**Effect of the Instrument on the Underlying Obligation**

Welcome to this podcast on the Effect of the Instrument on the Underlying Obligation brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is the relationship between the liability that parties have on an underlying contractual obligation and an instrument that is taken as payment for the same obligation, including using an instrument to achieve an accord and satisfaction as to a contractual dispute. For example, an individual enters into a contract for a large item such as a car and takes out a loan for payment, signing a promissory note. Similarly, an individual might contract to purchase routine goods and services, but be dissatisfied with the performance and want to write a check for an amount less than the total owed as an accord and satisfaction of the dispute. The rules of §§ 3-310-311 set forth when the payee can enforce the underlying obligation and when we can achieve accord and satisfaction using an instrument. You should carefully read these sections.

Let’s look at the relationship between an underlying obligation and an instrument generally. The rules of contract create an obligation of parties to perform, but when a party issues an instrument, it incurs a separate liability from the underlying obligation. When the payee accepts an instrument as payment on an underlying obligation, it seems unfair to allow the payee to also enforce the underlying obligation. Imagine you go to the grocery store and write a check as payment. It would seem odd if the grocery store, rather than cashing the check, appeared at your doorstep the next day and demanded cash. If you didn’t pay the cash, the grocery store might sue you for payment. On the other hand, the grocery store has not yet cashed the check and obtained cash payment for the groceries, so it would not seem correct to discharge your obligation to the grocery store either. While most checks are accepted by the drawee bank and paid, what if the check you wrote to the grocery store was dishonored when the grocery store presented it for payment?

Section 3-310 divides this problem into two types: (i) near cash items, such as certified checks; and (ii) ordinary instruments, such as notes and uncertified checks.

Let’s look at near cash items first. If a payee takes a certified check, cashier’s check or teller’s check for an obligation, the obligation is simply discharged as if the obligor had paid the same amount in cash. Due to the bank’s obligation to pay on these types of items, most parties that accept these instruments as payment consider it final. The risk for them would be if the bank itself became insolvent, much more remote than a check being dishonored. For example, if I contract to purchase a piece of real estate and the seller accepts a certified check as payment, the obligation on the underlying real estate contract is discharged, unless we have agreed otherwise.

Let’s look at ordinary instruments now. Because there’s more uncertainty on ordinary instruments than those that are near cash, the underlying obligation is not discharged. Instead, it is suspended as if the obligor had paid the same amount in cash. The primary difference here is being suspended, rather than discharged. In the case of an uncertified check, the suspension continues until the check is in the dishonored, paid or certified. If the check is paid or certified, then the obligation is discharged. If the check is dishonored, though, the suspension of the underlying obligation no longer continues. In such cases, the obligee can enforce the obligation, or if they are a PETE, can enforce the instrument. PETE of course being a person entitled to enforce the instrument under Article 3.

Presume I agree to purchase eyeglasses for my son, Leeland, from Lens Mate for $400. Lens Mate accepts a $400 check as payment. My obligation to pay Lens Mate the $400 for the glasses is suspended upon receipt of the check. Once the check is paid, then my contractual obligation is discharged. In the event that I don’t have enough money and the check is dishonored, though, that suspension is lifted and I have an obligation to pay the $400. Lens Mate can enforce the contractual obligation (using contract remedies) or bring suit on the check, if they are a PETE (using the liability of a drawer on a check).

The rules regarding promissory notes are similar. Once taken as payment, the suspension of the obligation continues until dishonor of the note or until it’s paid. Payment, like with a check, results in discharge of the obligation. Presume I contract to buy a car from Euro Sport, which accepts a promissory note for $40,000 to pay for the car. Euro Sport cannot also ask me for the cash for the car, because the underlying obligation is suspended. Moreover, once the note is paid, the obligation is discharged. If I fail to pay the note, however, the suspension is lifted, and Euro Sport can enforce the contractual obligation to pay for the car (using contract remedies) or it can bring suit on the note if they are a PETE (using the liability of an issuer of a note).

Let’s turn to the use of instruments to achieve an accord and satisfaction of the contract dispute. Section 3-311 provides a pathway for an informal method of dispute resolution using the issuance of an instrument. Sometimes you see this issue in a multistate bar examination question, so pay careful attention here. The rule is as stated as follows: if a person in good faith tenders an instrument to a claimant as full satisfaction of the claim where the amount of the claim is unliquidated or subject to dispute and the claimant received payment on the instrument then the claim is discharged so long as there was a written communication with a conspicuous statement to the effect of the instrument was tendered in full satisfaction of the dispute. Here there are three requirements for application of § 3-311: (1) good faith; (2) unliquidated or bona fide dispute; and (3) the claimant obtained payment on the instrument.

A simple example is in order. Presume I enter into a contract with an electrician to install an outlet in my garage for my new electric car at a price of $450. The electrician while performing the work damages the wall in the garage. When he submits the bill to me for payment, I tender a check to him for $300 with a statement on the check in all caps IN FULL SATISFACTION. The electrician takes the check and cashes it. The cashing of the check is deemed to be an acceptance of the proposed settlement of the dispute concerning the damage to my garage wall. As such, the electrician cannot bring suit against me on the underlying obligation. The result will be the same as if the electrician cashed the check UNDER PROTEST. The electrician simply has a choice to either accept the check in full satisfaction or to refuse it.

There are limitations to this rule. First, when it comes to organizations, if the organization has sent a conspicuous statement requiring communications to be sent to a designated person or office then an instrument tendered as an accord and satisfaction must be sent to that designated person, office, or place. Second, whether or not the claimant is an organization, the claimant can tender repayment of the amount of the instrument within 90 days after payment.

In our earlier example with the electrician, presume that the electrician cashed the check. The electrician would have 90 days after payment to retender the $300 back to me to essentially avoid an accord and satisfaction. Sometimes this will happen because a payee cashes the check inadvertently.

Let’s look at another example. Friendly Motor Company sends a letter to all borrowers requiring communications regarding undisputed debts to be sent to Felicia Friendly. Sam Sneak has a lawyer friend who told him the rule of § 3-311 and sent a check for one dollar to the PO Box where he makes his monthly payments on his European sports car, with the check marked in largeboldface type **PAYMENT IN FULL**. Sam would have several problems asserting an accord and satisfaction here, as his actions do not seem to be made in good faith and with a bona fide dispute concerning the car. Additionally, Friendly Motor Company sent a letter requiring these types of communications from borrowers to be sent to Felicia Friendly. Accordingly, Sam has not achieved an accord and satisfaction here.

At this point, you should be able to describe the effect on the underlying obligation when an obligee takes an instrument as payment. Additionally, you should be able to identify when there is an accord and satisfaction obtained by using an instrument.

I hope you’ve enjoyed this podcast on the Effect of the Instrument on the Underlying Obligation.

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