rights); \textit{In re Spiratos}, 103 B.R. 240, 245 (Bankr. C.D. Cal. 1989) (not exclusive); Cooper v. Cooper (\textit{In re Cooper}), 83 B.R. 544, 546 (Bankr. C.D. Ill. 1988) (Section 509 as source of codebtor’s subrogation without regard for state common law); \textit{In re Munzenrieder}, 58 B.R. 228 (Bankr. M.D. Fla. 1986) (invoking equitable subrogation without mentioning Section 509).

\textsuperscript{98} There remains one other danger for the issuer of an abstract obligation (or guarantor under a secondary guaranty) that claims subrogation to the beneficiary’s rights against the applicant. If the issuer makes a subrogation claim, it may not make a claim against the principal in the bankruptcy proceedings. \textit{See} 11 U.S.C. § 502(e)(1)(9)(C) (1994); Eber, \textit{The Role of Reimbursement Agreements, LETTERS OF CREDIT REPORT},
courts determined to grant subrogation relief in bankruptcy might hold that Section 509 is not exclusive and that there are other ways at common law for a codebtor to fashion the subrogation remedy.

It may also be important to note that close reading of the bankruptcy cases indicates that although courts sometimes couch their rulings in the "liable with" language of Section 509, often the facts of the cases do not support a subrogation remedy. Rather the facts suggest that the party seeking subrogation has not been able to show unjust enrichment or has otherwise failed to satisfy traditional requisites for subrogation.99


99. Traditionally, bankruptcy courts have imposed five requirements that a party must satisfy in order to have subrogation. See Bank of Am. Nat'l Trust & Sav. Ass'n v. Kaiser Steel Corp. (In re Kaiser Steel Corp.), 89 B.R. 150, 152 (Bankr. D. Colo. 1988). They are: (1) that the party seeking subrogation have acted to protect its own interests; (2) that it not have paid as a volunteer; (3) that the party must not have been primarily liable; (4) that the debt is fully paid; and (5) that subrogation not work an injustice against third parties. See White, supra note 23, at 55. Many of the letter of credit cases refer to the third element and thereby offend the Boss thesis and offend Section 5-117. But there is bankruptcy authority that relies on other elements and that arguably has engaged in unjust enrichment analysis. See In re Wilcox, 196 B.R. 212, 213 (Bankr. D. Me. 1996) (denying applicant subrogation to issuer's rights in mortgage after issuer had released mortgage); In re Agrownautics, Inc., 125 B.R. 350, 353 (Bankr. D. Conn. 1991) (same); Berliner Handels-Und Frankfurter Bank v. East Tex. Steel Facilities, Inc. (In re East Tex. Steel Facilities, Inc.), 117 B.R. 235, 241 (Bankr. N. D. Tex. 1990) (denying subrogation under both the third and the fifth elements); Merchant's Bank & Trust Co. v. Economic Enters, Inc. (In re Economic Enters., Inc.), 44 B.R. 230, 232 (Bankr. D. Conn. 1984) (finding that issuer had other sources for reimbursement and forcing issuer to pursue them); cf. Insurance Corp. v. Latino Americana de Reaseguros, S.A., 868 F. Supp. 520 (S.D.N.Y. 1994) (similar non-bankruptcy case). Some cases that grant subrogation are devoid of any analysis, holding simply that abstract obligations are similar to suretyship undertaking and, therefore, that subrogation should lie. See In re National Serv. Lines Inc., 80 B.R. 144 (Bankr. E.D. Mo. 1987); In re Sensor Sys., Inc., 79 B.R. 623 (Bankr. E.D. Pa. 1987). The opinion in In re Valley Vue Joint Venture, 123 B.R. 199 (Bankr. E.D. Va. 1991), is surely the most egregious example of an opinion that fails to analyze the transaction for unjust enrichment. See supra note 93. For a thoughtful opinion that rehearses the controversy with considerable attention to Judge Becker's dissent in Tudor and yet which denies subrogation to an issuer, see Mead Corp., 907 P.2d at 1179. In a Canadian insolvency case that admittedly uses language from the original version of Article 5 that Revised Article 5 renders invalid, the court denied subrogation to an issuer whose duty it was, in the court's view, to evaluate the creditworthiness of parties with whom it contracts. See Westpac Banking Corp. v. Duke Group Ltd., [1994] O.R.3d 515; see also Wilkins v. Commercial Inv. Trust Corp., 153 F.3d 1273 (11th Cir. 1998) (denying subrogation to applicant after analysis of underlying transaction); Tokyo Kogyo Boeki Shokai v. United States Nat'l Bank, 126 F.3d 1135 (9th Cir. 1997) (denying subrogation with similar thoughtful analysis concluding that
VII. PREVENTING COURT REALLOCATION OF PRIVATELY ORDERED BURDENS

It is a general feature of subrogation, one applicable but not confined to the abstract obligation context, that subrogation reallocates burdens that sophisticated commercial parties have allocated for themselves in their underlying contract bargaining. Similarly, subrogation can reallocate insolvency costs that an efficient regime would allocate to the party that made a credit misjudgment. Promiscuous granting of the subrogation remedy will inevitably prompt commercial parties to eschew the abstract obligation for other risk shifting arrangements.\textsuperscript{100} At this point, it may be necessary to make two assumptions: (1) that courts should not reallocate burdens that sophisticated commercial parties have allocated in their underlying relationship, and (2) that it is efficient and just to let a party that mistakenly grants credit to an incipient insolvent bear the cost of the credit mistake.

Subrogation has a purpose: to effect fairness when there is unfairness by obviating unjust enrichment. In some contexts one cannot deny the efficacy of subrogation. Classic subrogation cases are obvious instances of unjust enrichment that would go uncorrected but for the equitable remedy. Subrogation can prevent the insured under an automobile accident insurance policy from a double recovery,\textsuperscript{101} can prohibit a debtor from enjoying security freed from a lien by a guarantor’s payment of the debtor’s obligation,\textsuperscript{102} and can subordinate a second mortgagee to the rights of a payor that satisfied the first mortgage and thereby promoted the second mortgage.\textsuperscript{103}

Historically, subrogation arose in the suretyship setting, since sureties predate other kinds of guaranties and insurance.\textsuperscript{104} One historical function of the

\textsuperscript{100} See supra note 66 (suggesting alternatives).


\textsuperscript{102} See RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTRY § 28(1)(C) & cmt. e (1996).

\textsuperscript{103} In First Fed. Sav. Bank v. United States, 118 F.3d 532 (7th Cir. 1997), however, the court denied such subrogation when it was apparent that the party that would ultimately benefit from the subrogation, a title insurer, had been negligent. Id. at 534.

\textsuperscript{104} See RONALD HORN, SUBROGATION IN INSURANCE THEORY AND PRACTICE 227 (1964); Barlow Burke, Reclaiming the Law of Suretyship, 21 S. ILL. U. L.J. 449, 452 (1997); William H. Woods, Historical Development of Suretyship, in THE LAW OF
remedy was to encourage sureties to undertake suretyship obligations by granting them a sufficient remedy.\textsuperscript{105} Although early authority suggests that subrogation rested on the presumed intent of the parties,\textsuperscript{106} courts eventually came to view it primarily as a means to prevent unjust enrichment.\textsuperscript{107} As corporations came into the suretyship enterprise and various types of insurance became prominent features of commerce,\textsuperscript{108} courts and commentators struggled to tether the remedy. Sureties and casualty insurers usually were entitled to subrogation,\textsuperscript{109} but life and other "valued policy" issuers were not.\textsuperscript{110} Courts have gone to some lengths to distinguish indemnity coverage, which is subrogation remediable, and classic insurance coverage, which is not.\textsuperscript{111}

Traditionally, courts went to considerable effort to tie subrogation either to the unjust enrichment standard or to public policy standards. Subrogation was unavailable to a bail bondsman in an early case on the grounds that allowing subrogation would decrease the bondsman's incentive to get the defendant to the courthouse.\textsuperscript{112} Some more recent opinions have found, for public policy reasons, that subrogation may not be available even when a lender pays a secured debt and thereby creates a windfall for creditors of the bankrupt debtor\textsuperscript{113} or when a

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\textsuperscript{105} See Lloyd, supra note 104, at 40.

\textsuperscript{106} See, e.g., Hampton v. Phipps, 108 U.S. 260, 264 (1883); EDWARD SPENCER, THE GENERAL LAW OF SURETYSHIP 178 (1913); John Dawson, Restitution or Damages?, 20 OHIO ST. L.J. 175, 184 (1959).

\textsuperscript{107} See supra note 8 (citing authorities). Economists might argue that presumed intent, based on assumptions concerning the parties' relative ability to manage risk, remains a sufficient justification.

\textsuperscript{108} For accounts of that transition, see Lloyd, supra note 104, at 40; Willis Morgan, The History and Economics of Suretyship, 12 CORNELL L.Q. 153 (1926) (Pt. I), 12 CORNELL L.Q. 487 (1926) (Pt. II).

\textsuperscript{109} See, e.g., Gatzweiler v. Milwaukee Elec. Ry. & Light Co., 116 N.W. 633 (Wis. 1908). See generally GOFF & JONES, supra note 8, at 538; 1 PALMER, supra note 4, at 23.

\textsuperscript{110} Spencer Kimball & Don Davis, The Extension of Insurance Subrogation, 60 MICH. L. REV. 841, 845, 850 (1962).


\textsuperscript{112} United States v. Ryder, 110 U.S. 729 (1884).

\textsuperscript{113} See Mottaz v. Kiedel (In re Kiedel), 613 F.2d 172 (7th Cir. 1980), where the payment satisfied a secured debt, but the payor failed to obtain a proper security interest. The result, the court held, was justified in order to promote "the strong policy favoring diligence" in perfecting security interests. Id. at 175. A windfall to the debtor's estate

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lender makes an advance in circumstances that created risks for others. 114
Similarly, subrogation to a mortgagor's rights on a mortgage note may be
unavailable to an insurer of the mortgaged premises if the mortgagor pays for the
insurance but not if the mortgagee pays for it. 115

One of the disconcerting features of the whole debate on the rights of the
abstract obligation issuer is the dearth of unjust enrichment and public policy
analysis by those who favor subrogation. The premise seems to be that because
the function of the abstract obligation is similar to the function of the suretyship
undertaking and because the surety enjoys subrogation, the abstract obligation
issuer should have it, too. 116 It may be that subrogation in general has become
untethered, as at least two critics suggest. 117

was justified here, the court held, because of a public policy in favor of requiring
creditors to be diligent in having their liens noted on the title to a mobile home. Id. Cf.
First Fed. Sav. Bank v. United States, 118 F.3d 532 (7th Cir. 1997) (no subrogation when
remedy would benefit negligent party); In re Wilcox, 196 B.R. 212 (Bankr. D. Me. 1996)
(no subrogation for elderly woman who paid mortgage debt without benefit of counsel
and failed to ensure that mortgage was not released). But cf: Rinn v. First Union Nat'l
security interest when it paid secured debt); Ninth Dist. Prod. Credit Ass'n v. Ed Duggan,
Inc., 821 P.2d 788 (Colo. 1991) (allowing unjust enrichment claim against secured
creditor of feed supplier whose feed fattened lender's collateral, all with lender's
knowledge). For criticism of this last case, see Craig Tighe, The Unjust Enrichment
Doctrine: An Expanded Definition Threatens the Rights of Secured Lenders, 25 U.C.C.

114. See Compania Anonima Venezolana de Navegacion v. A.J. Perez Export Co.,

115. See authority cited in 4 PALMER, supra note 8, at 367-69; Morton Campbell,
Non-Consensual Suretyship, 45 YALE L.J. 69, 99 (1935).

116. Those who argue that the abstract obligation issuer should enjoy the
subrogation remedy, include Alces, supra note 12; James Barnes & James Byrne, UCC
Survey: Letters of Credit, 48 BUS. LAW. 1635, 1642 (1993); Boss, supra note 12, at
1128-31; Clark, supra note 94, at 19; Cohen, supra note 12, at 5; Cohen, supra note 94,
at 47; Hall, supra note 87, at 4; Jarvis, supra note 5; Klein, supra note 5, at 1; Gerald
McLaughlin, Standby Letters of Credit and Guaranties: An Exercise in Cartography,
34 WM. & MARY L. REV. 1139, 1154-55 (1993); White, supra note 23. Not all of the
writers agree, however. See Albert Givray, supra note 88, at 6; Mary Pappas, Comment,
Reconciling Standby Letters of Credit and the Principle of Subrogation in Section 509,
7 BANKR. DEV. J. 227 (1990). One commentator, writing before the revision of Article
5, pleaded for certainty, yet acknowledged that whether subrogation is allowed should
be a question decided by the equities of each case. See Avidon, supra note 87, at 129.

117. See Steven Walt & Emily Sherwin, Contribution Arguments in Commercial
967 F.2d 1069 (5th Cir. 1992) may illustrate the problem. In that case, Stephenson
guaranteed the debt of Corland to a bank. Id. at 1072. Corland, of course, issued its
promissory note to the bank to evidence the debt. Stephenson, in turn, executed a
guaranty. By virtue of the relationship, Corland owed money to the bank and owed a
When the surety satisfies the debt of the principal obligor, equity generally grants subrogation to the surety. 118 To effect that result when the surety pays the debt of its principal is not inconsistent with a rule that denies that result when the abstract obligation issuer satisfies the debt of its principal, the "applicant" who applies for the credit.

There are two reasons for this disparate treatment. One might argue that the first is a matter of public policy, the second a matter of unjust enrichment analysis. First, as subpart IV(A) explains, subrogation corrodes the independence of the obligation by its effect on the obligor's behavior. The issuer of an abstract obligation or of a secondary guaranty who knows he will have subrogation behaves differently from the issuer who knows he will not. In the guaranty setting, that difference is benign; in the abstract obligation transaction, it is pernicious. The second reason lies in the difference between classic suretyship and classic banking and rests on the notion that it is not unjust to let a lender that makes a bad loan pay the costs of its misjudgment. The classic surety assumes risks; the classic banker is risk averse. Efficient commercial rules let the market pay the risk taker according to the law of risk. Efficient commercial rules do not reward the banker that takes an unwarranted risk by making a bad loan.

Subrogation in the abstract obligation context, even if in theory it is only available post-payment, will impact the independence of the credit and damage the bank product. Thus, a legal distinction, the primary/secondary distinction, demands different application of the subrogation remedy to abstract obligations on the one hand and secondary guaranties on the other, not simply because the issuer is paying its own debt (the line of analysis rejected by Boss and Revised Article 5) but because the subrogation remedy corrodes an important feature of abstract obligations. This is not a rhetorical distinction forbidden by Revised Article 5; it is a distinction based on the policy of protecting the abstract obligation as a viable commercial device.

reimbursement obligation to Stephenson. Corland's balance sheet should have reflected that reality. The opinion recites, however, that Corland, as part of the transaction, took a promissory note from Stephenson. The court was curious about the reason for this second note, as well it might have been; but the court did not dwell on the point. It should have. Possibly, the second note was a device to disguise the fact in Corland's financial statements that it had incurred a liability with no offsetting asset. By taking Stephenson's note, Corland's financial statements would show a liability with a corresponding asset, plus, of course, the proceeds of the loan, which undoubtedly vanished with celerity. This explanation is all conjecture, of course, but if it is an accurate characterization of the true facts, which are unknown, Stephenson was party to a fraud and was decidedly not entitled to subrogation or any other equitable remedy. Because the Corland court was less interested in the underlying facts than true unjust enrichment inquiry would require, we do not know whether there was fraud or whether Stephenson was truly entitled to subrogation.

118. See RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 27 (1996); RESTATEMENT OF SECURITY § 141 (1941).

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Other differences between the guaranty and abstract payment obligation products that support different application of the remedy concern matters of equity, that is, matters of subrogation law itself. For purposes of policy analysis, these differences are also compelling. It would be a non-sequitur to say that the abstract obligation transaction is subject to subrogation, if as a matter of subrogation law, equity would deny subrogation to the abstract obligation parties. In truth, subrogation law often would deny subrogation because, in the abstract obligation transaction, the essential ingredient of subrogation, unfairness, is usually missing.

While the position advanced here—that issuers and others are generally not entitled to subrogation—usually will disfavor banks, who are abstract obligation issuers, the fact that the law does not consider issuers sureties may favor banks in some instances. California law, for instance, protects letter of credit issuers from state mortgage anti-deficiency legislation\(^\text{119}\) but denies that protection to sureties.\(^\text{120}\) Arguably, that example is consistent with the policy advanced here of differentiating the two commercial products.

\(\text{A. Suretyship vs. Lending}\)

When a fidelity company issues a bond to a bank to protect it against the dishonest acts of its depositors and pays the bank for losses the bank sustains by virtue of a depositor’s dishonest scheme, the law wisely subrogates the fidelity company to the bank’s rights against the depositor. In this instance, subrogation effects fairness, for absent subrogation, either the bank would have two recoveries (one from the fidelity company and one from the depositor), or the fidelity company’s payment would free the dishonest depositor from liability, having satisfied the depositor’s obligation to the bank.\(^\text{121}\) This example illustrates the circumstances in which equity strives to prevent unjust results and uses the subrogation remedy to correct a situation that would otherwise shock the conscience.

This application of subrogation, moreover, is consistent with the bonding industry’s practice of pricing its fidelity bonds through actuarial computation. The price of fidelity bonds reflects the history of past industry losses and predictions of future industry losses. As losses increase, premiums mount; as losses decrease, premiums diminish. True, in recent years fidelity companies have become more concerned with an insured’s financial strength,\(^\text{122}\) and some

\(\text{119. CAL. CIV. CODE § 580.5 (West Supp. 1998).}\)

\(\text{120. Western Sec. Bank, N.A. v. Superior Court, 933 P.2d 507, 516-17 (Cal. 1997).}\)


\(\text{122. It is a curious coincidence that fidelity companies that issue some bonds take an abstract obligation issued by the principal’s bank as security for their principal’s}\)
banks have become more concerned with statistical loan evaluation\textsuperscript{123} as products from the two industries have begun to overlap. Subrogation’s application in the fidelity industry context, however, evolved during the period when fidelity companies engaged in classic suretyship conduct.\textsuperscript{124} If fidelity companies grow more and more to resemble banks, the law of subrogation may become less and less suitable to them. It is not the purpose of this Article, however, to examine that issue because the issue here is whether subrogation is suitable to a traditional bank product, the abstract obligation.

To the extent that subrogation succeeds in the classic fidelity context in avoiding unjust enrichment of dishonest employees, for example, it also succeeds in reducing the fidelity industry’s losses. It has the beneficial effect of reducing the cost of fidelity coverage, a product whose price traditionally is a function of loss. It also internalizes costs, putting the embezzlement loss on the dishonest employee rather than spreading those losses to employers of honest employees.\textsuperscript{125} Generally, insurers are efficient risk bearers because they pool these risks efficiently.

In these settings, the fidelity industry’s recovery via subrogation is largely fortuitous. The fidelity company does not know at the time it writes the fidelity bond whether future dishonest employees will have assets that it can exploit. Yet, losses in the fidelity industry are also fortuitous. Fortuity is inherent in classic fidelity practices and, to some extent, in fidelity bond law. Note, moreover, that in the fidelity bond transaction, the fidelity company is in no position to take collateral or other security from employees, many of whom are not employed at the time the fidelity company writes the blanket bond.

Abstract obligations, unlike actuarially priced fidelity products, are primarily commercial bank products. Bankers issue abstract obligations not on the basis of an actuary’s loss prediction but on a loan officer’s credit judgment.


\textsuperscript{125} For discussion of the evolution of fidelity insurance, see Morgan, supra note 108.

\textsuperscript{126} It is not clear whether the employee or the employer bears the cost of fidelity insurance. One of them must. Perhaps it is the employer, perhaps the employee, perhaps they should share the cost. In any of these cases, it is fairer and more efficient to allocate the cost of employee infidelity to the unfaithful employee.
that the borrower will repay the bank’s advance when and if the bank honors the beneficiary’s payment request under the abstract obligation.¹²⁶ Bank abstract obligation application agreements usually require the bank customer to grant a security interest to the credit issuer to secure advances made under the abstract obligation, and the application agreements generally reserve to the bank the right to refuse to issue future obligations if the bank becomes dissatisfied with the applicant’s credit.¹²⁷ In short, the banking industry engages in the traditional banking activity of evaluating credit risk in marketing its abstract obligation product whereas the fidelity company generally engages in actuarial evaluation in issuing many of its products.¹²⁸

These distinctions between classic fidelity industry products and classic banking industry products are not rhetorical; they are matters of commercial function, and the impact of these differences on subrogation analysis is compelling. Just as it makes good sense generally to invoke subrogation in the traditional fidelity industry setting, so it makes good sense generally not to invoke it in the traditional bank abstract obligation setting. The following discussion uses two abstract obligation transactions to illustrate the point.¹²⁹

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¹²⁶ “The bank should either be fully collateralized or have a post-honor right of reimbursement from its customer or form another issuer of an independent undertaking,” Comptroller of the Currency, Interpretive Ruling, 12 C.F.R. § 7.1016(b)(1)(iv) (1998); see also McGuinness, supra note 13, ¶ 12.106 (explaining the differences between surety evaluation of a transaction and banker evaluation of it).

¹²⁷ For an illustration of such an application agreement, see Dolan, Letters of Credit, supra note 49, app. E, doc. 13.

¹²⁸ There are some who contend that banks issue letters of credit rather than guaranties because banking law traditionally forbids banks to issue “guaranties.” See, e.g., Richard Lord, The No-Guaranty Rule and the Standby Letter of Credit Controversy, 96 BANKING L.J. 46 (1979). In fact, the issue is not one of restricting banks from issuing guaranties; it is one of restricting their issuance of secondary obligations. As the Comptroller’s interpretive ruling makes clear, as long as banks issue undertakings that are payable against documents rather than against the happening or non-happening of events, banking soundness and safety considerations are satisfied. Comptroller of the Currency, Interpretive Ruling, 12 C.F.R. § 7.1016(a) (1998); see also Republic Nat’l Bank v. Northwest Nat’l Bank, 578 S.W.2d 109 (Tex. 1978) (rehearing the controversy and explaining the distinction).

¹²⁹ The discussion in the text would limit subrogation to cases in which the remedy does not harm the independence of the credit. For the view that subrogation should never lie in what is essentially a loan transaction, see Paul v. Speirway Ltd., 2 All E.R. 587, 598 (Ch. 1976) (“As it seems to me, where a court, on a review of the facts, comes to the conclusion that what was intended between the parties was really an unsecured borrowing, there is no room for the doctrine of subrogation.”).
B. The Privately Bargained Abstract Obligation Transaction

In a simple and quite common transaction, a developer of real estate uses an abstract obligation (usually a standby letter of credit) as the developer's equity in a real estate development transaction. First, the developer seeks a mortgage loan and grants the lender a mortgage in the real estate. Often, the mortgage is non-recourse. The lender does not disburse the loan proceeds, however, until the developer provides its equity, say, ten percent of the development cost. The parties agree that the developer may contribute its ten percent by having its bank issue a standby letter of credit in favor of the mortgage lender. The credit provides that, upon the mortgage lender's certification that the developer has defaulted on a term of the mortgage note, the credit issuer will pay the lender the ten percent. The bank issuing the standby must make a credit judgment concerning the developer's ability to reimburse the bank in the event the lender calls on it to pay under the credit. The credit issuer may seek security from the developer, such as a security interest in stock or certificates of deposit, personal guarantees of financially strong individuals or corporations, or a mortgage on other real estate.

In the event of default on the mortgage and the mortgage lender's draw on the abstract obligation, the bank will pay the lender and will seek reimbursement from the developer. Sometimes the bank may find that it erred in its credit judgment, that the developer is unable to satisfy its reimbursement obligation to the bank, and that the security taken by the bank is inadequate to make the bank whole. In this event, the bank may seek to subrogate itself to the lender's mortgage interest to the extent of the ten percent the bank paid the lender.


131. In a non-recourse mortgage, the mortgagee may look only to the mortgaged premises to recoup its losses and may not make a deficiency claim against the mortgagor. For discussion of nonrecourse security interests such as nonrecourse mortgages in bankruptcy, see David Gray Carlson, Bankruptcy's Organizing Principle, 26 FLA. ST. U. L. REV. 549 (1999).

132. It is common for the mortgage lender to insist that the mortgaged real estate be free from all liens, except its own, so that the developer may not grant the bank a mortgage interest in that real estate. These facts are a simplified version of the apparent financing arrangements in In re Valley Vue Joint Venture, 123 B.R. 199, 201-02 (Bankr. E.D. Va. 1991).

133. It may be, of course, that the bank has made no error and that it is adequately collateralized for this loss. The bank, however, may have made other loans to the developer and may want to preserve its collateral for defaults under those loans rather than exhaust it on the developer's default on the reimbursement obligation.

134. Significantly, if the bank cannot recover from the applicant, the mortgagor, it may seek reimbursement from guarantors of the reimbursement obligation. Payment by those guarantors would give them a subrogation remedy under traditional subrogation

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In a jurisdiction following the mechanical subrogation analysis rejected by Boss and Revised Article 5, it is clear that the credit issuer would be denied subrogation. When the credit issuer paid the lender, the issuer satisfied its own debt to the lender. Subrogation is not, as a matter of rhetoric at least, available to a party that satisfies its own debt. As Boss shows, however, that rhetorical argument misses the critical point that the bank's payment to the lender satisfied at least part of the developer's debt. To that extent, Boss would subrogate the bank to the mortgage interest in the developed real estate.

Subrogation in this context, however, upsets the risk structure and substitutes a different allocation of costs and risk from the one the parties themselves fashioned when they entered into the transaction. Subrogation rewards the bank issuer, moreover, in the face of its credit misjudgment and penalizes other parties (presumably the creditors of the developer, if the developer is insolvent) who will now have fewer assets out of which to satisfy their claims. Denying subrogation here has the beneficial effect of internalizing the cost of the bank's misjudgment by leaving that cost on the bank.

A second illustration of the general unsuitability of subrogation in the abstract obligation setting involves a confirming bank. In the mortgage transaction described above, it may be that the mortgage lender is not satisfied with the credit of the bank issuer and, therefore, insists that there be a financially strong bank to confirm the issuer's credit. To grant the confirmer subrogation rights after it pays the mortgage lender yields similar reallocation of bargained-for risk allocation. When the confirmer pays the mortgage lender, the confirmer seeks reimbursement from the credit issuer. If the credit issuer fails, the

rules. Such a result is implicit in the holding of the court in In re Valley Vue Joint Venture, 123 B.R. 199 (Bankr. E.D. Va. 1991), where the applicant reimbursed the confirmer and successfully subrogated itself to the confirmer's rights. Whether subrogation should obtain in that setting is a matter that is beyond the scope of this Article, though this analysis suggests that subrogation in that setting is inefficient and not supported by unjust enrichment analysis.


136. See Boss, supra note 12, at 1111 (supporting the analysis in In re Valley Vue).

137. Significantly, traditional subrogation law does not subrogate the credit issuer to the rights of the mortgage lender in this illustration unless the credit fully satisfies the lender's debt. See RESTATEMENT (THIRD) OF SURETYSHIP AND GUARANTY § 27 (1996).

138. These facts are a simplified version of In re Glade Springs, Inc., 826 F.2d 440 (6th Cir. 1987).

139. A confirmer undertakes to honor the issuer's obligation much as if the confirmer were the issuer. See U.C.C. § 5-102(a)(4) (1995); UCP 500, supra note 26, art. 9(b). For obvious reasons, a beneficiary is often well advised to insist that it have the benefit of a confirmation by a strong financial institution in its own market.
confirmers seeks subrogation against the collateral the issuer took from the developer/applicant.

Although a confirmers may at the outset take an interest in the collateral the issuer holds, by failing to do so in this illustration when it decided to confirm, the confirmers relied only on the credit strength of the issuer. Its decision to confirm is as much an extension of credit to the issuer as the issuer’s act of issuance is an extension of credit to the developer. Bank regulators treat confirmations of standby credits as they treat standby credits. They require the confirmers to count the confirmed credit amount as an interbank extension of credit.140 Confirmers obviously may secure their reimbursement rights in those cases where the issuer’s credit is questionable or where reimbursement may be difficult. If the confirmers is not satisfied with the issuer’s credit, the confirmers may refuse to confirm or may seek an assignment from the issuer of its rights in the developer’s assets or it may seek collateral directly from the developer. The issuer and the developer may resist those efforts, however; and the confirmers may lose the confirmation business or may have to pay for the additional security by reducing its charges. The confirmers often does not know the developer, does not seek an interest in the developer’s property, and relies solely on the credit of the issuer.

Sometimes the confirmers errs in that reliance. If it does, it finds it must make a claim in the issuer’s receivership and that under the ex ante allocation of risks, it has no rights in the developer’s property when it seeks reimbursement from the issuer. To grant subrogation to the confirmers is to reallocate the positions under which the parties bargained to operate and to create an adventitious remedy.

There are two reasons for not upsetting the bargained-for allocation in these illustrative transactions: (1) cost internalization (letting commercial parties pay for their own misjudgments); and (2) consistency with rational insolvency schemes.

First, by hypothesis, commercial loss is always wasteful. To the extent the law internalizes that loss, there are incentives to keep loss to a minimum. To the extent the law externalizes loss, that incentive diminishes. The two illustrations above demonstrate that excluding subrogation in these abstract obligation transactions internalizes costs whereas granting subrogation externalizes them. Banks should not issue abstract obligations for applicants that cannot reimburse the bank. To do so is to invite commercial loss. In the event of such loss, if the law leaves it on the party that invited it, that party and others similarly situated will be reluctant to issue abstract obligations for applicants that are not creditworthy. Thus, by leaving the loss on the erring issuer, the law discourages conduct that leads to waste. By the same token, banks should not confirm abstract obligations for financially weak issuers. Again, such conduct invites


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loss, and the law’s allocation of that loss to the confirmer internalizes the cost and disciplines the confirmer for misjudgment.

Second, perhaps in part as an acknowledgment of the value in internalizing costs, federal insolvency regimes generally reward diligent creditors that obtain security and leave paltry dividends to the less diligent creditors that are unsecured. Under the Bankruptcy Code, unsecured issuers must await whatever dividends are available after the trustee in bankruptcy satisfies secured claims out of the estate’s insufficient assets. Similarly, bank insolvency law generally protects secured creditors. 141

It is difficult to characterize as unjust the view that the confirmer should proceed to file a claim in the issuer’s insolvency proceedings. In fact, it is quite fair that it, as an unsecured creditor of the issuer, should be satisfied with the same dividend that other unsecured creditors receive. The issuer’s receiver will, in turn, make a claim against the developer or its estate for the payment the confirmer made to the mortgage lender. The developer or its estate must satisfy that claim, just as the issuer or its estate must satisfy the claim of the confirmer. 142

All of this will strike some as circuitous, but it is not a useless circuit, for it forces commercial parties to make their claims through the filters of insolvency law. Subrogating the confirmer to the issuer’s rights in the developer’s collateral gives the confirmer the cake of the collateral instead of the crumbs insolvency law affords. Refusing to grant secured status to the confirmer *ex post* when that confirmer did not take security *ex ante* is hardly a case of injustice. On the contrary, one might view it as a supremely just result.

In both of the illustrative transactions, the absence of subrogation leaves the insolvency regimes intact. The credit issuer that does not take security is an unsecured creditor in the applicant’s bankruptcy. The confirmer that fails to take security is an unsecured creditor in the liquidation of the failed issuer. Subrogation in these cases would alter the results by treating the unsecured issuer in *Tudor* as a secured creditor and by giving the confirmer in the second illustration (the *Glade Springs* facts) rights against a third party the confirmer did not bargain for. These illustrations are typical. 143 The reason for the subrogation


142. It is not clear from the opinion in the *Glade Springs* case that the issuer’s receiver ever made a claim against the applicant; that failure with its attendant windfall for the applicant, which was itself insolvent, may have prompted the court’s unfortunate decision.

143. For an opinion describing a third abstract obligation setting in which the court denied subrogation, see *Tokyo Kogyo Shokai v. U.S. Nat’l Bank*, 126 F.3d 1135 (9th Cir. 1997) (denying subrogation of applicant to issuer’s rights against bank nominated to make advances under red clause credit). The *Tokyo Kogyo Shokai* opinion is spiced with irreverent humor and at least one barb for the applicant seeking subrogation: “A ‘red clause’ is so called because it is often printed in red so as to call attention to it. It may
remedy, unjust enrichment, is often absent in the abstract obligation transaction. Principles of equity, then, usually do not support subrogation in the abstract obligation context.\textsuperscript{144} In short, as a matter of classic subrogation analysis, abstract obligation issuers usually should not benefit from subrogation.

One might raise objections to this analysis by pointing to Revised Article 5 as positive law enshrining subrogation in the abstract obligation transaction. There are two obvious objections: (1) that the issuer’s payment of its own assets to the beneficiary has benefitted the unsecured creditors of the developer’s estate, thereby enriching them, perhaps unjustly, and (2) that the analysis offered here applies to so many transactions, most of them outside the abstract obligation context, that subrogation will have little room to operate.\textsuperscript{145}

also be the color of the face of whomever at [the applicant] agreed to this provision.” \textit{Id.} at 1135 n.2. The result is consistent with the thesis of this Article that there is nothing unjust in letting parties, bankers or others, pay for their mistakes. In another case, the court denied subrogation to a letter of credit applicant whose letter of credit proceeds satisfied maritime liens on a vessel to which the liensors had made repairs. In \textit{Wilkins v. Commercial Inv. Trust Corp.}, 153 F.3d 1273 (11th Cir. 1998), the court refused to grant the subrogation remedy. Rather than grant or deny the remedy mechanically, the \textit{Wilkins} court reasoned that since the purpose of the transaction was to protect the defendant/owner of the vessel from liens, there was no unjust enrichment in denying the subrogation. Instead, the court concluded, it would be unjust to grant the remedy and thereby defeat the purpose of the transaction. Because they engage in unjust enrichment analysis, \textit{Tokyo Kogyo Shokai} and \textit{Wilkins} should survive enactment of Section 5-117. See also Stewart v. Tansnet, Inc., 718 So. 2d 820 (Fla. Dist. Ct. App. 1998) (denying subrogation to applicants who received stock and failed to take any subrogation rights when they agreed to reimburse confirmer of standby credit).

144. Subrogation might lie in some cases, those where there is true unjust enrichment and where subrogation would not alter the parties’ allocations of risks and costs. In such a case, subrogation would be proper. It is that case, one must assume as a matter of principled statutory construction, that the drafters of the original version of Article 5 had in mind when they comment that an issuer would be subrogated “in a proper case.”

145. The analysis is also contrary to a line of decisions, \textit{infra}, which, by and large, do not engage in any analysis. The decisions stand in opposition to the \textit{rule} advanced here but are not contrary to the \textit{analysis} offered here. They do not have any analysis of the questions the text raises and tend to apply the remedy without any unjust enrichment inquiry. In short, the cases are generous in affording subrogation relief. To that extent, they are generally opposed to the suggestion of this Article that courts be chary of granting such relief. The decisions on these points, however, tend to grant subrogation as mechanically as the cases that Boss criticized and that decline to grant it. \textit{In re Valley Vue Joint Venture}, 123 B.R. 199 (Bankr. E.D. Va. 1991), is the paradigm of such cases. There, the court decried mechanical jurisprudence of those cases that deny subrogation and then, in turn, applied the remedy without any analysis of its own. See also FDIC v. Liberty Nat’l Bank & Trust Co., 806 F.2d 961 (10th Cir. 1986); Sun Co. v. Slamans (\textit{In re Slamans}), 148 B.R. 623 (Bankr. N.D. Okla. 1992), \textit{aff’d. sub nom.} CCF, Inc. v. First Nat’l Bank & Trust Co., 175 B.R. 762 (N.D. Okla. 1994), \textit{rev’d}, 69 F.3d 468 (10th Cir. 1995); \textit{In re Minnesota Kicks, Inc.}, 48 B.R. 93 (Bankr. D. Minn. 1985).
Neither objection is persuasive. The answer to the first is evident in analogous rules of commercial law. That law often penalizes a party whose assets contribute to an estate if that party’s behavior otherwise offends good policy. When a bank makes a loan to a debtor and takes a security interest from the debtor but fails to perfect that security interest, the Bankruptcy Code does not permit the bank to enforce its security interest. \[146\] Thus, the law takes the bank’s loan proceeds and uses them to enrich unsecured creditors of the borrower at the expense of the bank. Virtually every secured transaction that fails by virtue of a poorly drawn security agreement, a misfiled financing statement, or an inadequate financing statement are instances of similar enrichment by a creditor for the benefit of third parties that the law does not view as unjust. As a general rule, subrogation does not relieve the distress of these erring creditors. \[147\] In the past and to some extent today, bulk buyers that failed to comply with the bulk sales laws enacted in some states faced a similar fate. If they failed to comply with the notice provisions of the bulk sales law, they might take the seller’s goods subject to the claims of creditors \[148\] or might be liable for the claims of the seller’s creditors \[149\] even though they paid value for the goods, which value might also be available to the general creditors. Similarly, a secured party that extends credit to a debtor, takes a security agreement, but fails to file its financing statement for more than ten days, will lose its collateral to the trustee in bankruptcy or debtor in possession if the debtor files a petition in bankruptcy within ninety days, even though the secured party’s loan proceeds will enrich the debtor’s unsecured creditors. \[150\] The law of negotiable instruments provides that a party that fraudulently raises a negotiable instrument discharges obligors even though the discharge may operate to give the obligors a windfall. \[151\]

These rules rest on the perception that even though one of the parties has enriched another, commerce should not bear the burden of allowing the claimant

\[146\] Under the strong arm clause of the Bankruptcy Code, the unperfected security interest loses to a later hypothetical lien creditor and, therefore, to the trustee in bankruptcy whom the Bankruptcy Code endows with the later hypothetical lien creditor’s rights. See 11 U.S.C. § 544(a)(1) (1994); U.C.C. § 9-301(3) (1995).


\[150\] The Bankruptcy Code treats the late filing as the date of the transfer and thus renders the grant of the security interest a transfer of the debtor’s property on account of an antecedent debt and therefore avoidable under the preference section. See 11 U.S.C. § 547 (b)&(e)(2) (1994).

\[151\] See U.C.C. § 3-407(b) (1995).
to recover. In each of these instances, the law countenances enrichment of third parties at the hands of a lender or other creditor because policies paramount to the unfairness of a particular case dictate such a result. In these cases, the courts and the legislatures are saying that there may be enrichment at the expense of the claimant, but that the enrichment is not unjust. In the abstract obligation setting, the policy of protecting the abstract obligation device through the independence principle and the policy of internalizing costs normally justifies similar denial of subrogation.

The second objection that the analysis proposed here would, if accepted, leave no room for the subrogation remedy is also unsound. It is true that this Article advances arguments that would apply in many subrogation settings other than the abstract obligation setting; but those arguments do not apply in all subrogation settings; they do not apply in all abstract obligation settings. They do not apply in cases where the credit issuer has no opportunity to bargain before the fact with the parties against whom it seeks subrogation after the fact. They do not apply to the classic fidelity bond setting out of which it originally made sense: the actuarially priced undertaking of an enterprise in the business of taking and evaluating actuarial risk that cannot bargain for rights with parties it does not know. One cannot deny that subrogation can be a troublesome remedy. It invites courts to reconstruct the transaction after the transaction has fallen

152. There is a substantial body of law, the commercial doctrine of good faith purchase, that permits certain purchasers to defeat secured creditors or true owners who create the appearance of ownership in a third party. See generally Grant Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 YAL E L.J. 1057 (1954); William Warren, Cutting Off Claims of Ownership Under the Uniform Commercial Code, 30 U. CHI. L. REV. 469 (1963). The doctrine protects the purchaser without regard to the fact that the true owner or secured party may have contributed more to the value of the property than the purchaser paid for it. Id.

Significantly, when commercial practices changed, some legislatures repealed their bulk sales laws, freeing the bulk buyer from the need to see that bulk sellers give notice of an impending sale, concluding, evidently, that it is unfair to penalize bulk buyers in such fashion. Some have argued that the bulk sales laws never worked, except to the extent that they occasionally trapped an unwary buyer. See Steven Harris, Article 6: The Process and the Product—An Introduction, 41 ALA. L. REV. 549, 549-51 (1990). The bulk sales laws rested on the assumption that creditors of the bulk seller were relying on its stock in trade or equipment and that the bulk sales unfairly deprived those creditors of their reasonable expectations that the bulk seller would use those assets to satisfy its creditors before it closed its business. Though the practice of extending unsecured credit on the basis of an enterprise's stock in trade and equipment was once a prime feature of open account credit, see John Dolan, Changing Commercial Practices and the Uniform Commercial Code, 26 LOYOLA L.A. L. REV. 579, 580-84 (1993), it is probably a vanishing commercial practice. For discussion of the policies served and disserved by the bulk sales laws, see Steven Harris, The Interaction of Articles 6 and 9 of the Uniform Commercial Code: A Study in Conveyancing, Priorities, and Code Interpretation, 39 VAND. L. REV. 179 (1986).
apart. It may simply be a currently popular commercial remedy particularly unsuited to some commercial transactions.  

VIII. CONCLUSION

It ought to be abundantly clear that mechanical denial of the subrogation remedy conflicts with the law of equity and yields pernicious results. Thus, courts should not deny equity on the basis of rhetorical analysis. Section 5-117 indorsers this view. This Article attempts to show, however, that mechanically granting the remedy is equally harmful. In short, whether subrogation should be granted or denied must turn on the equities of a particular case. The illustration of that analysis in the abstract obligation setting makes the case with some clarity.

One must admit that the case against subrogation in the abstract obligation context is not all embracing. There will undoubtedly arise cases in which it would be unjust to leave the parties where they have left themselves. The critical point this Article makes is that before they start altering commercial relationships that the parties themselves confected, courts should engage in full unjust enrichment analysis. That analysis is not complete when the court observes that one party has paid money that permits another party to be enriched. Courts must look to the entire transaction; and, when they do, they should not forget that permitting subrogation will damage what has been a successful commercial product: the abstract obligation. When they conduct that analysis, moreover, they are not violating Section 5-117 of Revised Article 5. They are only engaging in traditional subrogation inquiry, a staple of subrogation law that Section 5-117 denies any intention to alter.

Finally, this Article attempts to show that the lesson from the abstract obligation setting has universal application, that courts have been far too generous in according the remedy, and that the result has been the externalization of costs that guarantors should bear. Usually, though not always, guarantors and issuers that are present at the beginning of the underlying transaction are in a position to protect themselves, while those who appear later are not. The former are poor candidates for the remedy; the latter are prime candidates.

APPENDIX

§ 5-117. Subrogation of Issuer, Applicant, and Nominated Person.
   (a) An issuer that honors a beneficiary’s presentation is subrogated to the
   rights of the 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.

Official Comment
1. By itself this section does not grant any right of subrogation. It grants
   only the right that would exist if the person seeking subrogation “were a
   secondary obligor.” (The term “secondary obligor” refers to a surety, guarantor,
   or other person against whom or whose property an obligee has recourse with
   respect to the obligation of a third party. See Restatement of the Law Third,
   Suretyship and Guaranty § 1 (1996)). If the secondary obligor would not have
   a right to subrogation in the circumstances in which one is claimed under this
   section, none is granted by this section. In effect, the section does no more than
   to remove an impediment that some courts have found to subrogation because
   they conclude that the issuer’s or other claimant’s rights are “independent” of the
   underlying obligation. If, for example, a secondary obligor would not have a
   subrogation right because its payment did not fully satisfy the underlying
   obligation, none would be available under this section. The section indorses the

2. To preserve the independence of the letter of credit obligation and to insure that subrogation not be used as an offensive weapon by an issuer or others, the admonition in subsection (d) must be carefully observed. Only one who has completed its performance in a letter of credit transaction can have a right to subrogation. For example, an issuer may not dishonor and then defend its dishonor or assert a setoff on the ground that it is subrogated to another person’s rights. Nor may the issuer complain after honor that its subrogation rights have been impaired by any good faith dealings between the beneficiary and the applicant or any other person. Assume, for example, that the beneficiary under a standby letter of credit is a mortgagee. If the mortgagee were obliged to issue a release of the mortgage upon payment of the underlying debt (by the issuer under the letter of credit), that release might impair the issuer’s rights of subrogation, but the beneficiary would have no liability to the issuer for having granted that release.