



## Making an I.O.U. Legal / Promissory Notes

### What is a promissory note?

If you borrow or lend money, it is a good idea to make a promissory note. A promissory note is a written agreement to pay back money to a person or a business. The promissory note should have details about things like when and how the money is paid, if there is interest on the amount owed, and what happens if the money isn't paid back.

Promissory notes are also called **notes payable** or **negotiable instruments**.

If you are the person who owes the money, you are the **promisor, maker, or obligor**.

If you are the person who is lending the money, you are the **promisee, payee, or obligee**.

The money that is owed is called the **principal**.

If the promissory note is done right, it is legal, and a court can enforce it. See below, "**What should be in a promissory note?**" Promissory notes are used for personal loans, business loans and real estate transactions.

A promissory note is different from an I.O.U. because a promissory note says a person will pay the money back and lays out how and when it will be paid and other details. An I.O.U. just says that a person owes a debt to someone else.



### When do I use a promissory note?

If you borrow money from a bank, the bank often has you sign a promissory note. The bank gives you its own form with the terms or rules of the promissory note.

You usually can't negotiate the terms. Read it carefully to make sure you understand what you are promising to do, and what will happen if you don't do it. Ask the bank if any of the terms can be changed if you have a reason you need them changed. A good reason might be that the bank wants the payment on the 1<sup>st</sup> of the month, but you don't get paid until the 5<sup>th</sup>.

When friends or family loan each other money, they don't always write down the details about the loan, like how or when it will be paid back. A promissory note can help because it lays out the terms clearly, so everyone knows them.

## **A promissory note can be secured or unsecured.**

Secured means that the person repaying the money agrees to “security interest” or collateral. Basically, you offer something of value like a car and if you don't pay the money back, the lender can take your car to make up for it.

Unsecured means that the loan is not backed up by collateral. If you lend money to someone without getting collateral and they don't pay you, you can't take anything of value to make up for it. You can sue them for the money, but it might be hard to actually get the money.



## **What should be in a promissory note?**

Make sure your promissory note has specific details. That way a court can enforce the agreement.

Generally, a promissory note should include:

- The legal names, addresses and phone numbers for each person or company involved.
- The amount of the loan.
- When the loan has to be paid back. It can be all at once on a certain date or say "on demand." It could also set up payments over time. If it's in payments, write out when payments are due and how much a payment is.
- If you are charging interest, put down the amount of interest on the loan. Be careful. If you are not a bank, there are limits on how much interest you can charge.
- The final total amount of the loan after interest is added to the original loan amount. This is principal + interest.
- Default terms. What happens if payments are late or not made at all? For example: Are there late fees? How many missed payments before action is taken? Also, if the agreement has other terms, what happens if they are not done?
- The signatures of the parties and the date the promissory note is signed.

## **Read the promissory note carefully!**

Any time you sign a legal document, like a promissory note, read it carefully. Some promissory notes, especially those from banks, are often hard to understand.

Here are a few common things in promissory notes from banks:

- “Acceleration Clause.” This can mean you have to pay the entire balance if you “default.” The lender might say that missing one or more payments is a default.
- Try to make sure that "default" is defined carefully. You need to know what is considered a default on your payment.
- If it isn't already in the promissory note, ask the lender to add in a "Grace Period" or "Cure Period." This gives you extra time after a payment is due to make the payment. As long as you make the payment within the grace or cure period, the default penalties won't go into effect.

Make sure the promissory note does not have a "Pre-Payment Penalty." This means you have to pay a fee if you want to pay the loan off early.

## Other Common Issues

- **What if there is more than one borrower?** If more than one person borrows money, they are usually “jointly and severally liable.” This means that if one person stops making their part of the payment, the other person has to pay it all. Even if you and the other person agree to split the loan payments, the lender can sue just you for the entire loan.
- **What if I want to make changes to the promissory note after it is signed?** If you and the other party agree on the changes, write them down in a new agreement. In the new agreement, say if the new agreement replaces the original promissory note or just changes some things from the original promissory note. Read the original promissory note to see if it says you need to do anything else to make the changes effective.
- **What is a balloon payment?** A balloon payment is a type of payment schedule. You make lower monthly payments and one final, large payment to pay off the rest of the loan. Be careful when agreeing to a balloon payment. Make sure you will have enough money to cover the last, big payment.



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