MANAGING PAYMENT DISPUTES IN LOCKBOX COLLECTION OPERATIONS

Gary P. Hunt, Esq. Tucker Arensberg Attorneys

Major banks receive and process more than 10 million checks each month on behalf of wholesale and retail lockbox clients. While most of those checks represent a straightforward and proper payment, a remitter will occasionally send a check that includes phrases such as “payment in full,” “paid in full” or “in full satisfaction.” Businesses and individuals may fear that such a notation could limit their ability to collect any outstanding balances. Now, changes in the Uniform Commercial Code make it possible for banks to reduce the risks they face in accepting such items while improving efficiency and accelerating cash application.
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In order to appreciate how changes to the Uniform Commercial Code have made improvement possible, it is important to understand the concept of accord and satisfaction. A legal definition of an accord and satisfaction is “a contract under which a creditor promises to accept a substituted performance in satisfaction of the original duty of the debtor.”

General Legal Principles of Accord and Satisfaction

To be more specific, in the context of check payments, an accord and satisfaction is reached if four distinct elements are present. These elements will be discussed in greater detail later, but a short summary of the elements is:

- A creditor and a debtor have a bona fide dispute as to the amount of an unliquidated debt;
- The debtor/drawer, in good faith, sends a check to the creditor/payee in an amount less than that claimed to be due by the creditor/payee;
- The debtor/drawer clearly indicates on the check or an accompanying document that the amount tendered is offered in full settlement of the dispute; and
- The creditor/drawee accepts the check.

Assuming each of these elements has been met, the parties have reached an accord and satisfaction, and the creditor/payee can no longer recover the balance it claims is due from the debtor/drawer. This concept presents special problems to the users of lockbox services, who may receive thousands of checks daily or monthly, which are deposited before the creditor/payee sees them.

Old Law of Accord and Satisfaction with Respect to Checks

Prior to 1962, when the Uniform Commercial Code (“UCC”) was enacted, there did not exist a uniform statute affecting payment and receipt of checks. Therefore, if the elements described above were met, the common law rule of accord and satisfaction applied, and the creditor/payee would not be permitted to seek recovery of any balance due. That result was the same even if the creditor/payee added a notation to the check indicating that the check was being accepted under protest or in only partial satisfaction of the claim. Thus, the common law rule permitted the creditor/payee to either accept the check subject to the full satisfaction language stated by the debtor/drawer or refuse the check completely. The creditor/payee could not both accept the check and also refuse to be bound by the full satisfaction language. If a check was accepted with such language, even if the creditor/payee did not have actual knowledge that the language was included, the creditor/payee was simply out of luck.

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Old Law of Accord and Satisfaction with Respect to Checks (Cont.)

The UCC did not contain a provision that specifically dealt with the "full payment" check. However, the UCC did contain provisions that appeared to have changed the common law rules of accord and satisfaction.

Some courts concluded that the common law rule of accord and satisfaction was superseded by this "reservation of rights" provision of the 1962 UCC. In other words, these courts concluded that even if a debtor/drawer tendered a check of lesser value than the claimed amount and marked "payment in full" in an attempt to obtain full satisfaction of the disputed claim, the creditor/payee could accept the check, note on the check that it was accepted with a "reservation of rights" and still have the right to demand that the debtor/drawer pay the balance due.

This view of the application of the statute was adopted by a relatively small number of jurisdictions.

Other courts (in fact, the majority of jurisdictions) concluded that §1-207 of the 1962 UCC was not intended by the drafters to change the common law rule of accord and satisfaction. In these jurisdictions, if the creditor/payee accepted a "full payment" check, even with a reservation of rights, the creditor/payee would not be permitted to demand payment of the balance from the debtor/drawer.

This issue created a great deal of uncertainty for creditor/payees and in particular for high-volume creditor/payees. Fortunately, there was a general recognition that high-volume creditor/payees have special needs. Therefore, in 1990, revisions to the UCC were proposed that not only cleared up any uncertainties relating to the concept of accord and satisfaction in the context of check payments, but also provided a practical mechanism to meet those needs.

Current Law of Accord and Satisfaction with Respect to Checks

The 1990 revisions to the UCC addressed many issues. One of those was the concept of accord and satisfaction in the context of check processing. The 1990 revisions to the UCC contained a new provision entitled "Accord and Satisfaction by Use of Instrument" (UCC §3-311). This section of the UCC provides a comprehensive framework for dealing with accord and satisfaction issues.

Generally speaking, UCC §3-311 is based upon the four elements of common law accord and satisfaction that were discussed above. A more thorough discussion of the four requirements of the accord and satisfaction doctrine in the context of lockbox operations will help to develop an understanding of the UCC approach to this issue.

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First, the debt in question must be subject to a bona fide dispute and must be unliquidated in amount. In other words, if there is not an honest dispute as to whether the debt is owed or the amount that may be owed, tender of a full-payment check will not work as an accord and satisfaction. For example, if a debtor/drawer admits owing $5,000 on a revolving charge account, a tender of a check in the amount of $4,000 marked “payment in full” will not operate as an accord and satisfaction, even if the check is accepted. On the other hand, if that debtor/drawer honestly contends that his account was charged with $1,000 of purchases that he did not make, the tender of such a check, if accepted, could establish an accord and satisfaction.

Second, the check in question must be tendered in good faith. The UCC defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Using the preceding example, if there was no dispute over the amount due, and the debtor/drawer was simply making the “offer” in the hope that no one would pick up the full-payment language on the check, the tender of the check would not be a good faith tender, and could not establish an accord and satisfaction.

Third, the check must be “conspicuously” marked as a full-payment check, or it must be accompanied by a written communication indicating that it is intended to be a full-payment check.

Two examples of the types of statements that meet this definition are:
- A printed heading in capitals is conspicuous (e.g., PAYMENT IN FULL).
- Language in the body of a form is conspicuous if it is in larger type or contrasting type or color.

The UCC also provides that in any lawsuit in which the conspicuousness of the statement is an issue, the judge will make that decision, rather than a jury. In those cases that have considered this issue, the general trend has been to find that almost any full-payment language on a check or included in a written communication accompanying a check is “conspicuous.”

Fourth, the check must be “accepted.” In this context, a check is clearly “accepted” if it is processed for payment. However, a check may also be considered to be “accepted” if the creditor/payee holds the check for an extended period of time, even if it is not processed for payment.

It should also be noted that the 1990 version of the UCC amended §1-207. New subsection (2) of §1-207 now states that the “reservation of rights” language of subsection (1) does not apply to an accord and satisfaction. Thus, for those states that had adopted the minority view with regard to reservation of rights, if they adopted the 1990 version of the UCC, there is no longer a question as to whether §1-207 applies to an accord and satisfaction.

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Solutions to Accord and Satisfaction Problems

In recognition of the special problems posed by these items, the 1990 revisions to the UCC established a practical approach to address the problem of an inadvertent acceptance of a full payment, resulting in an unintended accord and satisfaction. The UCC provides two practical approaches to this issue.

The term “conspicuous” is defined by UCC §1-201(10) as follows:

“Conspicuous,” with reference to a term, means so written, displayed, or presented that a reasonable person against which it is to operate ought to have noticed it.

Debt dispute office solution. First, UCC §3-311(c)(1) gives the creditor the option of designating a particular person or office to which all communications regarding disputed debts are to be sent. This provision specifically includes full-payment checks as a “communication regarding a disputed debt.” In order to make such a designation, the creditor must provide that information to the debtor in a “conspicuous” statement, within a reasonable time prior to the tender of the check at issue. This mechanism gives the creditor the practical option of including such a designation on all billing statements, account statements, or in the sales agreement (should one exist).

If such a procedure is adopted and is appropriately communicated to the debtor/drawer, a full-payment check sent to a lockbox rather than to the debt dispute designee will generally not establish an accord and satisfaction.

Repayment solution. Second, UCC §3-311(c)(2) permits a creditor to tender repayment of a check that has been inadvertently accepted. To be effective, that repayment must be made within 90 days of payment of the full-payment check. This “give-back” rule is not available to a creditor who has adopted the procedure of designating a debt dispute office. Therefore, if your organization has adopted the “debt dispute office” procedure, and a full-payment check is sent to that office and is cashed, you will not have the option of changing your mind and refunding the payment to the debtor, even if you do so within 90 days of cashing the check.

The foregoing solutions are intended by the UCC to protect against the inadvertent acceptance of a full-payment check. Therefore, UCC §3-311 also provides that neither of these provisions will prevent the enforcement of the accord and satisfaction if the creditor accepts a check knowing that the check was tendered as a full-payment check. This catch-all provision addresses the issue of when a creditor “knows” that a check is tendered as a full-payment check. According to UCC §3-311, if someone with “direct responsibility” accepts such a check, an accord and satisfaction has been reached.
Each circumstance will present a unique set of facts, but a few examples of the operation of this rule might be helpful.

- Even if a debt dispute office has been established by the creditor/payee, an accord and satisfaction will be reached if a collection agency for the creditor/payee accepts a check, because that collection agency has direct responsibility for the debt or collection of the debt.
- A full-payment check sent to and accepted by the manager of a retail store where the debtor had bought goods on credit will probably establish an accord and satisfaction, because the manager of that store probably would be considered to have direct responsibility for the debt.
- A full-payment check sent to an executive of an organization who has no direct responsibility for the collection and who has no knowledge of the particular dispute will normally not work as an accord and satisfaction, unless the executive recognizes but disregards the full satisfaction language.
- If a debt dispute office has been established, an accord and satisfaction is not reached if a full-payment check is sent to a lockbox or other office that processes the checks for the creditor/payee even if an office clerk or bank employee recognizes the full-payment language, because the clerk does not have direct responsibility for the debt or collection of the debt.
- If a debt dispute office has not been established and a full-payment check is sent to the lockbox, even if language is added to the check that purports to reserve the rights of the creditor/payee to collect the full amount of the debt, an accord and satisfaction will be established if the check is accepted and is not refunded within 90 days.

**Issues in the States of New York and Oregon**

New York has not adopted the 1990 revisions to the UCC, retaining the minority view under the old UCC scheme that a creditor/payee avoids an accord and satisfaction by noting its “reservation” on the full-payment check. Oregon, while it initially adopted the 1990 revisions to the UCC, later repealed its version of UCC §3-311 and replaced it with language indicating that a full-payment check will not constitute an accord and satisfaction unless the creditor/payee agrees in writing to accept the check as full payment of the obligation.

It is therefore possible that the practical approach offered by the amendments to the UCC in §3-311 will not apply to checks issued by debtors in these jurisdictions, even if they are sent to a lockbox in a state where the newer version of the UCC has been adopted and retained. Notably, New York’s approach to managing payment disputes presents special challenges to users of lockbox services because it requires affirmative action by the creditor/payee to avoid the application of the accord and satisfaction rule.

The issues presented by non-conforming states can be addressed by including in customer credit agreements or sales agreements a provision stating that Pennsylvania law (or the law of another state that adopted the 1990 revisions to the UCC) will apply to all such transactions. Such an agreement is expressly permitted by the UCC (UCC §1-105).

**Summary of Procedural Options for Dealing with Full-Payment Checks**

Together, the provisions of the UCC discussed above provide a rational framework for adopting practical solutions to the problems posed by full-payment checks.

**Four key points must be considered in developing a solution to the problems posed by full-payment checks.**

- **In order to protect against the possibility that a full-payment check may be issued by a debtor who resides in New York or a state like Oregon that does not follow the procedure outlined in UCC §3-311, the customer credit agreements or sale agreements or other appropriate documents should contain a provision establishing that the governing law shall be that of Pennsylvania or other applicable state.**

The discussion regarding the solutions offered by UCC §3-311 may not be applicable to checks issued by debtor/drawers in the states of New York and Oregon.

- **The procedure that most expansively addresses the issues posed by full-payment checks is the conspicuous designation of a “debt dispute office.” Appropriate language can be added to billing statements, account statements or sales agreements that designates a particular address as the address to which all debt dispute communications, including full-payment checks, are to be sent. If this procedure is appropriately implemented, an accord and satisfaction will not be established unless a person who is charged with the responsibility of dealing with such issues makes a knowing, affirmative decision to accept the full-payment check.**

- **If a “debt dispute office” procedure is not established, the creditor can implement a process to identify all accord and satisfaction claims that have arisen as the result of acceptance of a full-payment check. The procedure that is implemented must identify such claims within 90 days of the date the full-payment check was paid, because the refund must be made within that period of time. Obviously, this procedure is likely to be more cumbersome than the creation of a “debt dispute office.”**

- **Regardless of the procedure adopted, if an individual with direct responsibility for the debt or collection of the debt accepts a full-payment check, an accord and satisfaction may be established.**
§3-311. ACCORD AND SATISFACTION BY USE OF INSTRUMENT

(a) If a person against whom a claim is asserted proves that (i) that person in good faith tendered an instrument to the claimant as full satisfaction of the claim, (ii) the amount of the claim was unliquidated or subject to a bona fide dispute, and (iii) the claimant obtained payment of the instrument, the following subsections apply.

(b) Unless subsection (c) applies, the claim is discharged if the person against whom the claim is asserted proves that the instrument or an accompanying written communication contained a conspicuous statement to the effect that the instrument was tendered as full satisfaction of the claim.

(c) Subject to subsection (d), a claim is not discharged under subsection (b) if either of the following applies:

(1) The claimant, if an organization, proves that, (i) within a reasonable time before the tender, the claimant sent a conspicuous statement to the person against whom the claim is asserted that communications concerning disputed debts, including an instrument tendered as full satisfaction of a debt, are to be sent to a designated person, office or place, and, (ii) the instrument or accompanying communication was not received by that designated person, office or place.

(2) The claimant, whether or not an organization, proves that within 90 days after payment of the instrument, the claimant tendered repayment of the amount of the instrument to the person against whom the claim is asserted. This paragraph does not apply if the claimant is an organization that sent a statement complying with paragraph (1)(i).

(d) A claim is discharged if the person against whom the claim is asserted proves that within a reasonable time before collection of the instrument was initiated, the claimant, or an agent of the claimant having direct responsibility with respect to the disputed obligation, knew that the instrument was tendered in full satisfaction of the claim.

Conclusion

As noted, every circumstance presents a unique set of facts. The operations of your organization may be more suitable for one type of solution to the full-payment check problem than another. In developing your particular approach, you should not rely solely upon this discussion, but should instead consult with your in-house or outside counsel to help you develop the most appropriate solution for your particular operation.

Regardless of the procedure adopted, if an individual with direct responsibility for the debt or collection of the debt accepts a full-payment check, an accord and satisfaction may be established.

ABOUT THE AUTHOR

Gary P. Hunt is a commercial litigation attorney and shareholder of Tucker Arensberg, P.C. He has been representing financial institutions for most of his career, and has been lead counsel in complex litigation. He regularly serves as both a court appointed mediator and a private mediator. He has litigated matters in many jurisdictions, including New York, Ohio, West Virginia, New Jersey, Florida, Georgia, Connecticut, Michigan, California, Virginia, Delaware, Indiana, Missouri, Minnesota, South Dakota and Wisconsin. Hunt graduated from the University of Notre Dame and the University of Pittsburgh School of Law, cum laude, where he was also a member of the Law Review.