



Promissory Note Comparison Guide

Borrowing from or lending money to a friend or colleague is a sensitive situation. A lender wants to be sure money is returned on a timely basis. A borrower wants enough time to repay the amounts and some flexibility on interest rates.

If you lend money to a family member or borrow money from your neighbor, you may find it useful (and comforting) to keep a record of the exchange and set out a schedule for repayment. By writing down specific terms, you are creating a “promissory note” to be evidence of the debt. A promissory note is not the same as an IOU. An IOU tells the world money is owed, but does not provide details about when and how it will be repaid. A promissory note gives the details of both the debt and the repayment plan, including any deadlines or interest payment requirements.

Like most agreements, promissory notes can be tailored to meet your needs. There are, however, certain essential elements of a promissory note. Be careful if you’re signing (or offering) a promissory note that doesn’t meet the following requirements.

Writing. Promissory notes must be in writing. There is no such thing as a “verbal” promissory note. Someone may promise to repay you, but it will be difficult to prove, and you may not be able to get it enforced in court without a written record.

For Money. A promissory note is valid only if it is a promise to pay money. A promise to give property (or both property and money) is not a promissory note.

Payable on Demand or on Specific Date. Many differences among promissory notes relate to when and how the borrowed amount will be repaid. Although you are free to negotiate terms that work for your arrangement, your note must either have an end date or be payable when the lender demands it.

Unconditional. The borrower’s payment cannot depend on an event or any other possibility. It must be unconditional. This means once it’s written and signed, the only thing left to happen is repayment. If payment may or may not happen, the promissory note is not valid.

Specific Amount. The note must indicate a specific amount owed that will be paid. If the document indicates the payment will be of “\$10,000 and other amounts owed,” the promissory note is not valid. This does not apply to interest that may be required by the note. A note that doesn’t state exactly how much interest will be paid over time (i.e., has just an interest rate and not a dollar amount) it is still valid.

Transferable. A promissory note must state that it’s either “payable to order” or “payable to bearer.” These phrases mean the amount owed by the borrower could be payable to some unknown third party in the future. In other words, the note is transferrable from one person to another.

Signature. The individual that owes the money must sign the note. The lender may (but doesn’t have to) sign it.

Secured vs. Unsecured Transactions

In a secured transaction, the lender obtains a “security interest” in specific items of the borrower’s property (also called “collateral”). If the borrower doesn’t pay back the money or keep up with any other loan conditions, the lender can take the collateral to repay the loan. To put it another way, a security interest is a right in property held by one party (the lender) to make sure that the other party (the borrower) pays its debt. The security interest ends when the debt is repaid.

By contrast, in an unsecured transaction the lender has no security interest in the debtor’s property. The lender can’t count on getting property immediately if the borrower doesn’t pay. This doesn’t mean the lender has no options. It can bring a lawsuit to get its money back. If the lawsuit is successful, the lender may end up with a court order allowing it to take the borrower’s property or put a lien on the borrower’s income. This can be a lengthy and expensive process. Moreover, if the borrower has taken out many loans and owes money to other creditors, there may not be enough money to go around – even armed with a court order, a lender can lose its investment.

So why would a lender ever agree to lend money without getting a security interest in the borrower’s property? The terms of an unsecured note are often more favorable to the lender than the terms of a secured note. Because the lender is entering a more risky investment, it may require the borrower to pay a higher interest rate or may engage in more rigid monitoring of the borrower’s activities.

Definitions of Common Promissory Note Terms

Acceleration Clause: A part of a promissory note or loan agreement saying that if certain things happen (e.g., late payments), the entire unpaid loan amount becomes due immediately. In other words, the payment schedule speeds up (accelerates).

Amortization: The gradual repayment of a loan in regular amounts.

Amortized Payment Promissory Note: A note that provides for the gradual repayment of a loan in regular, (mostly) equal amounts over a specific period of time. Each payment is used to pay back both principal and interest. There is no larger payment at the end of the term.

Balloon Final Payment: A large payment that includes all of the remaining principal and interest owed by the debtor to the lender at the end of the loan period. This is sometimes also referred to as a “lump sum payment.”

Borrower: The person or company that receives money in exchange for the promise that it will pay back that amount (plus additional fees) in the future.

Collateral: Property offered by the borrower so the lender can be sure that repayment of a secured loan will happen. If the borrower defaults on the loan, it gives up the collateral and the lender becomes the owner of that property.

Compound Interest: Interest that is paid both on principal and on interest earned earlier.

Continuing Guaranty: A guaranty that is not limited to a particular transaction or loan. Under these documents, guarantors ensure any amounts the borrower borrows. In some cases, the guarantor will place a limit on the total amount that can be owed at any one time.

Default: The failure to do something that was required under an agreement. A default under a note could be a late payment or non-payment.

Delinquency: Failure to make payments by a deadline. In other words, late (or non) payment.

Demand Promissory Note: A note that needs to be repaid immediately when the lender asks. There is no specific term or due date for the money under these notes.

Due Date: The date on which a loan must be paid in full. This is sometimes called the “maturity date.”

Earnest Money Promissory Note: A note given by a potential homebuyer to a seller that indicates their good faith intention to buy the house.

Grace Period: A time period in some loan agreements during which a late payment will not result in a default.

Guarantor: Someone who promises to pay another person’s debt if that person does not do so.

Guaranty: A written document in which a promise is made to pay a debt if another party does not. For example, if Person A borrows money from Person B, and Person C signs a guaranty to ensure the repayment of this money. If Person A doesn’t pay, Person C must pay. In most cases, Person B will try to collect from Person A before turning to Person C.

Installment Promissory Note: A note under which payments are made on a regular basis (in “installments”) over time. Usually, equal payments are made monthly. In some arrangements, the last payment will be the largest and include any amounts not yet paid. In others, each payment (including the last) will be equal.

Interest: A fee paid by the borrower to the lender in exchange for the lender giving the loan. This is usually written as a percentage of the amount that was borrowed. The limit on how high an interest rate can be varies from state to state and situation to situation. For example, courts may be more tolerant of a high interest rate if the borrower is a corporation and not a person.

Interest Only Promissory Note: A note in which regular monthly payments of interest are made. These payments do not include any repayment of the initial amount borrowed (i.e., the principal). At the end of the term, the borrower will pay the entire principal plus any remaining interest.

Lender: The person or company that gives money temporarily in exchange for the promise that it will receive a certain amount in the future.

Loan: Money provided temporarily on the condition that it will be returned, often with interest.

Loan Agreement: A document that provides information about a loan. It can include information about collateral, guaranties, any financial reporting requirements, fees, and other terms. Essentially, a loan agreement is a more detailed version of a promissory note.

Lump Sum Payment: A large, one-time payment of money. This is sometimes also referred to as a “balloon final payment.”

Lump Sum Payment Promissory Note: A note that must be paid in full (including all principal and interest) on a specific date. In other words, the payment will be in one “lump sum.”

Maturity Date: The date on which a loan must be paid in full. This is sometimes called the “due date.”

Negotiable Instrument: A document representing a promise to pay that can be transferred from one person to another. A promissory note is a kind of negotiable instrument (as is a check, which can be endorsed over to another person).

Prepayment: A payment made by the borrower of an amount owed before it is due.

Principal: With respect to loans, the total amount of money borrowed.

Promissory Note: A written promise made and signed by a borrower that it will repay loan money it received. Also called a “note.”

Secured Promissory Note: A note in which the borrower’s promise to pay a certain amount is backed up by certain specified property (called “collateral”). If the borrower does not repay, the lender can take the collateral. A lender is more protected under a secured note than under an unsecured note. It has the certainty that if money isn’t available, it can at least get something of value without going to court.

Security Agreement: An agreement that supports a secured promissory note. It describes the collateral and the lender’s rights if the borrower defaults on the note.

Simple Interest: Interest that is earned on the principal amount of the loan only. Compare this with “compound interest,” which is paid on both principal and on any interest earned earlier.

Specific Guaranty: A guaranty that ensures payment of a particular loan. Once that loan has been repaid, the guarantor has no more responsibility under the document.

Term: The time period of a note. On or before the last day of the term, a borrower must have repaid all of the money it borrowed.

Unsecured Debt: Loans that are not backed up with specific property. If a borrower doesn't repay his loan, the lender will have to take him to court to get that money.

Unsecured Promissory Note: A note that is not backed up by property. If the borrower doesn't repay his loan, the lender will have to take him to court to get that money.

Comparison Chart for Promissory Notes

	Amortized	Demand	Installment	Interest Only	Lump Sum
Regular payments	Yes	No	Yes	Yes	No
Is every payment the same amount?	Yes	N/A	Yes	Yes	N/A
Distribution of payments	Part to interest, part to principal	All principal and interest in one payment	Part to interest, part to principal	All periodic payments to interest; Final payment of remaining interest and all of principal	All principal and interest in one payment
Is there a due date?	No ¹	No	Yes	Yes	Yes
Penalty for late payment?	Yes	N/A	Yes	Yes	N/A
Signature required?	Yes	Yes	Yes	Yes	Yes
Can be secured or unsecured?	Yes	Yes	Yes	Yes	Yes

¹This can have a due date if the parties agree.