Financing the Farm

A law bulletin series on legal documents for farm financing

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Promissory Notes

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By its definition, a promissory note is simply a written promise to pay a stated sum. As is often the case, however, there can be more complexity to promissory notes than the definition suggests. This bulletin explains promissory notes and what a beginning farmer should understand before signing one.

What is a promissory note?

A **promissory note** is a written agreement to pay a certain sum of money at a specified time or on demand. A promissory note is a legally binding contractual agreement between a **promisor** who makes a promise to pay the money and the **promisee** who gave the loan. The note ensures that the promisee has a legal mechanism for enforcing the repayment agreement.

When do farmers use a promissory note?

Farmers use promissory notes in a variety of transactions, sometimes without even realizing it. Perhaps the most common occurrence is when a farmer borrows money to purchase real estate and signs both a promissory note promising to repay the loan and a mortgage that secures the promises with collateral. Loans for other types of goods used in farming might also involve a promissory note stating that the farmer will repay the loan by a certain date or upon demand. Whenever a farmer receives a loan from family members or friends, and promises in writing to repay that person, that is also a promissory note.

Types of promissory notes

There's not just one type of promissory note. A promissory note might be a **simple note**, which requires you to repay the entire loan amount in one payment by a specified date. Or it could be an **installment note,** which sets up a payment schedule with principal and interest being paid in

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installments over a period of time. An **open-ended note,** commonly used for operating loans, allows you to make draws on the loan amount over time, and to pay the amount drawn, plus interest, by a stated date. Be wary of a **demand note**, as it allows the creditor to demand full payment from you at any time, as long as the demand is made in good faith.

Common terms in promissory notes

A promissory note can be quite simple and as short as a paragraph, or may be more detailed and lengthy. The terms in a promissory note can vary from creditor to creditor, but there are a number of important terms that you can expect to see in a promissory note. It is in a farmer's best interest to read through the documents and make sure that he or she understands the terms because, once signed, the note is legally binding.

Here are common terms you might see in a promissory note:

The parties. The promissory note should include the names of the promisor who will repay the loan and the promisee who gave the loan as the parties to the agreement.

Principal loan amount. This is the dollar value of your initial loan amount.

Interest rate. A promissory note should state the interest rate that the promisee is charging you for the loan and how the interest amount is to be calculated.

Schedule of payments. Some promissory notes might spell out when payments are to be made and the amount of each payment, including interest. An amortization schedule shows the remaining balance after each payment, including both principal and interest. Others might not include a schedule and simply state that the entire amount is due by a certain date.

Loan term. The loan term is the length of time allowed for paying back the loan, and might also address how frequently you must make payments. Sometimes, although not common in farm finance situations, a note might state that repayment may be due "on demand" by the promisee.

Late payment penalties. The note might state when a payment is considered "late" and if so, may assess a penalty that you must pay for being late.

Early payment. Paying down the principal early can reduce the amount of interest a creditor will receive, so some creditors might include a provision that prohibits early payment. More common, however, is to include a penalty that you must pay if you choose to pay off the note before it is due. Some states, like Ohio, limit this penalty.

Default clause. This provision lays out when you are considered to be in default on the note, such as by being late on a payment for a certain number of days or missing a payment altogether. The default clause might also explain actions the promisee can take if you are in default.

Acceleration clause. Be aware of this type of clause, as it allows the promisee to demand the *entire* amount due on the note if you are in default.

Costs of collection. It's common for a note to state that you must pay all costs if the promisee has to take legal action to collect on the note.

Due on sale clause. A due on sale clause allows the promisee to demand payment of the remaining principal balance if you sell real estate that is tied to the promissory note through a mortgage. However, the clause might also allow the promisee to waive the provision if the new buyer agrees to continue paying on the promissory note.

Assignment. This provision allows a creditor to sell the note to another creditor and assign all legal rights under the note to the new creditor. If assignment occurs, your obligations automatically transfer to the new promisee.

Interest rates and limitations

Promissory notes should include an **interest rate.** This percentage rate can be fixed so that it is always the same percentage, or it can be variable and fluctuate with the market. Depending upon the agreement and when payments are due, the interest may be calculated daily, month, quarterly, annually, or on some other schedule.

State **usury laws** cap the interest rate a creditor may charge for a loan at a certain amount but can contain a number of exceptions. In Ohio, the state prohibits lenders from charging an interest rate above 8 percent, but allows a higher interest rate when the loan is for more than $100,000, is secured by an insured mortgage, or is a business loan, which includes agricultural loans. Note that many states also allow lenders to charge a higher interest rate by consent of the debtor.

You might be familiar with the federal **Truth in Lending Act**, which requires all lenders to disclose credit terms in order to protect consumers against misleading and unfair loan practice. Note that the Truth in Lending Act does not apply to business loans such as those used for farming purposes, however. This places a higher burden on you to make sure that you understand the credit terms in the promissory note.

Relationship to mortgages

Many people confuse mortgages with promissory notes. The two documents are often signed at the same time and are related, as a mortgage secures a promissory note. While a promissory note represents your promise to repay a creditor, a mortgage provides the security for your promise in the form of collateral. In the event that you default on the promissory note, the mortgage allows the creditor to seek a remedy against the collateral listed in the mortgage.

Other titles in the *Financing the Farm* law bulletin series

To continue to learn more about common legal documents for farm financing arrangements, see our law bulletins on *Mortgages, Installment Contracts, Leasing Arrangements* and *Secured Transactions*.

References and Resources

"Finance and Credit," THE NATIONAL AGRICULTURAL LAW CENTER, https://nationalaglawcenter.org/research-by-topic/finance-credit/.

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