Suretyship and Letters of Credit: Subrogation Revisited

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SURETYSHIP AND LETTERS OF CREDIT:
SUBROGATION REVISITED

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I. INTRODUCTION .................................................. 1088

II. THE CURRENT DRAFTING PROCESS: THE RESTATEMENT
OF SURETYSHIP AND ITS TREATMENT OF LETTERS OF
CREDIT .......................................................... 1090

III. CATEGORIZATION OF LETTER-OF-CREDIT TRANSACTIONS
AS SURETYSHIP TRANSACTIONS ............................. 1094

IV. THEORIES FOR DENYING SUBROGATION ................. 1097
   A. Article 5 Is Exclusive Source of Letter-of-Credit
      Law ...................................................... 1097
   B. Failure to Request Security ............................ 1099
   C. Letters of Credit Are Not Guaranties or Surety 1102
   D. Primary Obligation of Issuer ......................... 1104
      1. Different Uses of the “Primary-Secondary”
         Liability Dichotomy ................................ 1106
         a. Temporal Notion .................................... 1106
         b. Direct Liability .................................. 1108
         c. Inapplicability of Defenses .................... 1110
         d. Nonperformance of Underlying
            Obligation .......................................... 1113
         e. Issuer or Account Debtor ......................... 1115
      2. Redefining “Primary-Secondary”
         Obligations by Reference to the
         Restatement of Security and the
         Restatement of Suretyship .......................... 1117

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1087
I. INTRODUCTION

"Subrogation in letters of credit." The words strike fear in the hearts of some letter-of-credit aficionados. "If [the rules governing letters of credit] are subordinated to more pliable precepts appropriate to equitable resolution of disputes, the very existence of the letter of credit as a useful business device can be destroyed as surely as a wisteria vine can strangle an oak."

For others, the phrase is a welcome acknowledgment that certain principles of equity often applied in, but not limited to, the suretyship or guaranty context are equally applicable in the letter-of-credit context. With two parallel drafting processes underway, one in the guaranty or suretyship area with the promulgation by the American Law Institute of a Restatement (Third) of Suretyship, and the other in the letter-of-credit area with a revision of Article 5 of the Uniform Commercial Code, some resolution of the extent of the overlap between the two fields may be forthcoming.

1. Henry Harfield, Identity Crises in Letter of Credit Law, 24 Ariz. L. Rev. 239, 239 (1982). Another colorful passage continues the attack on equitable doctrines, asserting that "the hosts of Conscience, like roaches, are a hardy breed. If, as Conscience, they are not received in the courts, they seek with increasing success to return as Law." Id. at 247. Although the bulk of Mr. Harfield's comments deal with the inapplicability of equitable concepts to determinations of compliance with the terms of the letter of credit or to assignments of the whole benefit of credits, his words ring in the ears of those who similarly oppose application of the equitable doctrine of subrogation.
The present drafting of a *Restatement of Suretyship* is an ambitious effort to distill various types of devices (guaranties, assumptions of debt, performance bonds, payment bonds, and fidelity bonds) to their essence and to articulate basic commonly shared principles. In many respects, the effort is like that undertaken by the drafters of Article 9 of the Uniform Commercial Code, who endeavored to rationalize the principles applicable to the various types of security devices previously subject to divergent and often conflicting statutory treatment. Given such an ambitious effort, it is not surprising that debate surrounds decisions to include certain types of transactions and exclude others. One arguable type of surety relationship presently excluded from the scope of the *Restatement*, which this Article will examine at length, is the relationship arising from establishment of a letter of credit.

This exclusion reflects the implicit decision that many, if not all, of the rules governing guaranties and other suretyship devices are inappropriate in the letter-of-credit context. Such a decision is undoubtedly correct with respect to some of the suretyship rules, such as those relating to the secondary obligor’s payment obligation and the availability of what are known as suretyship defenses. Yet with respect to devices which it does cover, the *Restatement of Suretyship* acknowledges that not all the rules are applicable to every transaction. The possibility that devices could be made subject to some but not all of the suretyship rules raises the question

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2. At this time, the two current drafts of the *Restatement* are the *Restatement (Third) of Suretyship* (Tent. Draft No. 1, 1992) (covering §§ 1-20) and the *Restatement (Third) of Suretyship* (Tent. Draft No. 2, 1993) (covering §§ 18-45). Only §§ 1-17 of Tentative Draft No. 1 were approved by the ALI in May 1992. *Id.* at xv.

3. For the classic and most comprehensive treatment of these pre-Code security devices and the eventual drafting of Article 9 of the Uniform Commercial Code, see GRANT GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* (1965).

4. The area of fidelity bonds is such an example. The sections of the *Restatement* covering fidelity bonds have not yet been promulgated. See *Restatement (Third) of Suretyship* § 1 cmt. o (Tent. Draft No. 1).

5. *Id.* § 3(2).

6. Initially, one might opine on the distinction between a letter of credit and a nonletter of credit, whether labeled a guaranty or surety relationship. Professor McLaughlin, elsewhere in this Symposium, discusses at length the approaches used to distinguish between the two. See Gerald T. McLaughlin, *Standby Letters of Credit and Guaranties: An Exercise in Cartography*, 34 WM. & MARY L. REV. 1139, 1145-53 (1993).

of whether some but not all of the rules articulated in the Restatement could be applied to letters of credit. What, then, is the rationale for the exclusion of letters of credit?

This Article explores the applicability of the equitable doctrine of subrogation, as developed in the Restatement of Suretyship, to letter-of-credit transactions. Part II describes the current drafting process involving the Restatement of Suretyship and its treatment of letters of credit. It demonstrates that the present exclusion of letters of credit is not necessarily justified by application of the specific requisites for a suretyship transaction. Part III sets forth the theory that the decision whether to categorize letter-of-credit transactions as suretyship transactions should turn on the substantive results that flow from such a characterization. It develops the framework of distinguishing those rules that operate in the period prior to payment or performance by the secondary obligor, and are specifically rejected by letter-of-credit jurisprudence, from those which operate in the postpayment period. Part IV examines the reasons advanced for denying a right of subrogation in a letter-of-credit transaction and concludes that the right of subrogation does not violate any fundamental principles of letter-of-credit law. Part V looks at the right to subrogation in the letter-of-credit context and the parties that attempt to assert such a right. Part VI examines the response to the subrogation issue in the Article 5 revision process and concludes that the practical impact of the decision to exclude letters of credit from the Restatement of Suretyship may be minimized if the issue is appropriately addressed there.

II. THE CURRENT DRAFTING PROCESS: THE RESTATEMENT OF SURETYSHIP AND ITS TREATMENT OF LETTERS OF CREDIT

The proposed Restatement (Third) of Suretyship explicitly excludes letters of credit from its coverage.\(^8\) Although the comments

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8. Id. § 3(2). In the first draft of the Restatement, letters of credit were not excluded explicitly. See Restatement (Third) of Suretyship § 3 (Prelim. Draft No. 1, 1991). Instead, a comment merely noted that "the issuer of a standby letter of credit is not a secondary obligor because its obligation is independent of the underlying obligation." Id. § 1 cmt. j. To some extent, this comment improperly confused the independence principle with the notion of "primary-secondary" obligations. See infra parts IV.D-E. The comment, which was later revised and moved, continued: "To the extent that the law governing letters of credit is silent as to an issue, however, suretyship law might potentially provide helpful
to the Restatement acknowledge that the letter of credit fulfills economic functions similar to those of suretyship devices, two reasons are given for the exclusion. First, the law governing letters of credit is “quite well developed [and no] good purpose would be served by disturbing that state of affairs.” This reason begs the question of whether good reasons exist for applying (or not applying) such concepts as subrogation in a letter-of-credit context. In this comment, the drafters of the Restatement have merely explained that they prefer to leave issues regarding letters of credit to those primarily concerned with the law of letters of credit as opposed to the law of suretyship. Second, the drafters supplied a conceptual ground: “[A] standby letter of credit does not satisfy all of the criteria [for a surety relationship] of § 1” of the Restatement.

Relationships giving rise to suretyship status under the Restatement generally involve three parties: the principal obligor, who owes a duty of performance (the underlying obligation) to another person (the obligee), and a secondary obligor (the surety), who, pursuant to contract, promises to perform—in whole or in part—the duty of the principal obligor to the obligee. The two

analogy.” RESTATEMENT (THIRD) OF SURETYSHIP § 1 cmt. j (Prelim. Draft No. 1). Interestingly, this portion of the comment was retained. See RESTATEMENT (THIRD) OF SURETYSHIP § 3 cmt. b (Tent. Draft No. 1) (“To the extent that the law governing letters of credit is silent as to a particular issue, however, suretyship law is a potential source of generally appropriate analogies.”).

9. RESTATEMENT (THIRD) OF SURETYSHIP § 3 cmt. b (Tent. Draft No. 1).
10. Id.
11. The Restatement of Suretyship eschews use of the terms “surety” or “surety relationship,” speaking instead of relationships giving rise to suretyship status. Id. at xv. The reason for this somewhat awkward phrasing is that the term “surety” is often used in two ways. In its narrow usage, it denotes a specific type of relationship in which the surety assumes joint and several liability with the principal obligor; in its wider usage, it includes a variety of transactions, including surety bonds, guaranties, and similar devices. See id. In this Article, the term “surety” and “surety relationship” will be used in the broader sense unless the context otherwise indicates.
12. Id. § 1(1)(a).
13. Id. § 1(1)(b)(1). The secondary obligor may, instead of promising to perform, pledge its property to the obligee to secure payment or performance of the underlying obligation, id. § 1(b)(2), but that language generally would be inapplicable to a letter-of-credit transaction.
most common contractual mechanisms resulting in suretyship status are "suretyship" and "guaranty."\(^{14}\)

At the outset, a letter of credit may appear to fit within the framework of the Restatement definition. The letter-of-credit transaction generally involves three parties.\(^{15}\) The applicant or customer is the person who requests the issuer, generally a bank, to issue the letter of credit.\(^{16}\) The credit will allow a third person, the beneficiary, to draw upon the credit by presentation of the required documents.\(^{17}\) In a conventional commercial letter-of-credit transaction, the applicant will have a contract with the beneficiary (the underlying obligation) requiring it to pay a sum for the delivery of certain goods; the letter of credit functions as a payment mechanism, and by drawing on the letter of credit, the beneficiary receives the amounts on the underlying contract.\(^{18}\) In a standby letter-of-credit situation, the beneficiary is entitled to draw upon default of the applicant in the underlying contract; payment of the letter of credit functions in satisfaction of the applicant's performance.\(^{19}\)

The difficulty in bringing letters of credit under the Restatement of Suretyship emerges with the requirement of subsection 1(1)(c). Under that subsection, a transaction gives rise to suretyship status only if "to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other."\(^{20}\) Thus, in the traditional guaranty situation, full payment by the debtor or principal obligor would discharge the guarantor's obligation to the creditor. Similarly, payment by the guarantor would discharge the debtor's obligation to

\(^{14}\) *Id.* § 1 cmt. c; *see id.* § 12. For an explanation of the difference between the two, *see infra* note 74.

\(^{15}\) There may, however, be more. *See infra* part V

\(^{16}\) U.C.C. § 5-103(1)(g) (1990) (defining "customer"). The term "customer," which is used in the present version of Article 5, is being replaced with the term "applicant" in the revisions to Article 5 in order to make the language conform with the Uniform Customs and Practices for Documentary Credits. *See U.C.C.* § 5-103(a)(2) & cmt. 3 (Members Consultative Group Draft No. 1, Sept. 1, 1992).

\(^{17}\) U.C.C. § 5-103(1)(d) (1990).


\(^{19}\) *Id.*

SURETYSHIP AND LETTERS OF CREDIT

the creditor as well. Presumably, in a letter-of-credit context, payment of a letter of credit (the secondary obligation) would discharge the principal obligor or applicant of its obligation on the underlying obligation for which the letter of credit was issued. The difficulty is that payment or performance by the applicant or principal obligor is not a defense to a draw under a letter of credit.21 Thus, the requirement of subsection 1(1)(c) of the present Restatement technically is not met.

The requirement of subsection 1(1)(c) could be reworded, however, to track more closely prior definitions of suretyship22 by providing that the obligee is entitled to retain only one performance or satisfaction. Indeed, this was the formulation of the requirement in the first draft of the Restatement of Suretyship.23 Arguably, under this formulation, the letter of credit would satisfy the requirement. If the applicant or principal obligor performs the underlying obligation, but the creditor/obligee still draws on the letter of credit, one could conclude that although the issuer cannot rely on the full performance of the underlying obligation by the principal obligor to dishonor the draw, the issuer (or the applicant) can rely upon the dual payment to the obligee as a demonstration

21. Article 5 explicitly addresses the relationship between the letter-of-credit obligation and the underlying transaction: “An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.” U.C.C. § 5-114(1).

22. The predecessor to the Restatement of Suretyship, the Restatement of Security, defined suretyship as

the relation which exists where one person [the surety] has undertaken an obligation and another person [the principal] is also under an obligation or other duty to the obligee [the creditor], who is entitled to but one performance, and as between the two who are bound [i.e., the surety and the principal], the [principal] rather than the [surety] should perform.

RESTATEMENT OF SECURITY § 82 (1941).

23. See Restatement (Third) of Suretyship § 1(c) (Prelim. Draft No. 1, 1991) (giving suretyship status when “the obligee is entitled to only one performance”). This requirement was quickly revised into its present formulation, see Restatement (Third) of Suretyship § 1(1)(c) (Tent. Draft No. 1) (“A ‘secondary obligor’ has suretyship status whenever to the extent that the underlying obligation or the secondary obligation is performed the obligee is not entitled to performance of the other ”), and letters of credit were explicitly excluded. Id. § 3(2). As the comment to the latter section noted, under the current formulation, letters of credit will not give rise to suretyship status as “under the independence principle of letters of credit, performance of the underlying obligation will not necessarily discharge the issuer of a standby letter of credit.” Id. § 3 cmt. b.
of unjust enrichment. The obligee should not be entitled to retain two separate payments or performances on the ground that each is independent of the other but instead should be liable for restitution of the overpayment.\(^2\)

III. CATEGORIZATION OF LETTER-OF-CREDIT TRANSACTIONS AS SURETYSHIP TRANSACTIONS

Initially, it should be emphasized that one should not categorize a transaction as a "suretyship" or "nonsuretyship" transaction in the abstract. Rather, the focus should be on the consequences flowing from the categorization. There are two important consequences of suretyship status. First, the secondary obligor is given certain rights against the principal obligor:\(^2\) the suretyship rights of exoneration,\(^2\) reimbursement,\(^2\) and subrogation.\(^2\) Second, the secondary obligor's duties to the obligee are subject to defenses arising out of the underlying transaction as well as out of the suretyship status (the suretyship defenses).\(^2\) Yet, as the Introduction to the Restatement of Suretyship notes: "[This Restatement] does not obliterate differences between suretyship devices where they exist."\(^3\) The Restatement preserves the distinctions between various

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\(^{24}\) As this Article discusses later, one of the main justifications advanced for denying subrogation in the letter-of-credit context is that it would violate the principle of the independence of the letter-of-credit obligation from the underlying obligation. See infra note 35 and accompanying text. Recognizing that a beneficiary should not simultaneously be able to retain payments from both the applicant on the underlying obligation and the issuer on the letter of credit demonstrates that the issuer's obligation on the letter of credit is not for all purposes independent of the underlying obligation between the applicant and the beneficiary. Although one cannot introduce evidence of performance of the underlying obligation as a ground for failing to pay the letter of credit, demonstrating that there was no default on the underlying obligation (i.e., that the obligee already received the performance it deserved) and that the draw was made nonetheless should give rise to a potential action by either the issuer or the applicant to recover the overpayment. If the two obligations were completely independent as some seem to suggest, the obligee would be entitled to keep both payments or performances under the two independent contractual relationships. The right to recover the overpayment, however, is a postpayment remedy, not a prepayment remedy, and therefore does not violate the independence principle.

\(^{25}\) Restatement (Third) of Suretyship §§ 13(1), 14 (Tent. Draft No. 1).

\(^{26}\) Id. § 17.

\(^{27}\) Restatement (Third) of Suretyship §§ 18-21 (Tent. Draft No. 2, 1993).

\(^{28}\) Id. §§ 23-27.

\(^{29}\) Restatement (Third) of Suretyship § 13 (Tent. Draft No. 1).

\(^{30}\) Id. at xv.
types of sureties." Thus, not all sureties may assert suretyship defenses, nor may all sureties claim a right of reimbursement or a right of exoneration.

What, then, is the main dispute about classifying (or not classifying) letters of credit as suretyship devices? Unfortunately, the tendency in much of the literature and in many of the cases is to resolve the definitional issue first—for example, categorizing the issuer of a letter of credit as a guarantor or surety—and then let the substantive law implications flow from the characterization. The thesis of this Article is that we must first examine the substantive implications, such as the right of subrogation, and ask whether they make sense in a letter-of-credit context, before we reach the definitional issue. The Restatement of Suretyship already employs this "functional approach": "[S]ubstance rather than form determines whether suretyship status rights attach."[32]

The first substantive result of classifying a transaction as a suretyship device is that the secondary obligor may raise any defenses that the principal obligor may have on the underlying obligation.[33] In addition, the secondary obligor may raise certain "suretyship defenses," such as impairment of recourse, release or modification of the underlying obligation, extension of time, impairment of collateral, or other impairment of recourse.[34]

If these were the only results of categorizing a transaction as a suretyship transaction, then the whole fabric of letter-of-credit law would be violated by applying these results to letter-of-credit transactions. Under the "independence principle" which is at the heart of letter-of-credit law, courts consider the letter-of-credit transaction independent of the underlying transaction.[35] Thus, the

31. The Restatement preserves distinctions between three-party and two-party relationships, between consensual and nonconsensual sureties, between compensated and uncompensated sureties, between commercial and noncommercial, and between consumer and nonconsumer. See id.
32. Id. § 1 cmt. b. Undoubtedly the most vivid example of this functional approach in the Restatement of Suretyship is its treatment of both the traditional surety and the guarantor under the same set of rules, despite the fact that previously, distinctions frequently had been made between the two. Id. cmt. c.
34. Id. §§ 33-43.
35. See Occidental Fire & Casualty Co. v. Continental Bank, 918 F.2d 1312, 1315 (7th Cir. 1990) (recognizing that the independence principle prevents the issuer from looking outside
issuor must honor a documentary tender conforming to the requirements of the credit “regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.” Similarly, the issuer's obligation to the applicant does not include responsibility “for performance of the underlying contract for sale or other transaction between the customer and the beneficiary.” The fact that the beneficiary may have breached the underlying contract and thus given the applicant a defense to the underlying contract is not a defense available to the issuer. “Only staunch recognition of this principle by the issuers and the courts will give letters of credit the continued vitality that arises from the certainty and speed of payment under letters of credit.”

Letters of credit are used to ensure prompt and expeditious payment to the beneficiary. Thus, the issuer is denied the ability to raise defenses arising from the underlying contract. Similarly, the issuer should be denied the advantages of other “incidents of suretyship status” that operate in any way to frustrate the prompt payment mechanism. Moreover, the issuer should not be able to assert the suretyship defenses, the impact of which denies the beneficiary a swift, up-front payment mechanism, and shifts the burden to the beneficiary to sue the applicant on the underlying contract. Indeed, the focus of the concerns about the independence of the letter-of-credit transaction are in the prepayment period, where any rule or principle that operates to delay or frustrate the payment mechanism should be rejected.

the documents); Kellogg v. Blue Quail Energy, Inc. (In re Compton Corp.), 831 F.2d 586, 590 (5th Cir. 1987) (noting that the independence principle is “the cornerstone of letter of credit law”), on reh'g, 835 F.2d 584 (5th Cir. 1988); Arbest Constr. Co. v. First Nat'l Bank & Trust Co., 777 F.2d 581, 584 (10th Cir. 1985) (“The issuer is immune from responsibilities to police the underlying transaction because it lacks control over it, or possibly even knowledge of it.”); Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 493 F.2d 1285, 1286 (9th Cir. 1974) (stating that the purpose of the letter of credit is to assure payment “cheaply by eliminating the need for the issuer to police the underlying contract”); Page v. First Nat’l Bank (In re Page), 18 B.R. 713, 717 (D.D.C. 1982) (holding that the commercial vitality of the letter of credit is that the promise by the issuer is independent of the letter of credit).

37. Id. § 5-109(1)(a).
39. This point is specifically recognized in the latest drafts of Revised Article 5. Id. § 5-102(f).
Suretyship and Letters of Credit

Yet, to the extent these suretyship principles apply in the postpayment period, their application would not interfere with the purpose of letters of credit: providing a swift payment mechanism that makes the beneficiary the stakeholder in the event of disputes on the underlying contract and shifts the burden to the applicant to seek relief. The second set of rights that flow from suretyship status are those of the secondary obligor against the principal obligor—more specifically, the rights to exoneration and subrogation. A third right of suretyship status, the right to reimbursement, is already available to issuers under Article 5. Indeed, this statutory grant of the right of reimbursement to issuers can be viewed as an acknowledgment that some of the rights of suretyship status are applicable in the letter-of-credit context. Although the unavailability of the right of subrogation to issuers of letters of credit is often justified on the ground that such a right is fundamentally inconsistent with the independence principle of letter-of-credit law, this Article argues that allowing resort to the right of subrogation in no way compromises the independence principle. The right to subrogation is a postpayment right that does not in any way affect the commercial vitality of the letter of credit. This Article furthermore argues that the theory behind the right of subrogation is as applicable in a letter-of-credit context as it is in any suretyship context.

IV Theories for Denying Subrogation

A. Article 5 Is Exclusive Source of Letter-of-Credit Law

Some courts, in denying subrogation, have argued that Article 5 of the Uniform Commercial Code is the sole source of letter-of-credit law, and thus it is improper to import subrogation principles. This argument relies in part on comments to Article 5 that

42. Id. §§ 18-21.
44. E.g., Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 362 (3d Cir. 1992) (Article 5, "viewed in its entirety, evinces an intent to keep the law of guarantee and the law of letters of credit separate.").
distinguish between letters of credit and guaranties; to that extent, this formal argument ignores the black letter of Article 5 and other comments that underscore the limited scope of the article and the nonexclusive nature of its provisions. The argument also fails to recognize that Article 5 implies in its comments that subrogation might be available in certain situations not within the black letter of the Code itself.

It bears noting that prior to the enactment of original Article 5, the question of the availability of subrogation in a letter-of-credit context was never squarely raised, so that it is highly unlikely that fears about improper subrogation prompted the language distinguishing guaranty law. More likely, as a matter of drafting intent, the doctrine of subrogation was unaffected by the passage of Article 5.

45. See, e.g., U.C.C. § 5-101 official cmt. ("The other source of law respecting letters of credit is the law of contracts with occasional unfortunate excursions into the law of guaranty."); id. § 5-103 official cmt. 3 ("The issuer is not a guarantor of the performance of the [ ] underlying transactions."); id. § 5-109 official cmt. 1 ("[T]he issuer receives compensation for a payment service rather than for a guaranty of performance.").

46. Section 5-102(3) states:

This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for

Id. § 5-102(3); see also id. § 5-101 official cmt. (speaking of "further development of letters of credit"); id. § 5-102 official cmt. (noting that the rules of Article 5 are not exhaustive of the law applicable to letters of credit); id. official cmt. 2 ("[N]o statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful financing device.").

47. Id. § 5-109 official cmt. 1 (recognizing that the issuer may be subrogated to the rights of the applicant against the beneficiary in a "proper case").


49. Indeed, the relationship between subrogation notions and the Uniform Commercial Code has been extensively litigated in a different context: whether subrogation rights survive the enactment of Article 9 and whether a subrogee has rights superior to those of a secured party. As one court observed, equitable subrogation is "too hardy a plant to be uprooted by a Code which speaks around but not to the issue." National Shawmut Bank v. New Amsterdam Casualty Co., 411 F.2d 843, 849 (1st Cir. 1969); see also Mid Continent Casualty Co. v. First Nat'l Bank & Trust Co., 531 P.2d 1370, 1373 (Okla. 1975) ("All of the still viable decisions hold that the doctrine of equitable subrogation in suretyship cases has not been affected by the adoption of the Code.").
More importantly, this argument does not address whether Article 5 should allow subrogation in the letter-of-credit context. The tendency to look solely to Article 5 for governing principles may reflect the concern, discussed below, that wholesale importation of principles of suretyship will undermine the commercial uniqueness and legitimacy of letters of credit. To preserve the integrity of letter-of-credit law against possible strangulation by the encroachment of the hardy vine of equity, it may be preferable to keep the law governing letter-of-credit transactions within one statutory framework, rendering unnecessary resort to extraneous nonstatutory authorities such as the Restatement of Suretyship. Ultimately, however, whether the issue is addressed in the Restatement or in Article 5, the question still remains whether subrogation should be available in a letter-of-credit context.

B. Failure to Request Security

Some courts have refused to grant a right of subrogation on the theory that the party seeking subrogation could have demanded the rights to which it seeks subrogation, either from the person whose rights are being asserted or from the person against whom rights are sought. In other words, if the party could have asked for subrogation at the time the letter-of-credit transaction was entered into but did not, it is doomed. As one court said, “There is no equitable reason to grant [applicant] protection which neither it

50. See infra part IV.E.
51. See supra note 1 and accompanying text.
52. See, e.g., In re Agrownautics, 125 B.R. 350, 353 (Bankr. D. Conn. 1991) (involving an issuer who “chose not to bargain for the protection of the [beneficiary’s] mortgage, presumably being content with the credit worthiness of the [applicant]”); Beach v. First Union Nat’l Bank (In re Carley Capital Group), 119 B.R. 646, 650 (W.D. Wis. 1990) (denying equitable subrogation when the plaintiffs demanded consideration for their actions and could have required security but did not).
53. As one court noted:

Furthermore, there is no equitable reason to grant such additional rights to the plaintiffs in this case since they could have achieved the same protection by contract. They could have obtained such security directly in their contract with the debtor through a secondary security interest in the collateral granted to the creditor, or they could have obtained such security by requiring the assignment of excess security rights under the terms of the letter of credit when contracting for its issuance.

Carley Capital, 119 B.R. at 650.
nor [the issuer] sought. On the other hand, some courts deny subrogation on the ground that no privity exists between the parties, i.e., between the person seeking subrogation and the person against whom subrogation is sought. Thus, the party seeking subrogation is in an untenable position: if privity existed, the party will be denied recovery for failing to request the security; if privity did not exist, it may be denied recovery even though it could not have requested the security.

The emphasis on what the person seeking subrogation could or could not have requested is misplaced. First, as has been observed elsewhere, parties generally do not expect that standby letters of credit, as opposed to commercial letters of credit, will be drawn upon, so their failure to address issues such as reimbursement or collateralization in their underlying agreements may not be surprising. More importantly, however, as the Restatement of Suretyship notes:

Subrogation does not spring from contract although it may be confirmed or qualified by contract. Rather, it is a rule that the law adopts to compel the eventual satisfaction of an obligation by the one who ought to pay it. Subrogation is often called an equitable assignment, or an assignment by operation of law.

Indeed, in most cases involving a surety or guarantor seeking to be subrogated to the rights of the creditor against the debtor, the surety or guarantor arguably could have demanded that the debtor

55. See, e.g., *In re Munzenrieder Corp.*, 58 B.R. 228 (Bankr. M.D. Fla. 1986). The applicant, who reimbursed the issuer, sought subrogation to the rights of the beneficiary against the debtor on an underlying contract. *Id.* at 230. The court, in denying subrogation, emphasized the fact that the issuer had no direct or indirect interest in the discharge of the debtor's debt to the beneficiary. *Id.* at 231.
56. See, e.g., Chemical Bank v. Craig (*In re Glade Springs, Inc.*), 826 F.2d 440 (6th Cir. 1987) (granting subrogation despite the failure of the confirmer to demand security).
58. *Restatement (Third) of Suretyship* § 23 cmt. a (Tent. Draft No. 2, 1993). Sometimes, distinctions are drawn between "legal subrogation," which arises out of equitable considerations, and "conventional" subrogation, which is founded upon some understanding, agreement, or contract. See Jarvis, supra note 48, at 365 n.48.
give it security for its undertaking, or it could have asked that the creditor requesting the bond or guaranty agree to assign any rights the creditor had against the debtor in the event of payment by the surety or guarantor.69 A per se rule denying subrogation to any person who could have but did not demand security would gut the application of subrogation in most ordinary commercial transactions.

This is not to say that the ability of a creditor to protect itself ex ante may not be taken into consideration in determining the equities of subrogation in any particular context.60 Thus, when an issuer has the personal guaranties of three persons and mortgages on three other properties to secure its claim for reimbursement, allowing subrogation to the rights of a beneficiary who had a first mortgage on other property, which the issuer never requested, may be inequitable.61

59. Of course, one might argue that frequently guarantors are noncommercial entities or that they lack bargaining power comparable to that enjoyed by the creditor, whereas letter-of-credit issuers are generally banks that can set the terms under which they will issue any particular credit. That is not always the case, however. See, e.g., In re Sensor Systems, Inc., 79 B.R. 623 (Bankr. E.D. Pa. 1987) (noting that a bank loaning one million dollars to the debtor demanded a security interest in all the debtor's assets as well as letters of credit in the bank's favor from sixteen individuals).

60. In Tudor Development Group, Inc. v. United States Fidelity & Guaranty Co., 968 F.2d 357 (3d Cir. 1992), for example, the issuer of a standby letter of credit payable upon the failure of the applicant to complete certain site improvements had taken an assignment of the proceeds of a construction bond covering those site improvements. Id. at 359. The applicant defaulted and a draw was made, but the proceeds of the site-improvement bond were insufficient to reimburse the issuer. Id. The issuer then sought subrogation to the customer's proceeds under other bonds covering specific buildings. Id. In such a case, the issuer's demand that the site-improvement bond be assigned, combined with its failure to demand that the other bonds be assigned and the fact that these other bonds were not related to the specific default giving rise to the draw under the letter, could be sufficient to warrant a denial of a right to subrogation. See id. at 363-64 n.4 (Garth, J.) (suggesting an addition to the majority opinion).

An argument may be made, however, that irrespective of the equities this is not a traditional subrogation case. The issuer was not asserting the rights of the beneficiary paid pursuant to the letter of credit, nor was it seeking to assert the rights of its customer against the beneficiary or other wrongdoer. Instead, it was seeking to assert its customer's rights on unrelated third-party contracts.

61. See, e.g, Merchants Bank & Trust Co. v. Economic Enters., Inc. (In re Economic Enters., Inc.), 44 B.R. 230 (Bankr. D. Conn. 1984) (denying subrogation in such a situation, but also holding that the independence principle precluded subrogation). Under the general theory of marshalling, the court in such a situation might require the issuer to resort to its other guaranties and mortgages to satisfy its claim before granting subrogation rights.
C. Letters of Credit Are Not Guaranties or Surety

Letters of credit are now being used in many of the same situations in which guaranties and surety bonds were traditionally used. In many respects, the willingness of creditors to accept letters of credit in place of guaranties or bonds is an indication of the fact that a letter of credit fulfills many of the functions traditionally performed by these other devices. In addition, the acceptability of these letters of credit may demonstrate awareness on the part of some creditors that the security they get from a letter of credit is greater than that from a guaranty or bond: the creditor will receive payment upon presentation of the documents without having to demonstrate actual default or performance of the underlying contract; the creditor takes free of any defenses a surety or guarantor might have; the creditor's modification of the underlying contract or release of the debtor does not discharge the letter of credit; and if any litigation does stem from the underlying contract, the creditor remains the stakeholder and retains the proceeds of the letter of credit until the claimant (generally the debtor) proves its right to recover based on the underlying contract.

Many courts that have confronted the subrogation issue have focused on the similarities and differences between letters of credit and guaranties. Those courts that have found a right to subrogation often stress the similarities between the two. Others, in denying subrogation, have stressed that, although the letter of credit may perform a function similar to that performed by a bond or a guaranty, a letter of credit is distinct from a guaranty and is therefore subject to a different body of law. Indeed, the Official Com-

62. See, e.g., In re National Serv. Lines, Inc., 80 B.R. 144, 145 (Bankr. E.D. Mo. 1987) (reasoning that a bank which pays a debtor's obligation pursuant to a letter of credit "functions in substance like a guarantor or surety of the debtor's obligation"); Sensor Systems, 79 B.R. at 626 (noting that the issuer of standby letter is "logically characterized as a 'guarantor' or a 'co-debtor'"); In re Minnesota Kicks, Inc., 48 B.R. 93, 104-05 (Bankr. D. Minn. 1985) (granting subrogation to guarantors but not issuers of credits "would be no more than an exercise in honoring form over substance").

63. See, e.g., Tudor Development, 968 F.2d at 362 (holding that despite "superficial similarities between guarantees and letters of credit, their 'legal' characteristics remain quite distinct and thus the remedies available should remain distinct as well"); 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) (holding that numerous differences between
ments to Article 5 stress the differences between the two. Accord-.

ing to those courts that emphasize the differences rather than the

similarities, because subrogation is a doctrine that applies to guar-

anties and bonds, it cannot be invoked in the letter-of-credit

context.

Yet the fact that standby letters of credit are similar to or dis-

tinguishable from guaranties begs the issue. The doctrine of sub-

a letter of credit and a guaranty "prohibit the issuer from sharing a guarantor's subro-

gative rights").

64. See U.C.C. § 5-101 official cmt. (1990) ("The other source of law respecting letters of

credit is the law of contracts with occasional unfortunate excursions into the law of guar-

anty."); id. § 5-103 official cmt. 3 (stating that an issuer is not a guarantor); id. § 5-117

official cmt. (stating that an issuer acts as a principal, not as agent for its customer, and

engages its own credit).

65. The use of standby letters of credit in situations in which traditionally guaranties or

bonds were used was the original impetus to the suggestion that letters of credit were suffi-

ciently similar to such surety relationships to justify application of the doctrine of subro-

gation. Such arguments are somewhat misleading in that they fail to recognize that even com-

mercial letters of credit share one critical element in common with guaranties: under a

commercial letter of credit the issuer, upon honoring the presentation, typically satisfies the

debt owed by its customer to the beneficiary in the underlying commercial transaction.

Thus, any of the arguments made about the propriety of subrogation in a standby letter-of-

credit context apply equally in a conventional commercial letter-of-credit context.

Most of the discussion of subrogation in a letter-of-credit context has occurred in discus-

sions of standby as opposed to commercial letters of credit. Several theories may explain

this distinction. First, standby letters of credit involve greater risk than do traditional let-

ters of credit. See Boris Kozolchyk, The Emerging Law of Standby Letters of Credit and


standbys embodies a greater degree of risk of unreimbursed payment for the issuing or con-

firming bank than does the commercial letter of credit."); Edward L. Symons, Jr., Letters of

Credit, 54 Tul. L. Rev. 338, 343 (1980); Michael Stern, Note, The Independence Rule in

Standby Letters of Credit, 52 U. Chi. L. Rev. 218, 222 (1985). In part the greater risk is due

to the absence of a bill of lading giving the bank a claim to the goods in the event of non-

payment by the applicant. Without that security, the issuer has recourse only to the appli-

cant based on its reimbursement right; any right to collateral must be based on a contrac-

tual grant of a security interest or on an assertion of a right to subrogation to any security

interest granted the beneficiary. With the growth in use of standby letters of credit, then,

issuers arguably need to resort to subrogation in more contexts than in the traditional let-

ter-of-credit situation.

Second, standby letters of credit, far more so than conventional commercial letters of

credit, resemble guaranties and are used in place of guaranties. Thus, not surprisingly, com-

parisons between the two lead to discussions of whether certain rights of guarantors, such as

the right to subrogation, extend to standby letters of credit. Nonetheless, the doctrine of

subrogation may be equally important in a conventional commercial letter-of-credit context.

See, e.g., East Texas Steel, 117 B.R. 235; National Service Lines, 80 B.R. 144 (upholding an

issuer's subrogation claim to a creditor's priority claim in bankruptcy without determining

its basis on a commercial or standby letter of credit).
rogation is an equitable doctrine which applies to transactions other than the typical guaranty or bond.\textsuperscript{66} As one leading treatise on suretyship observed, “Subrogation is not limited in its application to transactions in suretyship. Whenever one pays the debt of another, although not obligated to do so, if the payment was necessary for the protection of his own interests, the equity of subrogation arises.”\textsuperscript{67} Indeed, the Restatement of Suretyship itself is not limited to guaranties or bonds, but adopts a “broad, functional manner that emphasizes the substance of relationships rather than their form.”\textsuperscript{68} Thus, the recognition that a letter of credit is not a guaranty or bond should not preclude application of the equitable doctrine of subrogation in a letter-of-credit context.\textsuperscript{69}

\textbf{D Primary Obligation of Issuer}

Courts and commentators rejecting the application of subrogation notions in the letter-of-credit context frequently stress that the duty of the issuer of the letter of credit is “primary” and not “secondary” as in the case of the guarantor’s obligation.\textsuperscript{70} These writers seldom explain either what is meant by “primary” or “secondary” obligations, or why that distinction is at all relevant to the application of subrogation principles. As a result, use of “primary-

\begin{itemize}
\item \textsuperscript{66} Thus, the articulation of the equitable doctrine of subrogation in the Restatement of Restitution does not limit its application to the strict guaranty situation or the suretyship situation. Restatement of Restitution § 162 (1937); see also Compania Anonma Venezolana de Navegacion v. A.J. Perez Export Co., 303 F.2d 692, 697 (5th Cir.) (stating that subrogation is a mechanism universally applied in new and unknown circumstances), cert. denied, 371 U.S. 942 (1962).
\item \textsuperscript{67} ARTHUR A. STEARNS, THE LAW OF SURETYSHIP § 11.1 (5th ed. 1951); see also LAURENCE P. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP § 47, at 205 (1950) (“Any person who, being obligated on the debt of another has paid the debt, is entitled to be subrogated to the creditor’s rights against the debtor.”).
\item \textsuperscript{68} Restatement (Third) of Suretyship at xi (Tent. Draft No. 1, 1992).
\item \textsuperscript{69} Chemical Bank v. Craig (In re Glade Springs, Inc.), 826 F.2d 440, 442 n.4 (6th Cir. 1987); In re Valley Vue Joint Venture, 123 B.R. 199, 208 (Bankr. E.D. Va. 1991) (noting that neither equity nor 11 U.S.C. § 509(a) (1988) requires that a party seeking subrogation be a surety or guarantor).
\item \textsuperscript{70} Many of these courts cite, as a prerequisite to application of the doctrine of restitution, the requirement that the person seeking subrogation not have been primarily liable for the debt. See, e.g., Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 397 (3d Cir. 1992); United States Fidelity & Guar. Co. v. United Penn Bank, 524 A.2d 958, 963 (Pa. Super. Ct.) (citing a five-prong test for availability of subrogation), allocatur denied, 536 A.2d 1333 (Pa. 1987).
\end{itemize}
SURETYSHIP AND LETTERS OF CREDIT

"primary-secondary" terminology often obfuscates rather than clarifies the issue of whether subrogation should be recognized in a letter-of-credit context.\textsuperscript{71}

The confusion stems in part from the failure to reconcile the use of "primary-secondary" terminology in two different and distinct contexts: 1) the context of determining whether a person who claims the right is entitled to subrogation, or whether the person was paying a debt completely separate and distinct from the debt giving rise to the claim of subrogation; and 2) the letter-of-credit context, in which courts have attempted to distinguish between letter-of-credit transactions and other transactions, such as guaranty or suretyship transactions, or to differentiate standby letters of credit from conventional commercial letters.\textsuperscript{72} In each context, the "primary-secondary" dichotomy serves a different purpose, and yet the distinction is often recited indiscriminately without any complete analysis of what is meant.\textsuperscript{73}

Most of these analyses do little to demonstrate the inapplicability of notions of subrogation to letters of credit; to the contrary, they demonstrate that the arguments against such application are more rhetorical than substantive. An initial look at how the terms "secondary" and "primary" may be used to describe the obligations of the issuer and the applicant will demonstrate that the distinguishing feature of a letter-of-credit transaction is not which of the two parties has the primary obligation, but the fact that the issuer's obligation is sufficiently independent of the underlying obligation so that the issuer cannot dishonor a draw simply because of defenses the applicant may have on the underlying obligation. A

\textsuperscript{71} The confusing nature of the "primary-secondary" dichotomy has been noted by others. See Tudor Development, 968 F.2d at 365-66 (Becker, J., dissenting); Jarvis, supra note 48, at 366 n.50; Kozolchyk, supra note 65, at 321 n.9.

\textsuperscript{72} Kozolchyk, supra note 65, at 321 n.9.

\textsuperscript{73} It is interesting to note that the "primary-secondary" terminology has also been used within the area of suretyship law to distinguish a surety, whose obligation is deemed to be secondary and unconditional upon default by the principal obligor, from a guarantor, whose obligation is deemed primary and conditional upon default. See, e.g., Rhode Island Hosp. Trust Nat'l Bank v. Ohio Casualty Ins. Co., 789 F.2d 74, 77 (1st Cir. 1986); Simpson, supra note 67, § 4, at 6-8, § 5, at 8-9. The distinction between the two, however, is minimal: when sued, a guarantor has a defense that the principal has not yet defaulted, a defense that is unavailable to a surety. Rhode Island Hospital Trust, 789 F.2d at 78; United States v. Frisk, 675 F.2d 1079 (9th Cir. 1982) (citing the distinction but noting it was of no consequence to rights after payment).
further examination of the use of the terms “secondary” and “pri-
mary” as factors in the determination of whether the equitable
remedy of subrogation is available will further demonstrate that,
according to the usage of those terms in the context of subrogation,
the letter-of-credit issuer’s obligation is secondary, and therefore
subrogation should not be denied.

1. Different Uses of the “Primary-Secondary”
   Liability Dichotomy
   
   a. Temporal Notion

   The statement that the issuer is “primarily liable” could be used
   in one temporal sense to mean that the issuer must pay upon pres-
   entation of a proper demand complying with the terms of the
   credit without any prior demand upon or default by the debtor. Of
course, one could argue that in a standby situation, the issuer is
not “primarily liable” because a demand will not be made under
the letter until there has been a default by the debtor, even though
under the independence principle, inquiry into whether default has
actually occurred is precluded. Whether or not the issuer is “pri-
marily liable” in this temporal sense, however, subrogation should
not be precluded for this reason.

   Under the Restatement of Suretyship, suretyship status arises
   (and the right to subrogation may accrue) whether the secondary
obligor is unconditionally liable along with the principal obligor or
is only conditionally liable after default by the principal.74 Thus,
suretyship status may arise (and the right to subrogation
may accrue) whether the surety’s obligation to pay was uncondi-
tional or conditional upon default by the principal. In other words,
suretyship status may arise, and thus subrogation may be available
to a surety, whether the surety’s obligation was “primary” or “sec-

74. Restatement (Third) of Suretyship § 1 cmt. 1 (Tent. Draft No. 1, 1992). The Re-
statement thus eliminates the distinction that exists in some states between a “surety” obli-
gation (in which the promise of the surety is unconditional yet is a secondary, collateral
obligation) and the “guaranty” obligation (in which the guarantor’s obligation is conditional
yet is deemed to be independent and primary). See, e.g., Rhode Island Hospital Trust, 789
F.2d at 77; Griswold v. Wells Aluminum, Moultrie, Inc., 274 S.E.2d 7, 8 (Ga. 1980); Indiana
Univ. v. Indiana Bonding & Sur. Co., 416 N.E.2d 1275, 1278 (Ind. 1981); General Motors
Acceptance Corp. v. Daniels, 492 A.2d 1306, 1309 (Md. 1985) (giving a right to subrogation
to a surety whose obligation is primary with the obligor, although unconditional).
ondary” in the temporal sense. Thus, whether an issuer is “primarily liable” in this temporal sense should be equally irrelevant to the determination of whether subrogation is available in letter-of-credit transactions.\textsuperscript{75}

One factual situation embraced by the Restatement of Suretyship illustrates the application of the Restatement and the availability of its subrogation principles to instances in which the surety is “primarily liable” in this temporal sense. If the owner of encumbered property transfers it to a transferee who assumes the mortgage, under the Restatement the transferee would be the primary obligee and the original owner the secondary obligee because, as between the two of them, the transferee has agreed to be primarily liable.\textsuperscript{76} Yet, when payments are due under the mortgage, the mortgagee/obligee may make a demand upon the original owner/secondary obligor without a prior demand upon the transferee/principal obligor. Thus, in a temporal sense, the owner’s obligation may be deemed primary, but in the determination of who, as be-

\textsuperscript{75} It should be noted that the position of the Restatement of Suretyship that a transaction may give rise to suretyship status (and the right to subrogation) even though the undertaking of the secondary obligor is unconditional, see Restatement (Third) of Suretyship § 1 cmt. 1 (Tent. Draft No. 1), is not universally accepted. In the case of In re St. Clair Supply Co., 100 B.R. 263 (Bankr. W.D. Pa. 1989), noninsiders had agreed to provide collateral for a letter of credit issued on behalf of a Chapter 11 debtor to its suppliers to secure the debtor’s reimbursement obligation. Id. at 265. In essence, the noninsiders were “guaranteeing” the applicant’s reimbursement obligation by providing the collateral. Under the agreement, the issuer was entitled to use the collateral to satisfy the debt without first proceeding against the debtor. Id. at 265-66. When the issuer proceeded against the collateral after honoring the credit, the noninsiders claimed subrogation to the issuer’s rights against the debtor. Id. at 266. As the court noted:

Inasmuch as a surety is a primary obligor, there is no claim to which [the noninsider] could be subrogated. That [the noninsider] is a primary obligor to [the issuer] is made clear by the language of the Guaranty and Suretyship permitting [the issuer] to proceed against [the insider] without first attempting to collect from Debtors.

Id. at 267.

This outcome may be based on the traditional distinction drawn in some jurisdictions between a “suretyship arrangement” and a guaranty. A “surety” was seen as having a “primary” obligation to perform coequal to that of the obligor, whereas the guarantor’s obligation was “secondary.” See, e.g., Rhode Island Hospital Trust, 789 F.2d at 77 (“[Surety] is used in a narrow sense to indicate a direct, primary obligation to pay someone else’s debt, as distinguished from the secondary, collateral obligation of a ‘guarantor.’ ”). This distinction is eliminated under the Restatement of Suretyship.

\textsuperscript{76} See Restatement (Third) of Suretyship § 1 cmt. m, illus. 18-19 (Tent. Draft No. 1).
between the owner and the transferee, should be liable, the transferee's obligation is primary. If the owner made the payment upon such a demand, it would be entitled to be subrogated to both the mortgagee's rights against the transferee and the right to be subrogated to its mortgage, upon total satisfaction of the mortgage debt.

Similarly, an accommodation comaker of a note is obligated to pay a note holder even if the holder did not first seek recourse against the accommodated note maker; in this sense, the accommodation comaker is primarily liable. Nonetheless, as between the accommodation and accommodated comakers, the latter bears the ultimate obligation to pay, and thus the law recognizes that the accommodation comaker is entitled to subrogation under general equitable principles. Thus, the "temporal" notion of primary and secondary obligations should be irrelevant in determining whether the right of subrogation is available.

b. Direct Liability

A second possible use of the "primary-secondary" terminology is to demonstrate that the issuer is arguably "primarily liable" because it has a direct liability to the beneficiary, based on the letter of credit, and that no one else is liable on the same obligation. The issuer is thus paying "its" debt and not any debt arising from the underlying obligation. As one court stated:

[While the issuing bank in the letter of credit situation may be secondarily liable in a temporal sense, since its obligation to pay does not arise until after its customer fails to satisfy some obligation, it is satisfying its own absolute and primary obligation to make payment rather than satisfying an obligation of its customer.]

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77. U.C.C. § 3-419(b) (1990).
Again, this notion of "primary liability" should not preclude operation of the equitable doctrine of subrogation. First, even though the obligation of the issuer is based on the letter of credit, the payment itself may still satisfy an underlying obligation of its applicant, whether the letter is a standby letter of credit or a conventional commercial letter of credit. Thus, at the same time the issuer satisfies its own obligation, it is also satisfying the obligation of its applicant.

Second, a party that did not have a direct obligation to pay the creditor, or an obligation of its own, would run the risk that upon payment subrogation would be denied because the party acted as a mere volunteer. Indeed, the letter-of-credit obligation of the issuer is a clear demonstration that the issuer is under a duty to make the payment and is not acting as a volunteer, and hence should not be denied subrogation on that basis.

Third, in most traditional suretyship situations, in which the guarantor or surety enters into a contractual undertaking with the obligee, one can argue that the guarantor, in making payment, is also satisfying its own primary obligation to make payment. A surety that issues a bond to a beneficiary is primarily liable in this sense: its liability is based on an independent contractual undertaking running to the beneficiary, and no one else is liable on that basis.

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the customer's rights); In re Munzenrieder Corp., 58 B.R. 228, 231 (Bankr. M.D. Fla. 1986) (holding that the issuer has no direct or indirect interest in the discharge of the debtor's debt to the beneficiary).


81. On the other hand, where the plaintiff is not officious, and he uses his property or his property is used in discharging the obligation of another or a lien upon another's property, he is entitled to reimbursement and is entitled to the remedy of subrogation. He is not officious where he was under a duty to make the payment, as for example where he was a surety.

Restatement of Restitution § 162 cmt. b (citation omitted); see also In re Minnesota Kicks, Inc., 48 B.R. 93, 105 (Bankr. D. Minn. 1985) (holding that an applicant who had a reimbursement obligation to a letter-of-credit issuer was not acting as a volunteer and was entitled to subrogation to the beneficiary's rights against the debtor).
obligation. Yet, a surety is entitled to subrogation under the Restatement of Suretyship. Similarly, an insurance company is liable on the basis of a contractual undertaking to its insured—a contractual obligation for which no one else is liable—yet the insurer may be subrogated to the rights of its insured against third parties not privy to that undertaking. The Restatement of Suretyship recognizes that a suretyship obligation may arise contractually, in a contractual undertaking between the surety and the obligee to which the principal obligor is not privy or of which the principal obligor may be unaware. It similarly recognizes that the obligation of the surety may be different from the obligation of the debtor. To the extent that the secondary obligation arises by an independent contract and is different and even more onerous than the underlying obligation, the secondary obligor appears to have a direct liability for which no one else is liable. Thus, attempts to draw distinctions between letters of credit and other suretyship devices on this basis appear misguided.

\[c. \text{ Inapplicability of Defenses}\]

One could argue that the issuer is “primarily liable” in that its liability is not derivative of the applicant/customer’s liability, and therefore the issuer cannot take advantage of any defenses the applicant/customer/account debtor may have on the underlying obligation. As one court stated: “In the letter of credit context, the statement that the issuer’s obligation to honor a letter of credit is primary goes to the issue of whether the issuer can avoid its obliga-

82. The surety obligation was often labeled “primary” and independent. See, e.g., Rhode Island Hosp. Trust Nat’l Bank v. Ohio Casualty Ins. Co., 789 F.2d 74, 77 (1st Cir. 1986); supra note 75.
83. See supra note 41 and accompanying text.
84. See Restatement (Third) of Suretyship § 2(a) (Tent. Draft No. 1, 1992) (stating that a suretyship obligation may arise from a contract between the secondary obligor and the obligee); id. § 1(2)(d) & cmt. l (stating that the principal obligor does not need to know of the secondary obligation).
85. Id. § 1 cmts. j-k (stating that a secondary obligation need not be identical to the underlying obligation and may be more burdensome than the underlying obligation).
86. 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 on the ground that letters of credit differ from guaranties because, inter alia, “the guarantor can set up defenses which the principal has against a creditor, but an issuer may not assert the customer’s defenses against the beneficiary”).
tion by relying on underlying transaction defenses." As two noted commentators have stated:

[T]he guarantor can often set up defenses that the principal debtor has against the creditor. An issuer of a letter of credit cannot do so. In that sense the issuer's obligation to the beneficiary (the creditor) is said to be primary, i.e., not subject to the defenses the debtor might have against the creditor.

Using the "primary-secondary" distinction in this manner improperly imports it into the discussion of subrogation. Subrogation deals with situations in which one entity already has paid the debt of another and seeks to assert remedies its transferee may have had against another. On the other hand, the "primary-secondary" distinction is being used here in the prepayment period to determine what defenses, if any, an obligor may raise to its obligation to pay.

In this respect, the notion that the issuer is "primarily liable" is a somewhat misleading statement of the independence principle, that the issuer's liability is independent of the underlying obligation of the customer, and the issuer must therefore pay independent of any defenses to the underlying obligation. Yet the confusion of the two statements is a clue to the fear that confronts some letter-of-credit aficionados: if the obligation of an issuer is deemed "secondary" for purposes of permitting the issuer to be subrogated

89. See Valley Vue, 123 B.R. at 210 (noting that the requirement that a person seeking subrogation possess the right to assert defenses based on the underlying obligation is a "novel but nonsensical requirement in the subrogation context").
90. As one court explained:
It would appear, therefore, that the notion that an issuer's obligation to honor the letter of credit is a "primary obligation" should be interpreted to mean that, under the independence principle, the issuer may not avoid its obligation to honor the credit by identifying deficiencies in underlying contracts or by otherwise asserting defenses that are typically available to parties who are generally considered to be "secondarily liable" such as guarantors and sureties.

Id. at 206. For a discussion of the implication of the independence principle in the subrogation context, see infra part IV.E.
to the rights of the beneficiary against the applicant, then soon the obligation of the issuer will be deemed "secondary" for purposes of allowing the issuer to assert defenses that could have been asserted by the applicant. Thus, although the issuer's claim to subrogation may not, in and of itself, undermine the independence principle, some fear that allowing subrogation may open the door to subsequent attempts to abandon that principle.

There are instances in which guarantors—who would be given the right of subrogation—are unable to raise defenses which the principal obligor has to the underlying obligation. The guarantor of collection of a negotiable instrument, for example, is secondarily liable in the sense that it may be pursued only after default by, and action against, the maker of the instrument. Nonetheless, the guarantor of collection may not be able to raise any defenses arising from the underlying contractual obligation against a holder in due course of the instrument. Thus, the fact that the guarantor's obligation is "primary," in the sense that the guarantor must pay irrespective of any defense, does not destroy the otherwise "secondary" nature of the guarantor's obligation when subrogation is an issue.

Furthermore, the surety or guarantor's obligation to pay is independent of any defense to the underlying contract based on discharge in insolvency, voidability of the underlying obligation due to incapacity of the principal obligor, or release of the principal obligor (as long as the right of recourse is preserved). Most importantly, guarantors may, and frequently do, contractually waive any defenses the principal obligor has to the underlying contract. Indeed, a letter of credit may be viewed in the same manner as the guaranty of a negotiable instrument: because of the commercial nature of the instrument or credit, the guarantor or issuer has statutorily waived the right to raise certain defenses against the holder or beneficiary.

91. U.C.C. § 3-419(d) (1990).
94. Id. § 30(1)(b).
95. Id. § 30(1)(c).
96. See id. § 30(1) (stating that defenses are available unless "otherwise agreed").
d. Nonperformance of Underlying Obligation

The phrases “primary liability” and “secondary liability” have also been used to describe whether the issuer’s obligation to pay depends upon actual nonperformance of the underlying obligation. A typical passage appears in a leading treatise on letter-of-credit law: “The liability of the guarantor is secondary and arises upon nonperformance by the third party, the ‘principal obligor.’ The liability of the issuer under a credit is primary, not secondary, and it arises upon the presentation of documents, not on the nonperformance of a principal obligor.” Because the issuer must pay upon presentation of documents, “regardless” of the underlying obligation, some courts have viewed the payment on the credit as satisfying only the obligation of the issuer and not that of the debtor on the underlying obligation; thus, the issuer was paying a debt for which it was primarily liable.

As the passage above makes clear, the “primary-secondary” distinction is being invoked here to distinguish letters of credit from guaranties or surety relationships by focusing on what triggers the obligor’s obligation to pay. The language is used to describe the relationship of the parties in the prepayment period. In most in-

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97. See, e.g., Bank of Am. Nat'l Trust & Sav. Ass'n v. Kaiser Steel Corp. (In re Kaiser Steel Corp.), 89 B.R. 150, 153 (Bankr. D. Colo. 1988) (holding that the obligation of the guarantor cannot mature unless the principal debtor actually has defaulted, but that the actual facts were irrelevant to the obligation of the issuer).

98. JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT ¶ 2.1011 (2d ed. 1991). As two other authors observed:

Recovery under a guarantee is predicated upon the primary obligor’s nonperformance in fact of its guaranteed obligations. The guarantor is therefore only secondarily liable with respect to the same obligation of the primary obligor. Recovery under a standby letter of credit, on the other hand, requires only the presentation of the requisite documents (whether or not the applicant has in fact performed its obligations under the underlying agreement), and the issuer is primarily liable with respect to its obligations under the letter of credit (which obligations, needless to say, are different from those of the applicant under the underlying agreement).

Arnold & Bransilver, supra note 57, at 279-80 (citations omitted). The authors state elsewhere: “The engagement is a letter of credit if the issuer has a primary obligation that is dependent solely upon the presentation of conforming documents and not upon the factual performance or nonperformance by the applicant of its obligations under the underlying agreement.” Id. at 281.

99. See Kaiser Steel, 89 B.R. at 152.

100. Id.
stances, the "primary-secondary" distinction is used to determine initially which body of law applies to a specific undertaking: the letter-of-credit law or the law of guaranties or suretyship. Most often, the issue has been whether an issuer can raise defenses arising from the underlying contract. Nonetheless, the same distinction has served to deny subrogation in a letter-of-credit context. Yet, the focus of this analysis is prepayment, i.e., what triggers the issuer's payment obligation. Importing this analysis into the postpayment period without careful scrutiny is misleading.

The use of the "primary-secondary" distinction in this sense is merely a restatement of the independence principle in determining whether the obligation undertaken by the bank is that of an issuer under a letter of credit or that of a guarantor. If the undertaking is independent of the underlying transaction, the transaction is a letter of credit; if it is dependent upon the underlying transaction, the transaction thus qualifies as a guaranty.

More importantly, this use of the "primary-secondary" distinction focuses on the prehonor stage—the events that give rise to the issuer's obligation to pay—and does not deal with the posthonor stage at all. Such use does not answer the question of whether payment by the issuer, in addition to satisfying the issuer's letter-of-credit obligation, also satisfies the applicant's obligation on the underlying transaction. Nor does it answer the question of whether,

101. See Prudential Ins. Co. v. Marquette Nat'l Bank, 419 F. Supp. 734, 735 (D. Minn. 1976). Commentators have observed that the "primary-secondary" test is analogous to the test focusing on whether performance depends upon the presentation of documents or the existence of facts such as default, effectuating the same principle. Arnold & Bransilver, supra note 57, at 281 & n.32. Thus, an obligation is deemed to be "primary" and a letter of credit if the obligor undertakes to pay against the presentation of documents, independent of the underlying transaction. See Dolan, supra note 98, ¶ 1.05[2] (noting that some foreign banks issue "first-demand guarantees" which are functionally letters of credit).

102. Beach v. First Union Nat'l Bank (In re Carley Capital Group), 118 B.R. 982, 986 (Bankr. W.D. Wis.) (holding that a letter of credit was not a guaranty because the issuer's obligation to pay upon the presentation of complying documents is primary whereas the guarantor's obligation to pay upon the principal obligor's default is secondary), aff'd, 119 B.R. 646 (W.D. Wis. 1990).

once payment has been made to the beneficiary, the issuer or the applicant should carry the ultimate responsibility for the payment.

e. Issuer or Account Debtor

Last, determining who is “primarily liable” may refer to ascertaining who, as between the issuer and the account debtor (the person against whom subrogation is sought), is ultimately responsible for the debt. The Restatement of Suretyship uses the phrase “principal obligor” instead of “primary obligor” to refer to the one of the two people owing performance to the same obligee who has the duty to the other to perform the underlying obligation. The key is the relationship between the two obligors (in a letter-of-credit context, the issuer and the applicant), not the relationship between one of the obligors (the issuer) and the obligee (the beneficiary).

Under the law of subrogation, one frequently articulated requirement is that the payment by the subrogee (the person seeking subrogation) must have been used to satisfy a debt for which the subrogee was not primarily liable. This requirement has operated, for example, to deny subrogation for a partner’s payment of tax debts found to be part of the partner’s own obligations. An obligor may have an independent contractual obligation to the obligee based on a surety bond or guaranty, and in this sense the obligor’s undertaking is “primary.” If, however, as between that obligor and a second obligor, the second obligor has assumed an obligation to reimburse, such that the second obligor’s undertaking could be deemed “primary,” courts have allowed subrogation, even in the letter-of-credit context.

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107. O'Neal v. Stuart, 281 F. 715 (6th Cir. 1922) (allowing subrogation when, as between two makers of a note secured by the vendor's lien, one maker had agreed to be the principal obligor).
When the law of subrogation is considered, the key inquiry is whether the issuer or the applicant, i.e., the person seeking subrogation or the person against whom subrogation is sought, ultimately should be liable for paying the debt. As one court correctly noted in its discussion of a case that described the issuer's obligation as a "primary" obligation:

[The court] failed to distinguish between the primary liability of a debtor to its creditor to repay a loan and the primary obligation of the issuer to its beneficiary to honor a letter of credit. When a standby credit supporting a loan is honored, the issuer admittedly is satisfying its obligation as a primary obligor to honor the standby credit, but at the same time it is in fact satisfying a debt for which a person other than the issuer is primarily liable. This distinction, although not recognized by [the court], is critical. An issuer is not primarily liable on the debt supported by its standby credit.¹⁰⁹

This approach, which focuses not on the nature of the obligor's undertaking to the obligee, but on the relationship between the two obligors, is reinforced by the Bankruptcy Code's treatment of subrogation. Rather than using "primary-secondary" terminology, the Bankruptcy Code specifically provides that an entity may not be subrogated to the rights of a creditor if, "as between the debtor and such entity, such entity received the consideration for the claim held by such creditor."¹¹⁰ Under this provision, an entity that is ultimately liable on the debt cannot recover from a surety or codebtor.¹¹¹


2. Redefining “Primary-Secondary” Obligations by Reference to the Restatement of Security and the Restatement of Suretyship

The above discussion of the use of the “primary-secondary” dichotomy demonstrates that in the letter-of-credit context, claims that the issuer’s obligation is “primary” have focused on the pre-payment period. The thrust of those uses is 1) what triggers the payment obligation, and 2) what defenses to payment are available.

Subrogation, however, is a doctrine that applies after payment has been made. In this context, the terms “secondary” and “primary” take on a different meaning. In determining whether the obligation of the issuer is a “primary” obligation depriving the issuer of the ability to invoke the doctrine of subrogation, it seems appropriate to examine the application of the doctrine of subrogation—particularly the requirement that the “payment must satisfy a debt for which the codebtor was not primarily liable.”

The above-quoted statement recognizes, as it must, that one codebtor may be subrogated to the creditor’s rights against the other codebtor, even though codebtors are arguably jointly and severally liable in most situations. Under joint and several liability, the creditor may proceed against one of the codebtors for the whole without prior demand upon or default by the other codebtor. In this context, then, “primary” does not mean “payable prior to demand upon or default by the other party”.

What is meant by “primary” can be gleaned from the comments to the Restatement of Restitution, discussing circumstances under which a person will be denied subrogation because he acted officiously. For example, the Restatement says, “He is not officious where he was under a duty to make the payment, as for example where he was a surety.” Moreover, the Restatement’s discussion

112. Kaiser Steel, 89 B.R. at 152.
113. The Bankruptcy Code recognizes the right of subrogation in 11 U.S.C § 509; it allows a right of subrogation to “an entity that is liable with the debtor” on the claim. 11 U.S.C. § 509(a). The Restatement of Suretyship recognizes that in a codebtor situation, one person may be a principal obligor as to part of an obligation (and therefore have no right to subrogation) and a secondary obligor as to the other part (with a right of subrogation). RESTATEMENT (THIRD) OF SURETYSHIP § 1 cmt. n (Tent. Draft No. 1, 1992).
114. RESTATEMENT OF RESTITUTION § 162 cmt. b (1937).
of officiousness contains a cross-reference to its general rule on indemnity, which provides: “A person who, in whole or in part, has discharged a duty which is owed by him but which as between himself and another should have been discharged by the other, is entitled to indemnity from the other.”115 Thus, the key is not whether the person—here the issuer—is under an independent contractual duty to pay the beneficiary. Indeed, “[s]o far as the creditor is concerned, the surety may be the principal obligor.”116 Rather, the key is whether, as between that person and another such as the applicant, the other should be liable.

This is precisely the approach adopted by the Restatement of Suretyship. Under the Restatement, the terms “primary” and “secondary” do not refer to the order in which the obligors are approached for payment, whether the secondary obligor has a contractual obligation to pay the obligee, or whether the secondary obligor’s duty to pay is conditional upon default by the primary obligee. Rather, the dichotomy between “primary” and “secondary” liability is used to determine which of two obligors bears the ultimate responsibility for payment. The Restatement of Suretyship, in its requirements for establishment of suretyship status, therefore provides: “[A]s between the principal obligor and the secondary obligor, the principal obligor has a duty to perform the underlying obligation or bear the cost of performance.”117 Thus, when an owner of property encumbered by a mortgage transfers the property to a person who assumes the mortgage debt, a suretyship relationship arises.118 Even though the first owner of the property remains liable to the mortgagee under the original mortgage and the mortgagee may pursue the owner without prior demand upon the transferee, the original owner is deemed to be the secondary obligor in a surety relationship with the transferee/principal obligor and the creditor because, as between the original owner and the transferee, the transferee has the obligation to perform.119

That the issuer also has an obligation running directly to the beneficiary based on the letter of credit should not be determina-

115. Id. § 76.
116. Restatement of Security § 82 cmt. f (1941).
117. Restatement (Third) of Suretyship § 1(d) (Tent. Draft No. 1).
118. See id. § 1 illus. 20.
119. See id. § 2 cmts. e-f.
tive. In most situations, a surety or guarantor has an obligation to the creditor based on a contractual undertaking to which the principal obligor is not privy. No direct relationship between the principal obligor and the obligee is necessary;\textsuperscript{120} although the undertaking of the secondary obligor must be contractual,\textsuperscript{121} the contract itself is most often between the secondary obligor and the creditor.\textsuperscript{122} Moreover, the obligation of the surety or guarantor to the creditor may be different from the obligation of the principal obligor to the creditor.\textsuperscript{123}

In the letter-of-credit context, the general rule is that in the postpayment period, the applicant (and not the issuer) has the ultimate responsibility (or is “primarily liable”) and hence must reimburse the issuer for the amount of the draw.\textsuperscript{124} This is true whether or not the issuer had contractually obtained a reimbursement right from the applicant. This statutory recognition of a right to reimbursement is strong evidence that, as between an issuer and an applicant, the applicant bears the ultimate responsibility for paying whatever was owed to the beneficiary. Thus, “as between the principal obligor [applicant] and the secondary obligor [issuer], the principal obligor has a duty to perform the underlying obligation or bear the cost of performance.”\textsuperscript{125} The requirement of the Restatement is met.

\textsuperscript{120} See \textit{id.} § 1 cmt. m.
\textsuperscript{121} \textit{Id.} § 1(1)(b).
\textsuperscript{122} See \textit{id.} § 2(a).
\textsuperscript{123} For the Restatement of Suretyship to apply, the secondary obligee must “owe[ ] performance, in whole or in part, of the duty of the principal obligor to the obligee,” \textit{id.} § 1(1)(b)(1), or the obligee must have “recourse against the secondary obligor or its property” in the event of the principal’s default or to protect the obligee against the obligor’s nonperformance. \textit{Id.} § 1(1)(b)(2). The secondary obligation need not be identical, but may be of a different character or for a smaller amount “so long as the essential purpose of the secondary obligation is to protect the obligee against the actual or potential nonperformance of the underlying obligation by giving the obligee recourse against the secondary obligation.” \textit{Id.} § 1 cmt. j. It should be noted that a letter of credit, whether commercial or standby, could pass that test. The essential purpose of a standby letter of credit is to protect the beneficiary in the event of default by the customer, whereas the purpose of the commercial letter of credit is to shift the risk of the buyer’s creditworthiness from the seller/beneficiary to the issuer—in other words, to protect the beneficiary/obligee against potential nonperformance by the primary obligor.
\textsuperscript{124} This rule assumes, of course, that a complying presentation was made. U.C.C. § 5-114 (1990).
\textsuperscript{125} \textit{Restatement (Third) of Suretyship} § 1(d) (Tent. Draft No. 1).
E. Issuer's Obligation Under a Credit Is Independent of the Underlying Obligation of the Applicant

As demonstrated above, the key question in resolving the applicability of the doctrine of subrogation to letters of credit is not whether the obligation of the issuer is "primary" or "secondary," or whether a letter of credit is or is not similar to a guaranty. Rather, the issue is whether application of the doctrine of subrogation violates the independence principle.\textsuperscript{126} Several courts have denied subrogation rights in the letter-of-credit context, asserting that "an issuer of a letter of credit may not look to the underlying contract between its customer and the beneficiary of the letter of credit in connection with its duty to honor the letter of credit."\textsuperscript{127}

One court, in denying subrogation because it offended the independence principle, observed:

\begin{quote}
[T]he doctrines of guarantee and subrogation are not applicable to letter of credit transactions. In addition, extension of those doctrines to a transaction involving a letter of credit would seriously undermine the usefulness of the instrument without substantially advancing the equities of the transaction. The unique contribution of letters of credit to commercial transactions is the certainty and swiftness of payment and the limitation of administrative and legal expenses. These goals would not be obtained if parties to the transaction were permitted to invoke the law of guarantee and subrogation.\textsuperscript{128}
\end{quote}

\textsuperscript{126} Professor Kozolchyk, in examining the protection that should be afforded shareholders and depositors of banks issuing standby letters of credit, made the same observation:

The risks involved in standby issuance are not inherent in the use of the guaranty label or in the assumption of a "secondary" as opposed to a "primary" liability. Rather, risks arise in the bank's involvement with underlying transactions instead of with the payment of monetary promises susceptible to documentary verification by banking employees.

Kozolchyk, \textit{supra} note 65, at 344.


\textsuperscript{128} Carley Capital, 119 B.R. at 651.
The court was undoubtedly correct in its conclusion that application of some of the doctrines of guaranty—for example, allowing the issuer to raise defenses available on the underlying obligation as a defense to payment on the letter of credit or allowing the issuer to assert the right of exoneration—would undermine the usefulness of letters of credit. If an issuer were permitted to raise defenses beyond the noncompliance of the documents presented, the use of letters of credit as a means of “rapid payment, up front” would be defeated, eliminating the certainty and swiftness of payment that is their hallmark. Moreover, if an issuer were not only permitted to use such defenses but also required to determine compliance with the underlying agreement, administrative costs, and presumably legal costs as well when such cases proceeded to litigation, would increase. As a result, most of the scholarship and case law to date on the independence principle has been concerned with attempts to defer or defeat payment obligations on letters of credit by asserting defenses that could be asserted to the underlying obligation, such as fraud in or breach of the underlying agreement. Indeed, it is the fear that defenses on the underlying obligation will “percolate up” into the letter-of-credit transaction that undoubtedly accounts for much of the rhetoric attempting to distinguish letters of credit from guaranty obligations.

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. Suretyship defenses or defenses available to guarantors are asserted in the prepayment period. As

129. Jarvis, supra note 48, at 359.
131. This fear explains the negative references to guaranty law in Article 5 itself. See, e.g., U.C.C. § 5-101 official cmt. (1990) (“The other source of law respecting letters of credit is the law of contracts with occasional unfortunate excursions into the law of guaranty.”); id. § 5-103 official cmt. 3 (“The legal relations between the customer and the beneficiary turn on the underlying transaction between them. The issuer is not a guarantor of the performance of these underlying transactions.”).
such, they will defeat prompt and certain payment. Subrogation and reimbursement claims are asserted in the postpayment period; as such, they should not defeat prompt and certain payment. Indeed, Article 5 implies a right of reimbursement in favor of the issuer upon honor of the letter of credit, whether or not the issuer bargained for the right. True, the right to reimbursement merely requires the issuer to demonstrate that it complied with its obligations under the credit, whereas subrogation requires the issuer to prove what rights existed on the underlying obligation. An issuer may determine that it does not want to invoke any of the rights arising from the underlying obligation because of the difficulty and costs involved in bringing and prevailing upon such a claim. Whether to pursue those rights, however, should best be left to the issuer, absent a compelling reason for denying the issuer that right.

Some may fear that once subrogation is recognized, an issuer will attempt to assert rights obtained through subrogation to defend an action based on the letter of credit. This situation would occur, for example, if the issuer attempted to assert its applicant’s rights against the beneficiary by dishonoring the credit. Attempts to invoke defenses or claims based on the underlying obligation to justify nonpayment of the letter of credit, or to enjoin payment of the credit, have traditionally been condemned under letter-of-

132. The suretyship right of exoneration, however, is a right which operates in the prepayment period. The secondary obligor has the right to force the primary obligor to perform before performance is required by the secondary obligor. Restatement (Third) of Suretyship § 17(2) (Tent. Draft No. 1, 1992). Application of this right in the letter-of-credit context would defeat the independence principle. First, performance of the underlying obligation by the primary obligor will not necessarily release the issuer from its obligations on the letter of credit, which operates independently of the performance or nonperformance of the underlying obligation. Second, the net effect of the exercise of the right of exoneration is to delay performance by the secondary obligor pending performance by the principal obligor; such an effect would destroy the certainty of swift payment that is at the heart of letter-of-

133. U.C.C. § 5-114.
134. Id.
136. The issuer would claim that if it paid the letter of credit, it would be subrogated to the customer’s rights against the beneficiary. Because it would have those rights after payment, it should be able to assert them prior to payment as a defense or counterclaim to the beneficiary’s action based on the credit.
SURETYSHIP AND LETTERS OF CREDIT

There is little reason to believe that this basic rule would change if subrogation were allowed. Under the Restatement of Suretyship, the right to subrogation arises only upon payment; thus, no subrogation claim can be raised as a defense to the payment by the issuer. When an issuer claims to be subrogated to an applicant’s rights against the beneficiary, not by operation of law but by virtue of an assignment of those rights to the issuer, the same possibility exists that the issuer may assert these rights in an attempt to avoid payment on the letter of credit; yet, the law is clear that an issuer must honor the draft regardless of whether the goods conform to the underlying contract. An issuer may not refuse payment upon tender of conforming documents absent agreement to the contrary. The same result should follow if the issuer claims to be subrogated as a matter of equity. This result could, of course, be made even clearer and more explicit if such matters were dealt with in a restatement or statutory provision.

Alternatively, the issuer might attempt to argue that the beneficiary’s release of collateral to which the issuer would be subrogated discharges the issuer from its obligations on the credit. These results unquestionably would violate the independence principle, because again the claim would delay prompt payment on the credit. Such an outcome, however, does not necessarily or inevitably flow once subrogation is allowed. The Restatement of Suretyship recognizes waiver of suretyship defenses; such consent may

137. See U.C.C. § 5-114(1). For a more general discussion, see the authorities cited supra note 130.
138. In fact, a general principle of the equitable right of subrogation is that it does not arise until the entire debt is satisfied. Restatement (Third) of Suretyship § 23 (Tent. Draft No. 2) (providing that subrogation arises “[u]pon total satisfaction of the underlying obligation” and only “[t]o the extent that performance of the secondary obligation contributed to the satisfaction”); see also United States Fidelity & Guar. Co. v. United Penn Bank, 524 A.2d 958, 963 (Pa. Super. Ct.) (finding no right to subrogation until the surety has paid), allocatur denied, 536 A.2d 1333 (Pa. 1987). If the issuer has dishonored the letter of credit, its performance has in no way contributed to the satisfaction of the debt; if it has not honored the letter, its performance has not contributed to the satisfaction of the debt, nor has the debt been fully satisfied.
139. See U.C.C. § 5-114(1).
140. Id. §§ 5-106(2), -114(1).
141. See Restatement (Third) of Suretyship § 38 (Tent. Draft No. 2) (stating that impairment of collateral may discharge the secondary obligation).
142. Id. § 42.
be express or implied.\textsuperscript{143} The Restatement already lists some cir-
sumstances under which the law presumes a waiver; use of a letter of
credit easily could be added.

Nonetheless, some courts assert that allowing subrogation
"would violate the spirit and intent of the law developing under
Article 5 which prohibits an issuer from interfering with the
underlying contract."\textsuperscript{144} One court, applying the independence
principle, noted: "If a bank issues a letter of credit without first
securing funds from its customer, the beneficiary should not
be prejudiced by the bank's deliberate inaction or inadvertence."\textsuperscript{145}
Yet, if the beneficiary is paid in full as a result of the letter of
credit's being honored, and the issuer seeks subrogation to
the rights of the beneficiary against the applicant, it is difficult to see
how the beneficiary is prejudiced or the independence principle vi-
olated. The beneficiary has received payment in full and would not
be able to pursue these rights on its own. If the beneficiary has
been paid in full, and the issuer seeks subrogation to the rights of
the applicant against the beneficiary (e.g., for breach of the under-
lying obligation), the prejudice to the beneficiary is that the issuer,
rather than the applicant, is bringing suit. Indeed, in the latter sit-
uation, to deny subrogation would lead to unjust enrichment of the
beneficiary, who has been paid in full pursuant to the letter of
credit despite the beneficiary's failure to perform the underlying
contract.

As one court put it:

\begin{quote}
According to the independence principle each party is indepen-
dently liable. Absent some agreement to the contrary, a party in
a letter of credit transaction is not liable with any other party
on a claim. When [the issuer] paid [the beneficiary], [the
issuer] paid its own debt, not a debt of the Debtor. Subrogation
is not available to one who simply pays his own debt.\textsuperscript{146}
\end{quote}

\textsuperscript{143} Id. § 42 cmt. d.
\textsuperscript{144} Merchants Bank & Trust Co. v. Economic Enters., Inc. (In re Economic Enters.,
\textsuperscript{145} Id. (citing Data Gen. Corp. v. Citizens Nat'l Bank, 502 F Supp. 776, 788 (D. Conn.
1980)).
\textsuperscript{146} Berliner Handels-Und Frankfurter Bank v. East Tex. Steel Facilities, Inc. (In re
omitted).
What this court failed to recognize is that, as discussed above, a party may pay its own debt, and at the same time satisfy the debt of another. An insurance company which pays out on its fire insurance policy to its insured will be paying its own debt under the policy, but at the same time will be satisfying the debt that a third-party tortfeasor owes to the insured. A bonding company which pays out on a construction bond is paying out on a contractual obligation (the bond) on which no other party is liable; but in so doing, it is satisfying the debt of the insured to the beneficiary of the bond.

Thus, the independence principle does not mean that the obligations are completely and for all purposes independent. It means that the underlying contractual obligation has no effect upon the issuer's obligation on the letter of credit and that the issuer's obligation to pay on the credit is "independent" of the underlying transaction. Nor does it mean that the only rights and obligations are those existing between the issuer and the beneficiary, without any regard to any responsibility on the part of the applicant or any ability to claim rights based on the underlying transaction. Article 5 recognizes both the responsibilities of the applicant to the issuer and the possibility that the issuer may claim rights on the underlying obligation.

*Overseas Trading Corp. v. Irving Trust Corp.* was one of the first cases to hold that because the contract between a buyer and seller was completely independent of the letter-of-credit agreement between the buyer and the issuer, the doctrine of subrogation was inapplicable. *Overseas Trading* was not a case in which the issuer sought subrogation to the rights of the beneficiary against the applicant. Instead, the applicant sued the issuer, who had honored a draw on the letter of credit and recouped its advances from the applicant's funds, for wrongfully honoring the letter of credit. As one of its affirmative defenses, the issuer alleged that the applicant/buyer's failure to give notice to the beneficiary/seller of damage to the goods relieved the seller of its liability for breach of war-

148. *Id.* § 5-109 official cmt. 1.
149. 82 N.Y.S.2d 72 (Sup. Ct. 1948).
150. *Id.* at 73.
ranty and impaired the issuer's right of subrogation to the breach-of-warranty claim.\textsuperscript{151} The issuer did not raise this impairment of the right of subrogation as a defense to a claim of wrongful dishonor,\textsuperscript{152} but as a defense to the claim of wrongful honor. Either way, the applicant/buyer's actions with regard to the underlying commercial contract were used \textit{as a defense to} an action based on the letter-of-credit transaction. Thus, it was not the notion of subrogation per se that was objectionable and violated the independence principle.\textsuperscript{153} Instead, it was the use of an impairment-of-subrogation-rights theory to attempt to defeat an action based on the letter of credit. In essence, the issuer was saying, "I am released from my obligation to honor because the applicant impaired my right of subrogation."

As the court observed, even if the doctrine of subrogation were applied, the applicant/buyer's failure to assert its rights under the sales contract should have no bearing on an action based on the letter.\textsuperscript{154} This observation is consistent with the \textit{Restatement of Suretyship}, which provides that the obligee's impairment of collateral \textit{may} discharge the secondary obligor,\textsuperscript{155} but makes no similar provision in the event of acts by the principal obligor.

\begin{itemize}
\item \textsuperscript{151} \textit{Id.} at 76.
\item \textsuperscript{152} Were the claim of wrongful impairment of the right to subrogation raised in this context, the surety might argue that to the extent the impairment of the secondary obligor's right of subrogation resulted in a loss to the secondary obligor, the secondary obligor could raise this "suretyship defense" to the obligee's action. \textit{See Restatement (Third) of Suretyship} § 33(3)(e) (Tent. Draft No. 2, 1993). The defense would likewise fail, however, because the "impairing act" must have been an act by "the obligee, acting alone or in conjunction with the principal obligor or any other person." \textit{Restatement (Third) of Suretyship} § 33 (Prelim. Draft No. 2, 1992). Although Preliminary Draft No. 2 has since been superceded, I use its language here because it is more concise than the phrasing of subsequent drafts. In \textit{Overseas Trading}, the "impairing act" was that of the primary obligor, not the obligee; moreover it was raised not as a defense to a failure-to-honor claim, but as a defense to a claim of wrongful honor. \textit{See Overseas Trading}, 82 N.Y.S.2d at 74-75.
\item \textsuperscript{153} \textit{Overseas Trading}, 82 N.Y.S.2d at 76. The court apparently recognized the weakness of its position on the subrogation issue. Although it commented that "no principle of subrogation applies here," \textit{id.}, the court went on to say that "[e]ven if it did, this is not analogous to the situation which prevails in suretyship." \textit{Id.}
\item \textsuperscript{154} \textit{Id.} The court made an analogy to the insurer of goods stored in a warehouse, noting that failure by the owner of the goods to assert its rights against the warehouseman based on the contract of bailment is no defense to an action on the insurance policy. \textit{Id.}
\item \textsuperscript{155} \textit{Restatement (Third) of Suretyship} § 38 (Tent. Draft No. 2).
\end{itemize}
The case is nonetheless instructive about one of the fears that underlie the debate about subrogation in the letter-of-credit context: the fear that allowing subrogation will remove the wall between letters of credit and other suretyship devices, ultimately allowing other suretyship doctrines, such as the suretyship defenses, to be asserted as defenses to nonpayment in actions involving letters of credit. Whether that fear is justified is a matter of debate. Maintaining an artificial wall between letters of credit and other suretyship devices obviously discourages any such incursions. Yet Article 5 could recognize the subrogation doctrine and still make clear that the suretyship defenses will not be recognized, or that claims based on the right of subrogation cannot be raised in an action based on a letter of credit. Alternatively, the Restatement of Suretyship could provide that letters of credit are a type of suretyship device in which the rights against the principal obligor arising upon performance by the issuer accrue, but the suretyship defenses do not.

156. Under the Restatement, a secondary obligor has four main rights against the primary obligor: 1) the right of exoneration (the right to force the primary obligor to perform its duties), Restatement (Third) of Suretyship §§ 14(2)(a), 17 (Tent. Draft No. 1, 1992); 2) the right of reimbursement, Restatement (Third) of Suretyship §§ 18-21 (Tent. Draft No. 2); 3) the right of restitution, id. § 22; and 4) the right of subrogation, id. §§ 23-27. An issuer of a letter of credit already has a statutory right of reimbursement, U.C.C. § 5-114 (1990), and typically has a contractual right of reimbursement as well. Recognition of anything akin to a right of exoneration would clearly undermine a critical function of letters of credit: providing the beneficiary with a swift payment mechanism that does not require prior resort to the underlying commercial transaction. See supra text accompanying notes 128-31. The right of restitution is important only in those situations in which a secondary obligor does not have a right of reimbursement, see Restatement (Third) of Suretyship § 22 cmt. a (Tent. Draft No. 2); this claim to restitution may become important in a letter-of-credit context in which the issuer honors the letter of credit but loses its reimbursement right because it pays over on technically nonconforming documents. The more important remaining right in the letter-of-credit context, however, is the right of subrogation.

157. Other minor adjustments to general articulations of the subrogation doctrine arguably would be necessary if subrogation were applied in the letter-of-credit context. For example, under the Restatement of Suretyship, if the secondary obligor pays even though the primary obligor is not in default, it will be deemed subrogation. Restatement (Third) of Suretyship § 23 cmt. c (Tent. Draft No. 2). This rule, however, applies only if the liability of the secondary obligor was conditioned upon the actual default of the principal. Thus, in a letter-of-credit situation in which the obligation of the issuer (as secondary obligor) is to pay whether or not there is a default on the underlying obligation, the absence of default would not bar subrogation.
V Subrogation of Whom to Whose Rights Against Whom

The prior discussion focuses on the availability of subrogation in a letter-of-credit context and, principally, the claim of an issuer that it should be subrogated to the rights of the beneficiary against the applicant. Subrogation in a letter-of-credit context is much more complex, however. Many of the letter-of-credit subrogation cases are complicated by the courts' failure to distinguish which party is being subrogated to whose rights against whom, and their failure to identify the claimed implications of the right to subrogation. Ultimately, the determinations of whether the prerequisites of subrogation are met, whether the claimed subrogation violates any critical principles such as the independence doctrine, and whether equities favor subrogation may turn on such distinctions.

A. Subrogation of Issuer to Rights of Beneficiary

In a simple letter-of-credit transaction involving merely an applicant, an issuer, and a beneficiary, the subrogation issue arises when the issuer honors the draw and then claims to be subrogated to the beneficiary's rights against the applicant. When an issuer has honored a letter of credit, it has a statutory right of reimbursement against the applicant158 and often a contractual right of reimbursement as well. Nonetheless, at times the issuer may prefer to assert the beneficiary's claim against the applicant rather than its own; for example, the beneficiary's claim may be secured,159 the beneficiary's claim may be entitled to priority,160 or the beneficiary may have additional rights such as the seller's reclamation right against an insolvent buyer161 or a right to set off.162

158. U.C.C. § 5-114(3).
The current version of Article 5 of the Uniform Commercial Code does not address the ability to subrogate the issuer to the rights of the beneficiary. Yet, in many respects, this claim of subrogation appears on its face to satisfy the classic articulation of subrogation found in the Restatement of Restitution:

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 lienholder.

This general articulation of the doctrine has been refined in more specific situations. Thus, in the proposed Restatement of Suretyship, when by definition a surety or secondary obligor in satisfying the claim of the obligee discharges the debt owed by the principal obligor, the right of subrogation is given to the surety or secondary obligor. Many courts have espoused a five-part test which must be satisfied before the doctrine of subrogation may be invoked. Some of these courts have focused on the general articulation of equitable subrogation and found the requirements met in a letter-of-credit situation, while others have focused on the more specialized requirement in the five-prong test that the claimant “was not primarily liable on the debt” to deny subrogation.

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162. Sun Co. v. Slamans (In re Slamans), 148 B.R. 623 (Bankr. N.D. Okla. 1992) (allowing an issuer to be subrogated to a beneficiary’s right to offset amounts owed on credit card purchases).

163. Article 5 does mention in a comment the possibility of subrogation of the issuer to the customer’s rights against the beneficiary. See infra note 170 and accompanying text. That comment could be construed to imply that subrogation to the beneficiary’s rights is not permissible.

164. Restatement of Restitution § 162 (1937).


166. The elements of the test are: 1) the claimant paid the creditor to protect its own interests; 2) the claimant did not act as a volunteer; 3) the claimant was not primarily liable for the debt; 4) the entire debt has been satisfied; and 5) allowing subrogation would not cause injustice to the rights of others. See, e.g., Tudor Dev. Group, Inc. v. United States Fidelity & Guar. Co., 968 F.2d 357, 361 (3d Cir. 1992); United States Fidelity & Guar. Co. v. United Penn Bank, 574 A.2d 958, 963-64 (Pa. Super. Ct.), allocatur denied, 536 A.2d 1333 (Pa. 1987).

167. E.g., Tudor Development, 968 F.2d at 361.
It bears noting that the Uniform Commercial Code expressly recognizes subrogation in an analogous situation; an unreimbursed bank that has paid out over a stop order is subrogated to the rights of the payee against the customer in the underlying transaction.\textsuperscript{168} The right of subrogation is granted to prevent unjust enrichment whether the customer’s stop order and refusal to pay is wrongful or not.\textsuperscript{169}

B. Issuer Subrogation to Rights of Applicant Against Beneficiary

The only mention of subrogation in present Article 5 occurs in the Official Comments to section 5-109, which deal with an issuer’s obligation to its applicant. Noting that the issuer assumes no liability or responsibility for the underlying contract between the applicant and the beneficiary, the first comment observes: “The customer will normally have direct recourse against the beneficiary if performance fails, whereas the issuer will have such recourse only by assignment of or in a proper case subrogation to the rights of the customer.”\textsuperscript{170} Unfortunately, the comment does not elaborate on what circumstances might constitute a “proper case.” Assume, for example, that an issuer of a commercial letter of credit covering a shipment of goods honors a draft but fails to obtain reimbursement from its applicant because of the applicant’s intervening insolvency. The goods covered by the letter of credit turn out to be worthless. To allow the beneficiary to retain the proceeds of the letter of credit while shipping worthless goods would clearly result in the beneficiary’s unjust enrichment. Thus, allowing such an issuer to be subrogated to the applicant’s rights on the underlying contract may be one of those “proper cases” referred to in Article 5. This type of subrogation should be distinguished from attempts of the issuer to claim subrogation rights to moneys payable to the

\textsuperscript{168} U.C.C. § 4-407 (1990).
\textsuperscript{169} Similarly, U.C.C. § 2-506 grants a trade financer subrogation rights to the seller’s right to payment by the buyer.
\textsuperscript{170} U.C.C. § 5-109 official cmt. 1 (emphasis added).
applicant by a third party as a result of events unrelated to the letter-of-credit transaction.\textsuperscript{171}

\section*{C. Confirming Bank's Subrogation to Rights of Issuer}

Many letter-of-credit transactions involve more than three parties. A frequent additional party is the confirming bank, which engages to honor a letter of credit already issued by an issuer.\textsuperscript{172} Under Article 5, a confirming bank becomes liable on the letter of credit and acquires the rights of an issuer.\textsuperscript{173} When the confirmer rightfully honors the letter of credit but is not reimbursed by the issuer, the question arises whether it may claim subrogation to the rights of the issuer against the applicant, including any collateral given to the issuer to secure its right to reimbursement.

Unlike cases in which the claim is to subrogation based on the underlying contractual obligations, in this instance the confirmer's claim to subrogation is to rights granted in the letter-of-credit transaction itself. Thus, on the surface, such a transaction does not implicate the independence principle. The question is not whether a party to the letter-of-credit transaction can assert rights arising out of the underlying commercial transaction, but whether one party to the letter-of-credit transaction can assert the rights of another party arising out of the letter-of-credit transaction itself. Nonetheless, numerous reasons have been advanced for denying a right of subrogation in this context. In a recent study of Article 5, a task force of the American Bar Association, although not taking any position on the ultimate issue, advanced five such reasons: 1) it gives the confirmer the benefits but not the burdens of a relationship with the applicant; 2) it offends the notion of finality; 3) the confirmer does not rely on the applicant's credit and should not be able to resort to the applicant if the issuer becomes insolvent; 4) it rewards an imprudent confirmer that failed to bargain for contrac-

\textsuperscript{171} See Tudor Development, 968 F.2d 357, discussed supra note 60. Although the majority was undoubtedly correct that the issuer should be denied subrogation rights, it incorrectly did so on the ground that subrogation is unavailable to issuers of letters of credit, rather than on the ground that no subrogation rights exist to the applicant's rights against third parties.

\textsuperscript{172} U.C.C. § 5-103(1)(f).

\textsuperscript{173} Id. § 5-107(2).
tual rights against the applicant; and 5) permitting recovery to an imprudent payor brings about a result based on fortuity 174

Each of these reasons may be countered. First, the confirmer does have certain burdens, such as the obligation to honor the credit to the extent of its confirmation and the obligation to honor only presentations complying with the credit. Failure to satisfy those obligations will make the confirmer liable to the issuer and, presumably, to the applicant as well. Second, although one of the purposes of a letter of credit is to guarantee speedy payment of an obligation, the presence of a letter of credit is not a guaranty that a party unjustly enriched by the honor will not subsequently be held responsible. Third, in subrogation, the key issue is whether the person seeking subrogation satisfied the debt of the person to whose position it seeks subrogation, not whether the person seeking subrogation relied on the credit of the person to whom the debt or obligation was owed. Here, the person seeking subrogation (the confirmer) satisfied the debt of the issuer by paying the letter of credit and should now be permitted to exercise the rights of the issuer, whether or not it relied on the creditworthiness of the applicant. Fourth, the failure to bargain for contractual rights against the applicant should not be fatal; in most instances in which subrogation is granted (e.g., in the classic case of guarantors and sureties), it is equally possible to bargain for such rights, yet the failure to do so is not fatal to the subrogation claim. Last, denying subrogation would unjustly enrich the applicant; its debt to the beneficiary would be satisfied, yet its obligation to the issuer would be extinguished, all by the mere fortuity of the issuer's intervening insolvency 175

174. Task Force on the Study of U.C.C. Article 5, An Examination of U.C.C. Article 5 (Letters of Credit), 45 Bus. Law. 1521, 1582 (1990) [hereinafter Task Force Study]. Additional arguments against subrogation were raised (and dismissed) in In re Glade Springs, Inc., 47 B.R. 780 (Bankr. E.D. Tenn. 1985) (holding that the independence principle was violated; subrogation should not be allowed to displace the real agreement between parties; and a confirmer's obligation is an independent and contractual obligation, not a guaranty or surety obligation), aff'd sub nom. Chemical Bank v. Craig (In re Glade Springs, Inc.), 826 F.2d 440 (6th Cir. 1987).

175. See also Task Force Study, supra note 174, at 1582-83 (advancing other reasons in favor of subrogation).
In one case dealing with the confirmer's subrogation to the issuer's rights, the argument was raised that the confirmer's duty to honor the letter of credit was an independent and primary obligation and that no guaranty or suretyship relationship existed. The Sixth Circuit dismissed that argument, stating: "We need not address the question of whether the relationship between [confirmer] and [issuer] is a guaranty or surety arrangement since the Restatement [of Restitution] permits subrogation regardless of the precise nature of the obligation of the issuing bank to the confirming bank."

D. Subrogation of Applicant to Rights of Beneficiary Against Account Applicant

In the paradigm letter-of-credit transaction, there are three parties: the customer/applicant, the issuer, and the beneficiary. Yet in some instances, the person who applies for the letter of credit and obligates himself to reimburse the issuer (the applicant) is not the person for whose benefit the letter of credit is issued (the account debtor), who owes the underlying contractual obligation to the beneficiary. An agent may procure a letter of credit for one of its customers, for example, or a party lacking sufficient credentials to obtain a needed letter of credit may request another party to obtain the credit on its behalf.

In several such instances, applicants who have been called upon to reimburse the issuer honoring the letter of credit have in turn sought subrogation to the rights of the beneficiary against the account debtor. In effect, this scenario involves two levels of subrogation: subrogation of the applicant to the rights of the issuer and subrogation on behalf of the issuer to the rights of the beneficiary who had received security for its claim.

177. *Id.* at 441-42.
178. *Id.* at 442 n.4.
VI. The Article 5 Drafting Effort

The drafting of the Restatement of Suretyship has not been proceeding in isolation. In 1991, the sponsors of the Uniform Commercial Code, the National Conference of Commissioners on Uniform State Laws and the American Law Institute, established a drafting committee to undertake revisions to Article 5 of the Code which covers letters of credit. In the context of that effort, the applicability of subrogation and other suretyship concepts to letters of credit has received additional attention.

The latest draft of the Article 5 revision cautions, as do the earlier drafts, that it is "important to recognize the distinction between letters of credit and guarantees." The importance of the distinction, according to the comments, is that guarantors can raise as a defense to liability that the underlying debtor has been discharged or has no liability for other reasons, while the issuer's obligation is independent of the underlying obligation. Thus, the draft cautions against confusing guaranties or suretyship agreements with letters of credit and protects the swift payment mechanism that is the hallmark of the letter of credit.

What is noteworthy about these comments, however, is that they do not address principles applicable in the postpayment period. In the draft, the question of the right to subrogation in the letter-of-credit context was left uncovered, just as it had been left uncovered in the original version of Article 5. In the present instance, the failure to address subrogation cannot be attributed to the issue's lack of visibility, an explanation that might have been plausible fifty years ago. A suggested comment, however, noting

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181. Id. For the first time, the January draft gives explicit recognition to the independence principle as "a central part of letter of credit law." Id. § 5-102(d). What is noteworthy is the draft's articulation of the independence principle:

An issuer is not responsible for performance of the underlying contract or other related contract between an applicant and beneficiary. The duties of an issuer of a letter of credit are independent of the performance of those contracts. Unlike a guarantor, the issuer may not assert the defenses of its applicant against a beneficiary

Id.
182. Id.
that the issue of subrogation of a confirmer or any other person was left to other law, observes:

The independence principle is not inconsistent with the subrogation recovery of either a confirmer (in the case of failure of the issuer when the confirmer seeks to be subrogated to the issuer’s rights against the applicant) or of the issuer or applicant (when the issuer pays a beneficiary and the applicant or issuer seeks to be subrogated to the beneficiary’s security interest).\(^\text{183}\)

This, then, is the first “official” statement that subrogation might be appropriate in the letter-of-credit context, and it raises the question of why the matter needs to be left to other law. If, indeed, there is no inconsistency between subrogation and the independence principle, is it not time to recognize that in the black letter of Article 5 or the Restatement? Does this comment continue to leave to other law the question of whether the engagement of the issuer or confirmer is “primary”?\(^\text{183}\)

Ultimately, if Article 5 were to contain in its provisions (as opposed to its comments) an explicit acknowledgment of the right to subrogation, as it now contains an explicit acknowledgment of the right to reimbursement, the decision of the drafters of the Restatement to exclude letters of credit will be vindicated in practice, if not in theory. Indeed, the preferable course arguably is to cover subrogation and letters of credit in Article 5: it is a statute rather than a restatement and consequently is better able to change the results in states where the right to subrogation has been denied; Article 5 deals specifically with letters of credit and is the logical place to look for the rights of an issuer upon honor of the letter of credit; and Article 5 could develop specific provisions on the manner in which subrogation would be recognized in a letter-of-credit context. Letters of credit would remain governed by a statutory schema with minimal excursions into the “unfortunate world of guarantees.”\(^\text{184}\)

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183. Id. § 5-107 cmt. 3. The comment also endorses the position of Judge Becker in Tudor Development Group, Inc. v. United States Fidelity & Guaranty Co., 968 F.2d 357, 368 (3d Cir. 1992) (Becker, J., dissenting). Although the quoted comment addresses the rights of issuers, confirmers, and applicants, it appears in the section on confirmation.
The reality is that these letters of credit are being used interchangeably with guaranties and surety bonds. Indeed, given the ability of parties to adjust or modify the incidents of suretyship by contract, particularly the ability of a secondary obligor or guarantor to waive any defenses of the principal obligor to the underlying obligation as well as any suretyship defenses it may have, one possible way to view letters of credit is as a mere commercial form of guaranty, now subject to separate statutory treatment, for which, as a matter of trade usage (and later statutory formulation), a waiver-of-defenses clause is implied in every letter-of-credit transaction.

If issues such as subrogation were covered by Article 5, should letters of credit continue to be excluded from the Restatement of Suretyship? The mere fact that an issue is covered in a statutory provision does not preclude its coverage in a restatement as well. Contracts for the sale of goods are not excluded from the Restatement (Second) of Contracts merely because they are governed by Article 2 of the Uniform Commercial Code. Nor are suretyship devices such as accommodation notes excluded from the Restatement of Suretyship because they are governed by Article 3 of the Code. The failure of the Restatement of Suretyship to acknowledge the potential application of some of its provisions to letters of credit thus may be questionable in theory, rendering the Restatement less inclusive and comprehensive than might be desirable. The current status of the drafts of the Restatement and Article 5 are even less defensible: both avoid taking a definite stance and effectively

185. Restatement (Third) of Suretyship § 30 cmt. a (Tent. Draft No. 2, 1993) ("The secondary obligor is free to contract to be liable on the secondary obligation even when the principal obligor has a defense to the underlying obligation.").

186. Id. § 42. The term "suretyship defenses" refers to acts by the creditor or obligee (such as the discharge of the primary obligor, release of collateral, or modification of the debt) that change the secondary obligor's risks and potentially give rise to a claim of discharge. See id. Title B. Suretyship Defenses, introductory note; id. §§ 33-43.

187. Thus, one can view the independence principle as a statutory waiver-of-defenses clause. For many years, finance lessors included clauses in their leases under which the lessees waived any defenses or claims they might have had as a result of defects in delivery or in the goods leased. The new Article 2A, which for the first time formally recognizes finance leases, implies such a "hell or high water" waiver-of-defenses clause in every nonconsumer finance lease. U.C.C. § 2A-408 (1990). Similarly, the notion of strict compliance is a set of terms (agreed upon by the issuer and beneficiary, or implied by law) under which the guaranty is made.
relegate the matter to "other law." With only comments to guide them, courts confronted with subrogation issues in the letter-of-credit context will continue to struggle without the enlightened guidance of those knowledgeable in the field.