

Novation, Accord and Satisfaction, and Substituted Contracts

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*A Practice Note discussing the discharge of contractual duties by **novation**, accord and satisfaction, and substituted contract. This Note reviews the elements of each of these methods in the context of commercial transactions under general common law and the Restatement (Second) of Contracts. This Note includes a discussion of full-payment checks under [Section 3-311 of the Uniform Commercial Code \(UCC\)](#), as well as comparisons and contrasts between **novation** and assignment and between a substituted contract and an accord and satisfaction. This Note provides practical examples and links to relevant Standard Documents.*

The most common way to discharge contractual duties is by performance. However, just as parties are free to enter into a contract, they can agree to discharge an existing contract by substituting a new party for an original party or a new contract for the original contract. **Novation**, accord and satisfaction, and substituted contract are well-established methods that provide flexibility to adjust and discharge contractual rights and obligations and to settle disagreements informally, without having to resort to more costly dispute resolution or litigation.

The definitions of **novation**, accord and satisfaction, and substituted contract can vary from state to state. These differences, along with disparate treatment of the concepts under general common law, the Restatement (Second) of Contracts, and, where applicable, the Uniform Commercial Code (UCC), can be the source of confusion for practitioners. This Note reviews each of these concepts, comparing and contrasting them and providing practical illustrations.

This Note is not an exhaustive examination of the legal theories on discharging a contract. It focuses solely on:

- **Novation**.
- Accord and satisfaction.
- Substituted contract.

This Note **does not** contain a discussion of legal concepts where the parties agree to discharge contractual duties without substituting a new party or obligation, such as rescission, release, or contract not to sue. Theories of contract discharge that assert that no valid contract existed in the first place, such as voidable or illegal contract, are also beyond the scope of this Note.

For more information on defenses to contract performance, such as supervening events, impossibility, impracticability, frustration of purpose, failure of conditions, and anticipatory repudiation, see [Practice Note, Excuses for Non-Performance: Conditions Following Contract Formation](#).

Novation

The definition of **novation** can have slight variations under:

- Common law (see [Novation Under Common Law](#)).
- State law (see [Novation Varies Under State Law](#)).
- The Restatement (Second) of Contracts (see [Novation Under the Restatement \(Second\) of Contracts](#)).

Novation Under Common Law

Under general common law, a **novation** is the discharge of one party from a contract by substituting a third party. All parties agree that the substitute party replaces one of the original parties, which transfers all of its rights and obligations to the substitute party. The substitute party undertakes to perform all of the original (transferring) party's obligations. The remaining party agrees to the substitution and discharge of the transferring party and agrees to perform all of its obligations for the benefit of the new party.

A valid **novation** requires:

- A valid and enforceable original contract.
- An **agreement** by all the parties to a new contract.
- The extinguishment of the original contract.
- A valid and enforceable new contract.

As with all contracts, a **novation** must be supported by consideration.

Novation Immediately Discharges the Original Contract

The distinguishing characteristic of a **novation** is the immediate discharge of the original contract. If the substitute party breaches, the non-transferring party cannot sue the transferring party under the original contract (see **Novation Versus Assignment**). For an example of a **novation agreement**, see [Standard Document, Novation Agreement \(Short Form\)](#).

Novation Varies Under State Law

Novation is subject to state law and the definition of **novation** can vary from jurisdiction to jurisdiction. Some states define **novation** to mean the substitution of a new obligation for an existing obligation (for example, [Cal. Civ. Code § 1530](#)).

This definition of **novation**:

- Does not require the addition of a third party to step in and undertake the new obligation.
- Is sometimes referred to as a substituted contract (see [Substituted Contract](#)).

Novation Under the Restatement (Second) of Contracts

The Restatement (Second) of Contracts refers to **novation** as "a type of substituted contract that has the effect of adding a party, either as obligor or obligee, who was not a party to the original duty" ([Restatement \(Second\) of Contracts § 280](#), cmt. a). This definition of **novation** is the same as the common law definition. However, in contrast to the common law, under the Restatement (Second), a **novation** can involve a new duty that is either the same as or different from the original duty (referred to as a substituted contract under common law) ([Restatement \(Second\) of Contracts § 280](#), cmt. b).

The Restatement (Second) distinguishes between:

- **A simple novation.** A simple **novation** involves the substitution of one party (see [Simple Novation](#)).
- **A compound novation.** A compound **novation** occurs when both parties still have duties to perform under the contract (a bilateral executory contract) and one party drops out and is substituted by a third party (see [Compound Novation](#)).

([Restatement \(Second\) of Contracts § 280](#), cmt. b.)

Simple Novation

A simple **novation** involves the substitution of a new party for one of the original parties. The substitute party agrees to perform either:

- **The same duty as the transferring party originally owed to the non-transferring party.** For example, buyer and seller enter into a contract for the purchase and sale of office furniture for \$1,000 and seller has already delivered the furniture to buyer. Seller, buyer, and a third party agree that instead of the buyer paying \$1,000 to seller, the third party will pay \$1,000 directly to seller.

- **A different duty.** For example, buyer and seller enter into a contract for the purchase and sale of office furniture for \$1,000 and seller has already delivered the furniture to buyer. Seller, buyer, and a third party service provider agree that instead of the buyer paying \$1,000 to seller, the third party will provide agreed-on services to the seller.

([Restatement \(Second\) of Contracts § 280](#), cmt. e.)

Compound **Novation**

A compound **novation** under the Restatement (Second) of Contracts arises when there are two separate contracts between three parties and the common party owes a duty under the first contract and is owed the same duty under the second contract. Under a compound **novation**, the common party drops out and the remaining parties perform their original duties for the benefit of one another.

For example, buyer owes seller \$1,000 and seller owes service provider \$1,000. The parties enter into a compound **novation agreement** where:

- Buyer assumes seller's debt to service provider.
- Seller discharges buyer's debt to seller.
- Service provider discharges seller's debt to service provider.

([Restatement \(Second\) of Contracts § 280](#), cmt f.)

Less frequently, a compound **novation** can arise if buyer and seller each has a right against the other and agree that the buyer will drop out while the seller will perform another contract with a third party. For example, buyer and seller contract for the delivery of computer monitors for \$1,000. The parties enter into a compound **novation agreement** where:

- Seller agrees to:
 - deliver laptops to a third party for \$2,000 instead of the monitors; and
 - discharge buyer's duty to pay \$1,000 to seller for the monitors.
- Buyer agrees to discharge seller's duty to deliver the monitors.
- Third party agrees to pay seller \$2,000 for the laptops.

([Restatement \(Second\) of Contracts § 280](#), cmt f.)

Novation Versus Assignment

A **novation** differs from an assignment. When a contract is assigned:

- The assigning party (assignor) remains liable for the performance of the contract.
- The non-assigning party can sue the assignor for breach.
- Consent of the non-assigning party is not needed unless an exception applies. Exceptions include contracts that:
 - are personal in nature; and
 - contain an enforceable anti-assignment clause.

On the other hand, in a **novation**:

- The transferring party is discharged from the transaction without any further rights or obligations.
- The non-transferring party must always agree to the substitution and discharge of the transferring party.
- If the substitute party breaches the **novation agreement**, the non-transferring party cannot sue the transferring party.

For more information on assignment, see [Practice Note, Assignability of Commercial Contracts](#). For a sample assignment **agreement** containing an optional long-form **novation** clause, see [Standard Document, Assignment and Assumption Agreement and Optional Novation](#).

Accord and Satisfaction

An accord is the conditional discharge of contractual duties by the substitution of a new contract that provides for performance different from that due under the original contract. Satisfaction is performance of the accord and the discharge of the original contract.

A valid accord and satisfaction requires:

- A bona fide dispute or a disputed debt between the parties.
- A clear and unequivocal offer of payment or a change in performance as a replacement satisfaction of the original **agreement** (accord).
- Acceptance and retention of the payment (or substituted performance) by the offeree (satisfaction).

As with all contracts, an accord must be supported by consideration, which can be found in the resolution of the dispute.

An Accord Does Not Discharge the Original Contract

An accord only conditionally discharges contractual duties. The condition is the performance of the accord, referred to as satisfaction. The original obligations are not discharged until the satisfaction occurs. This is in contrast to a **novation**, where the original contract is discharged immediately when the parties agree to the **novation**. For more information, see [Accord and Satisfaction Versus Novation](#).

An accord and satisfaction of a commercial **agreement** between two businesses commonly arises under a sale of goods **agreement** when the buyer negotiates a lower payment because of a genuine claim that the goods were either:

- Defective.
- Otherwise non-conforming to the contract.

For example, buyer and seller enter into an **agreement** that seller will sell to buyer 100 laptops for \$80,000 (original contract). The seller delivers the laptops to the buyer. After inspecting the laptops, the buyer complains that the laptops lack DVD drives and therefore do not conform to the contract. The seller maintains that the buyer did not order laptops with DVD drives and therefore the delivered laptops conform to the contract.

To settle their dispute, the buyer offers to keep the delivered laptops but pay the seller only \$70,000 instead of \$80,000. The seller accepts the buyer's offer. The new **agreement** by the parties (100 laptops without DVD drives for \$70,000) is the accord. Payment by the buyer of \$70,000 is the satisfaction of the accord. Until the buyer makes payment of the new, lower purchase price, the original contract is not discharged. If the buyer does not make payment of the \$70,000, the seller can sue the buyer under the original contract for \$80,000.

Accord and Satisfaction Under the UCC (Full Payment Checks)

[Section 3-311 of the Uniform Commercial Code](#) (UCC) intends to streamline the common law doctrine of accord and satisfaction. It provides for an informal dispute resolution by use of a [negotiable instrument](#). Under [Section 3-311](#), if the buyer submits a reduced payment in good faith together with a notation that the payment is in full satisfaction of amounts owed on the contract (also referred to as a full payment check), the seller may be bound by an accord and satisfaction if it accepts and retains the reduced payment.

[Section 3-311](#) is consistent with common law accord and satisfaction and provides that the seller may either:

- Reject the buyer's offer by returning the check.
- Accept the buyer's offer by cashing the check.

This UCC rule is meant to encourage informal dispute resolution mostly between a consumer and a business ([UCC § 3-311](#), official cmt. 1).

Using the same example as above, buyer and seller enter into an **agreement** for 100 laptops for \$80,000 (original contract). After the seller delivers the laptops to the buyer, the dispute about the DVD drives arises. However, instead of negotiating with the seller and coming to a new **agreement** (an accord) as in the above example, the buyer simply sends the seller a check for \$75,000 with the notation "payment in full." If the seller cashes the full-payment check, it will not be able to sue the buyer for the \$5,000 shortfall of the purchase price because under [Section 3-311 of the UCC](#):

- The full payment check is deemed to be an accord.
- The cashing of the check is deemed to be the satisfaction.
- The accord, together with the satisfaction, discharge the original contract.

A common mistake that sellers make is to cash the full-payment check and attempt to negate the buyer's payment-in-full language, for example by:

- Crossing out the buyer's full payment language.
- Noting on the check:
 - "with all rights reserved";
 - "under protest"; or
 - "payment on account."

These attempts are unsuccessful under [Section 3-311](#) because the original contract is deemed to be discharged by an accord and satisfaction as soon as the seller cashes the check. Cashing the check constitutes the satisfaction.

For the buyer to succeed under [Section 3-311](#):

- The buyer must prove that:
 - the check contained a conspicuous statement that it was tendered as full satisfaction of the claim; and
 - the buyer tendered the check in good faith to resolve the dispute.
- The claim must be either:
 - unliquidated; or
 - subject to a bona fide dispute.

Exceptions

[Section 3-311](#) contains two exceptions. Cashing a full payment check and retaining payment do not result in the discharge of a contract by accord and satisfaction if the seller either:

- Directs all communications regarding disputed debts to a specific person, office, or place and the full payment check does not reach such person, office, or place. This exception applies if the seller:
 - is an organization; and
 - informs the buyer where to direct communications through a conspicuous statement that is sent to the buyer a reasonable time before the buyer tenders the check.

(UCC § 3-311(c)(1).)

- Tenders repayment of the check to the buyer within 90 days after cashing the check ([UCC § 3-311\(c\)\(2\)](#)).

These exceptions are intended to prevent inadvertent accord and satisfaction when a seller has many customers, such as a department store or a public utility. These businesses may be unaware that they are cashing full payment checks because the employees charged with processing the checks do not have any knowledge of the dispute and can easily overlook the full satisfaction language, especially if it appears on the reverse side of the check.

The first exception, stated at [Section 3-311\(c\)\(1\)](#), aims to prevent this situation by allowing the designation of a specific person, office, or place that deals with disputed payments and full satisfaction checks ([UCC § 3-311](#), official cmt. 5).

The second exception allows the seller to prevent an inadvertent accord and satisfaction by providing a 90 day grace period during which the seller can tender repayment of the cashed full satisfaction check. [Section 3-311\(c\)\(2\)](#) provides this alternative for a seller who may be reluctant to direct customers to a specific person, office, or place as suggested by [Section 3-311\(c\)\(1\)](#) out of concern that its customers may be confused and mistakenly send regular checks to the disputed payment department ([UCC § 3-311](#), official cmt. 6).

Accord and Satisfaction Versus **Novation**

Accord and satisfaction and **novation** are alternatives to discharging contractual duties by performance. They both consist of an **agreement** to a new contract to discharge the original contract. However, they differ in that:

- A **novation** involves:
 - the substitution of a **new party** for one of the original contracting parties; and

- the **immediate** discharge of the original contract.
- An **accord and satisfaction** involves:
 - the substitution of **new obligations** for the original obligations; and
 - the discharge of the original contract only **on performance** of the accord.

Substituted Contract

Parties to a commercial transaction can discharge their respective duties under the contract by agreeing to a new or substituted contract.

For example, buyer and seller enter into an **agreement** that seller will sell to buyer 50 monitors for \$10,000 (original contract). After the contract is executed but before the seller begins its performance:

- Buyer:
 - decides to replace its desktop computers and instead of buying monitors, to purchase laptops; and
 - offers to buy from seller 100 laptops for \$80,000 in lieu of the monitors.
- Seller accepts buyer's offer, resulting in a new contract (substituted contract).

A Substituted Contract Immediately Discharges the Original Contract

When seller accepts buyer's offer in the above example, the parties enter into a substituted contract. The original contract is immediately discharged. If the buyer breaches the substituted contract and does not pay for the laptops, the seller cannot sue the buyer under the original contract.

Substituted Contracts Under the Restatement (Second) of Contracts

Under the Restatement (Second) of contracts, a substituted contract:

- Is a contract that is accepted by the obligee in lieu of the original contract.
- Immediately discharges the original contract so that the obligee may not sue the obligor on the original contract.

([Restatement \(Second\) of Contracts § 279](#).)

This definition of substituted contract is the same as the common law definition. A common type of substituted contract contains a provision that is inconsistent with the original contract and the parties intend that the substituted contract replace the original contract in its entirety (see [Restatement \(Second\) of Contracts § 279](#), cmt. a).

Substituted Contract Versus **Novation**

Under common law, a substituted contract:

- Differs from a **novation** in that a substituted contract does not introduce a third party. The parties to the original contract remain the same parties to the substituted contract.
- Is similar to a **novation** in that a substituted contract immediately discharges the original contract. If the substituted contract is breached, the non-breaching party may only sue under the substituted contract and not the original contract.

The Restatement (Second) of Contracts, rather than distinguishing between a substituted contract and a **novation**, refers to a **novation** as a type of substituted contract that introduces a third party to replace one of the original parties (see [Novation Under the Restatement \(Second\) of Contracts](#)).

Some states define **novation** as a substitution of one duty for another, without the requirement to add a third party. Under this definition, the term **novation** is the same as a substituted contract (see [Novation Varies Under State Law](#)).

Substituted Contract Versus Accord and Satisfaction

A substituted contract:

- Is similar to an accord in that both involve an **agreement** by the parties to a new contract.
- Differs from an accord in that a substituted contract discharges the original contract immediately on execution.

An accord does not, by itself, discharge the original contract. That occurs only when the accord is performed or satisfied (see [Accord and Satisfaction](#)). If the accord is breached, the non-breaching party can sue under the original contract. In a substituted contract, the original contract is discharged even if the substituted contract is breached.

A substituted contract most often replaces a bilateral executory contract where both parties:

- Still have duties to perform.
- Wish to change their contractual duties.

An accord between the parties more commonly replaces a unilateral executory contract where:

- One party has already performed and the other party wishes to change its obligations.
- The party who has already performed accepts the counterparty's new obligation but agrees to a discharge of the original obligation only on the performance of the new obligation (satisfaction).

The following example illustrates the difference between a substituted contract and an accord and satisfaction. Buyer and seller enter into an **agreement** that seller will sell to buyer 100 laptops for \$80,000 and seller delivers the laptops to buyer. Buyer then decides that instead of paying seller the purchase price, it would rather perform consulting services for the seller and offers consulting services in lieu of the \$80,000. The seller accepts the offer.

This scenario is most likely an accord, rather than a substituted contract, because the seller likely did not intend to immediately discharge the buyer from its duty to pay \$80,000. The buyer's performance of the consulting services is the satisfaction, which then discharges its duty to pay the purchase price.

If the seller has already performed its duties under the contract, the seller:

- Has little incentive to immediately discharge the buyer's original obligation and agree to a substituted contract.
- Most often will insist on an accord so that if the buyer does not perform its new obligation (in this case, if the buyer does not provide satisfactory consulting services), the seller can sue for damages under the original contract (in this case, the seller can sue for the payment of \$80,000).

On the other hand, if the parties decide to change the contract before seller's performance, they may enter into a substituted contract. Because the seller has not delivered the laptops yet (and assuming that it will have no difficulty finding another buyer for the laptops), the seller is willing to discharge the buyer's duty to pay the purchase price.

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