INTERNATIONAL JOURNAL OF ADVANCE RESEARCH AND DEVELOPMENT

(Volume3, Issue8)

Available online at: www.ijarnd.com

Doctrine of subrogation and its uses in contract of guarantee

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ABSTRACT

This research includes the aspects related to the subrogation and its uses in the contract of guarantee. This research widens the topic form its origin to its uses in the contract of guarantee and contract of indemnity. Subrogation is the right of the surety to get back his money from the principal debtor.

Keywords— *Subrogation, Gaurantee, Surety*

1. INTRODUCTION OF THE TOPIC

Subrogation is the legal doctrine whereby one person takes over the rights or remedies of a creditor against his/her debtor. Rights of subrogation can arise in two different ways: either automatically as a matter of law, or by agreement as a part of the contract. Subrogation by contract most commonly arises in the contract of insurance. Subrogation as a matter of law is an equitable doctrine and forms part of a wider body of law known as unjust enrichment [1]. The two most common areas where subrogation is relevant are insurance and sureties. In each case, the basic premise is that where one person makes a payment on an obligation which, in law, is the primary responsibility of another party, the person making the payment is subrogated to the claims of the person to whom they made the payment with respect to any claims or remedies which are exercisable against the primarily responsible party [2].

For example, if a car owner has collision instance on their car and the car is damaged by a negligently third party, if the car owner elects to claim under his insurance policy, then any claims which the car owner had against the negligent party will pass to the insurance company in jurisdictions which recognise the doctrine.

Similarly, if a father guarantees the debts of his son to the bank, and the bank elects to call upon the guarantee rather than claiming against the son directly, then if the father pays out on the guarantee, he will become subrogated to the bank's claims against the son. The doctrine of subrogation can also pass proprietary rights, i.e. a security interest or claim to the ownership of the goods.

If a guarantee is paid out by a guarantor, but the bank also held a mortgage over the debtor's home, then the guarantor will be subrogated to the bank's rights as a mortgagee with respect of the debtor's home. In the most common areas where subrogation arises as a matter of law, it will also commonly be regulated in the terms of the relevant contract. Subrogation is sometimes misunderstood by lay people and criticised the basis that payment under an insurance claim is simply a right based upon their payments of insurance premiums and a belief that they should also retain a right to exercise any claims arising from the insured event.

2. ORIGIN

The term subrogation is derived from the Latin word sub (under) and rogare (to ask). The denotative sense has been transmuted from an asking, under the substitution or succession with respect to the right of payment. The origin and nature of the right of subrogation, was laid down in **Morgan v Seymore** where it was held that a surety who has performed the obligations of the principal which are the subject of his guarantee is entitled **to stand in the shoes of the creditor** and to enjoy all the rights that the creditor had against the principal. This is an equitable right. It is a right that arises out of the relationship between of surety and creditor itself.

3. MEANING AND DEFINITION

The universal dictionary provides that, the substitution of one person for another especially for one creditor for another.
"Subrogation simply means substitution of one person for another, i.e. one person is allowed to stand in the shoe of another and asserts that person's rights against the defendant. Factually, the case arises because, for some justifiable reasons, the subrogation plaintiff has paid a debt owed by the defendant." [3]

The doctrine of subrogation confers upon the insurer the right to receive the benefit of such rights and remedies as the assured has against third parties in regard to the loss to the extent that the insurer has indemnified the loss and made it good. The insurer is,

therefore, entitled to exercise whatever rights the assured possesses to recover to that extent compensation for the loss, but it must do so in the name of the assured.

Subrogation as defined under marine insurance act, 1963
The right of Subrogation' is statutorily recognized and described in section 79 of the Marine Insurance Act, 1963 as follows:

- *Where the insurer pays for a total loss, either of the whole, or in the case of goods of any apportion able part, of the subject-matter insured, he thereupon becomes entitled to take over the interest of the assured in whatever may remain of the subject-matter so paid for, and he is thereby subrogated to all the rights and remedies of the assured in and in respect of that subject-matter as from the time of the casualty causing the loss.*
- *Subject to the foregoing provisions, where the insurer pays for a partial loss, he acquires no title to the subject matter insured, or such part of it as may remain, but he is thereupon subrogated to all rights and remedies of the assured and in respect of the subject 1 matter insured as from the time of the casualty causing the loss, in so far as the assured has been indemnified, according to this Act, by such payment for the loss".*

Statutory provision for subrogation under Indian Contract Act, 1872
Section 140, of the Contract Act, 1872 deals with the principle of subrogation with reference to rights of a surety/guarantor. It says:
"140. Rights of surety on payment or performance: where the guaranteed debt has become due, or default of the principal- debtor to perform a guaranteed duty has been taken place, the surety, upon payment or performance of all that is liable for, is invested with all the rights which the creditor had against the principal- debtor."

4. HOW THIS RIGHT OF SUBROGATION ARISES
As already indicated, the right of subrogation arises in the following:
4.1 Under tort
This is a wrongdoing to another. A person cannot be wrong with another there causing damage to another's property of inflicting injury on the person of that another [4]. If it is so done then a right of action accrues in favor of the wronged and to the determent of the wrongdoer.

4.2 Under Contract
A contract may put some obligation on the person making a breach of contract to compensate the person who has been aggrieved as a result of the breach. For example Obligation under the contract of affreightment and contract of bailment etc.

4.3 Under statue
Statues may also create liability, for making compensation, arising out of a breach thereof. For Examples: Factories Act, Occupies Liability Act, Carriage of goods by Sea Act, etc.

5. TYPES OF SUBROGATION
Subrogation is considered as an equitable remedy and is subjected to all the limitations that apply to equitable remedies. Subrogation is considered to be a highly technical area of the law. Although the classes of subrogation rights are not fixed and vary between different legal jurisdictions, types of subrogation are commonly divided into the following categories:

- Indemnity insurance's subrogation rights
- Surety's subrogation rights
- Subrogation rights of the business creditors
- Lender's subrogation rights
- Banker's subrogation rights
- Trustee's subrogation rights

Although the various fields have the same conceptual underpinnings, there are subtle distinctions between them in relation to the application f the law of subrogation.

5.1 Indemnity insurance rights
With insurance subrogation, there are three parties involved: the insurer; the insured; and the tortfeasor. Under subrogation, the insurance company assumes the right to sue the tortfeasor for the amount of the damages reimbursed to the insured. An indemnity insurer has two distinct types of subrogation rights [5]. Firstly, they have the classic type of subrogation; viz. the insurer is entitled to take over the remedies of the insured against another party in order to recover the sums paid out by the insured and by which the insured would otherwise be overcompensated. Secondly, the insurer is entitled to recover from the insured up to the amount which the insurer has paid to the insured and by which the insured is overcompensated.

5.2 Surety's subrogation rights
A surety who pays of debt of another party is subrogated to the creditor's former claims and remedies against the debtor to recover the sum paid. This would include the endorser on a bill of exchange. In relation to the surety's subrogation rights, the surety will also have the benefit of any security interest in favor of the creditor for the original debt. Conceptually this is an important point, as the subrogate will take the subrogor's security rights by operation of law, even if the subrogee had been unaware of them. Accordingly, in this area of the law at least, it is conceptually improbable that the right of subrogation is based upon any implied term [6].

5.3 Subrogation rights against trustees

A trustee of a trust who enters into transactions for the benefit of the beneficiaries of the trust is generally entitled to be indemnified by the beneficiaries for personal loss incurred and has a lien over the trust assets to secure compensation. If, for example, the trustee conducts business on behalf of the trust and fails to pay creditors, then the creditors are entitled to be subrogated to the personal and proprietary remedies of the trustee against the beneficiaries and the trust fund. Where under the terms of the trust instrument the trustees are permitted to trade in derivatives as part of the trust‘s investment strategy, then the derivatives document will also normally contain a subrogation clause to bolster the common law rights [7].

5.4 Lender’s subrogation rights

Where the lender lends money to the borrower to discharge the borrower's debt to a third party, the lender is subrogated to the third party’s former remedies against the borrower to the extent of the debt discharge. However, if the original loan was invalid then the lender generally cannot enforce the third party’s claim against the borrower as this would indirectly validate an invalid loan. Nonetheless, the claim can subsist insofar as the unlawfully borrowed money was used to discharge lawful debts, by inferring the legality of the use of the funds to the right of subrogation. The law in this area has been subject to conflicting decisions.

5.5 Banker’s subrogation rights

Where a bank, acting on what it believes erroneously to be the valid mandate of its client, pays money to a third party which discharges the customer’s liability to the third party, the bank is subrogated to the third party, the bank is subrogated to the third party’s former remedies against the customer.

6. USES OF SUBROGATION UNDER GUARANTEE

The right extends to all securities which the bank has received from its customer before, contemporaneously with, or after the execution of the guarantee, and it is immaterial whether or not the guarantor knew of their existence at the time when he signed the guarantee [8].

A guarantor who pays off the whole debt is entitled, not only to securities deposited by the customer but also to those deposited by third parties. This is what right of subrogation is under English Law [9].

In India, the right of subrogation has been enunciated in Sections 140 and 141 of the Indian Contract Act, 1872.

When the surety has paid all that he is liable for he is invested with all the rights which the creditor had against the principal debtor. The surety steps into the shoes of the creditor. The creditor had the right to sue the principal debtor. The surety may, therefore, sue the principal debtor in the rights of the creditor.

The Supreme Court has laid down in **Amrit Lai Goverdhan Lalan v State Bank of Travancore [10]** that the surety will be entitled to every remedy which the creditor had against the principal debtor; to enforce every security and all means of payment; to stand in the place of the creditor; to have the securities transferred to him, though there was no stipulation for that; and to avail himself of all those securities against the debtor. This right of surety stands not merely upon contract, but also upon natural justice. The language of Section 140 which employs the words "is invested with all the rights which the creditor had against the principal debtor" makes it plain that even "without the necessity of transfer, the law vests those rights in the surety".

It was decided by the Bombay High Court in **State Bank of India v Fravina Dyes Intermediate [11]** that the guarantor by invoking the doctrine of subrogation can apply for a temporary injunction against the debtor even before making payment to the creditor if he apprehends that the debtor threatens or is about to remove or dispose of his property with intent to defraud the creditor. That is, the guarantor is entitled to a grant of Quia Timet injunction against the principal debtor under certain circumstances.

Section 141 of the Indian Contract Act, 1872 reads as under:
"Surety’s right to benefit of creditor’s security A surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of suretyship is entitled into, whether the surely knows of the existence of such security or not; and if the creditor loses, or, without the consent of the surety, parts with such security, the surety is discharged to the extent of the value of the security".

It was held by the Supreme Court in **State of M.P. v Kaluram [12]** that the term "Security" in Section 141 is not used in any technical sense; it includes all rights which the creditor had against the property of the principal at the date of the contract.

The difference between the English Law and the principle laid down in Sec 141 was explained by the Supreme Court in **Amrit Lai Goverdhan Lalan v State Bank of Travancore [13]** as under: "It is true that Section 141 has limited the surety’s right to securities held by the creditor at the date of his becoming his surety and has modified the English rule that the surety is entitled to the securities given to the creditor both before and after the contract of guarantee. But subject to this variation, Section 141 incorporates the rule of English Law relating to discharge from liability of a surety when the creditor parts with or loses the security held by him".

In **Bank of India v Yogeshwar Kant Wadhera [14]**, the Punjab and Haryana High Court held that where the delivery of goods is not given to the creditors as in the case of hypothecation (bank), the surety was not entitled to claim the protection of Section 141 of the Indian Contract Act, 1872.

As in hypothecation, the possession of the goods is with the borrower, it will be wrong to say that the goods are in constructive possession of the creditor - bank because it has no effective control over them [15]. By hypothecation, only an equitable charge is created and nothing more and therefore the Section 141 is not applicable to hypothecation.

7. CONCLUSION

In conclusion, when considering the applicability of the equitable principles of subrogation, it is critical to look carefully at the manner in which the insured party is reimbursed for the loss suffered. The existence or otherwise of rights of subrogation may significantly affect the profile of a given exposure, particularly in relation to large and complex risks involving multiple insured. Underwriters should, therefore, take account of this factor in their assessment or the risk prior to binding cover.

The party taking control of proceedings after a loss has occurred will need to take care in respect of any settlement, to ensure that it complies with its duty of good faith. The settlement will need to be consistent with legal advice as to the merits of the overall claim. Where a subrogated claim includes losses which are not covered under the policy, there remains some uncertainty as to who is entitled to control the proceedings and how the proceeds of any recovery should be distributed between them. The rights provided by the law provides all the securities to the surety so that they can get their claim in full amount.

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