KEY POINTS

- There is no decided case in which payment by the issuer/guarantor (G) pursuant to its obligations under an on-demand guarantee or other autonomous instrument has been held to give G subrogation rights.
- Dicta in two authorities suggest that G may be entitled to be subrogated in the following circumstances:
  - the on-demand guarantee is provided by way of security for the obligation of one party (A) owed under an underlying commercial transaction to another (B); and
  - the amount of A's liability to B is later ascertained to be less than the payment received by B under the on-demand guarantee giving A a right to an account from Party B in respect of the overpayment; and
  - A fails or declines to take steps to recover the overpayment.

Feature

Author Cristin Toman

Overpayments by the guarantor in on-demand guarantees: is the guarantor entitled to subrogation?

In this article, the author considers to what extent a guarantor who has overpaid under an on-demand guarantee, is entitled to recover that overpayment directly from the borrower.

There appears to be no decided case in which payment under a documentary credit has been held to give rise to subrogation; and "The orthodox view seems to be that, since the bankers' undertaking involves a primary obligation, subrogation, which relates to the law regarding secondary obligations, has no place" see McCormack and Ward *Subrogation and Bankers' Autonomous Undertakings* (2000) LQR 121 referred to by Mr Justice Vos (as he then was) in the first instance judgment in *Ibrahim v Barclays Bank plc* [2011] EWHC 1897 (Ch); [2012] EWCA Civ 640.

Nonetheless, the two cases discussed in this article contain *obiter dicta* suggesting that the beneficiary of an on-demand guarantee may be entitled to subrogation in the following circumstances:

- where the on-demand guarantee is intended to provide a provisional remedy for default of the underlying contract; and
- payment under the on-demand guarantee results in an overpayment to the non-defaulting party; then
- the party in default of the underlying contract has a right independent of contract to recover the overpayment under the principle in *Cargill International SA v Bangladesh Sugar & Food Industries Corp* [1996] 2 Ll Rep 524; and
- the issuer of the on-demand guarantee may be entitled to be subrogated such right.

IIG CAPITAL LLC v VAN DER MERWE & ANR [2008] EWCA CIV 542

In *IIG Capital Llc v Van Der Merwe & Anr* [2008] EWCA Civ 542 the Van Der Merwes were directors of Hurst Parnell Imports and Exports Ltd (HPIE) and gave a guarantee in respect of HPIE's borrowings from IIG Capital LLC (IIG). IIG sought summary judgment on its claim against the Van Der Merwes under the guarantee. The Van Der Merwes sought to raise defences which would have been available to HPIE if a claim had been brought against it under the loan agreement. In particular they sought to argue that the sums demanded were not yet due from HPIE to IIG. The lower courts and the Court of Appeal all concluded that the guarantee was an "on demand" guarantee so that the Van Der Merwes were not entitled to raise defences which would have been available to HPIE. IIG was entitled to summary judgment. Lord Justice Waller with whom the other members of the Court of Appeal agreed, expressed the view that even though the Van Der Merwes had not contracted with HPIE for an indemnity, it was strongly arguable that the Van Der Merwes were entitled to an indemnity from HPIE. HPIE would be entitled to an account from IIG of any overpayment on the principle in *Cargill International SA v Bangladesh Sugar & Food Industries Corp* [1996] 2 Ll Rep 524. If HPIE refused to seek return of the overpayment from IIG, the guarantors would have a right of subrogation by which they could force IIG to pay back sums found to have been overpaid.

ST MAXIMUS SHIPPING CO LTD v AP MOLLER-MAERSK A/S [2014] EWHC 1643 (COMM)

In *St Maximus Shipping Co Ltd v AP Moller-Maersk A/S* [2014] EWHC 1643 (Comm) the Maersk Neuchatel ran aground. In the course of salvage operations, the vessel suffered bottom damage and the cargo owners became liable in general average. The defendant ("Maersk") provided the owners of the vessel ("the Owners") with a letter of undertaking by way of security for the cargo-owners' liabilities. Mr Justice Hamblen held that on its proper construction Maersk was obliged under the letter of undertaking to pay the sum ascertained to be due in a general average adjustment prepared by the Owners' loss adjuster ("the Adjustment") even though it might later be determined that the sums due from the cargo owners were more or less than the amount set out in the Adjustment. The judge expressed the view that if there was an overpayment, then Maersk could recover the overpayment from the Owners by taking an assignment from the cargo-owners of their rights against the Owners to an account in respect of any overpayment or if there was no assignment Maersk "might well have rights of or analogous to subrogation against the Owners".

DISCUSSION

If there is a right of subrogation in the circumstances suggested by the cases of *IIG*

Feature

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Capital LLC v Van Der Merwe and *St Maximus Shipping Co Ltd v AP Moller-Maersk* ("Van Der Merwe subrogation") then it does not fit neatly into the traditional categories of subrogation.

The term "subrogation" usually means one of two things: first it can refer to the situation where a claimant who makes a payment is treated as though rights have been transferred to it through payment, although the effect of payment was to extinguish those rights ("subrogation to extinguished rights"); or it can refer to the right of an indemnity insurer who has paid its insured in respect of an insured loss, to claim against the third party who is liable to compensate the insurer for the loss ("subrogation to subsisting rights"). The insured's rights against the third party have not been extinguished, but the insurer is entitled to take proceedings (usually in the name of the insured) and to benefit from the judgment obtained in such proceedings, to prevent the insured making double recovery.

Van der Merwe subrogation differs from traditional "subrogation to extinguished rights", it does not involve the issuer (G) being treated as having acquired rights (through payment) belonging to the beneficiary (B): rather G would be treated as having rights *against* B, to recover the overpayment. Van de Merwe subrogation is possibly more analogous to "subrogation to subsisting rights". The authors of *Goff & Jones The Law of Unjust Enrichment* paras 21-01 to 21-04 describe the circumstances in which such a claim arises as follows:

> "It often happens that an insured suffers a loss in respect of which he has two claims: one against an indemnity insurer and one against a third party. In these circumstances he can generally choose which claim to pursue first. If he claims against the insurer, then the insurer must pay him to the full extent of its liability, and may not object that he should first have exhausted his rights against the third party …where the insured's rights against the third party subsist despite the insurer's payment, the insurer may be entitled to take over the insured's rights of action and to insist that the insured lends his name to proceedings to enforce these for the insurer's benefit."

In *Van Der Merwes* subrogation, A (applicant) has a right against B (beneficiary) under the *Cargill* principle to reimbursement in the event that payment by G (issuer) results in B being over-paid. This right subsists after payment by G to B. A then has a choice whether to pursue B or to do nothing. If A will be unable to reimburse G except out of the proceeds of a claim against B then by doing nothing A will leave the loss to fall on G. A's choice is broadly analogous to the choice of the insured whether to claim from the third party or from the insurer in the Goff & Jones example. In the event that A leaves the loss to fall on G, then like the insurer in the Goff & Jones example, G may be entitled to take over A's rights.

The idea that the subrogation arises only after A has elected to leave the loss to fall on G is consistent with Lord Justice Waller's view (with whom the other members of the Court of Appeal Agreed) at para 27 of his judgment in *Van der Merwe* that the right of subrogation would arise if HPIE failed to pursue the lender in that case for re-imbursement. In *St Maximus Shipping Co Ltd v AP Moller-Maersk* Mr Justice Hamblen did not expressly state that the cargo-owners' refusal to assign their rights to Maersk (or pursue those rights themselves) would be a pre-condition of Maersk's subrogation, but he heard evidence that such assignments were rarely obtained.

Van der Merwe subrogation appears inconsistent with the autonomy principle. In the context of on-demand guarantees it has been said that the "well-understood and long-hallowed approach is that the guarantee is intended to be an autonomous contract, independent of disputes between the seller and the buyer as to their relative entitlements pursuant to the different contract between themselves" *Wuhan Guoyu Logistics Group Co Ltd & Anor v Emporiki Bank of Greece* [2013] EWCA Civ 1679 per Tomlinson J. In that case the issuing bank argued that sums paid by it (to an escrow account) under an on-demand guarantee were held on trust for the bank, because by the time payment was made it had been conclusively determined that the sums secured by the on-demand guarantee had not fallen due. The Court of Appeal rejected the bank's argument. The autonomy principle was "completely inimical to the implication of a trust impressed upon the moneys in the Seller's hands by reason of circumstances arising after accrual of the Seller's completed cause of action under the guarantee". Similarly, in *Uzinterimpex JSC v Standard Bank plc* [2008] EWCA Civ 819 the Court of Appeal refused to imply into an on-demand guarantee a term to the effect that the issuing bank would be entitled to repayment of sums paid under the guarantee to the extent that payment under the guarantee resulted in the beneficiary receiving more than it was entitled to under the underlying contract.

Van der Merwe subrogation would enable the issuer of an on-demand guarantee to achieve by a circuitous route a similar outcome to those contended for by the banks and rejected by the Court of Appeal in *Wuhan Guoyu* and *Uzinterimpex*.

CONCLUSION

Van der Merwe subrogation, if recognised by the Courts could provide G (issuer) with a valuable remedy in circumstances where A (applicant) is not able to reimburse G, and has failed to pursue a *Cargill* type claim for reimbursement from B (beneficiary). But it is unclear what the precise extent of the rights to which G might be entitled by *Van der Merwe* subrogation might be; would, for example, G be entitled to retain the whole of the proceeds of its subrogated claim against B in the event of A's insolvency, or would the proceeds have to be shared with the general creditors?

There is no reported case in which a claim for *Van der Merwe* subrogation has been considered. And its apparent conflict with the autonomy principle may give the Courts good reason not to recognise it.

It follows that there is considerable uncertainty as to: (i) whether the Courts will recognise *Van der Merwe* subrogation; and (ii) the scope of its operation. ■

Further Reading:

- Devil in the detail: messages from recent guarantee cases [2008] 3 JIBFL 128.
- Guarantees and performance bonds: problems of drafting and interpretation [2013] 10 JIBFL 614.
- LexisNexis Loan Ranger blog: Demand guarantees – the consideration dilemma.