Borrowing Money

Understanding Promissory Notes in General

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FORMS

You can download the forms discussed in this chapter on this book’s companion page on nolo.com. See Appendix A for the link.
Many small business owners need more funds than they currently have to expand a small business. And of course, extra cash may be necessary in an emergency to cover extensive unforeseen expenses or even just to cover low cash flow months. No matter what the reason, if you need to tap outside sources for a loan, you essentially have two choices: to borrow the money privately from friends or family members or to apply for a loan from a bank or another institution.

Whether you borrow money from a bank or someone you know, you’ll sign a promissory note to document your assurance that you’ll repay the money. A promissory note says, in effect, “I promise to pay you $__________ plus interest of ___%” and then describes how and when you’re to make payments.

This chapter contains four promissory notes designed for use when your business borrows money from a friend or relative. Banks and other commercial lenders write up their own forms for you to sign, so if you’re getting a loan from a commercial lender, you’ll use their forms.

**Understanding Promissory Notes in General**

A promissory note is a binding legal contract. As with all contracts, something of value is exchanged between two parties. In this case, you (the borrower) receive money. The lender receives your promise to repay the money with interest on specified dates. If you don’t meet the repayment terms, the lender can sue and get a judgment against you for the amount you owe plus court costs and possibly lawyers’ fees. With a judgment in hand, the lender can then collect the money owed from your bank accounts and other assets.

Before borrowing money and signing a promissory note, you need to fully understand the terms and details.

**Interest**

Unless otherwise specified in the note, interest is paid at the end of the borrowing interval—not in advance. For example, if you borrow money on January 1 and agree to pay interest each month on the first day of the month, your February payment will cover the interest for your use of the money in January.

State usury laws cap the rate of interest a lender can charge—often in the range of 10% to 20% for loans. A lender who charges more may face financial penalties and is not allowed to go to court to collect the excess amount. However, state laws generally allow a lender to charge a higher interest rate when a business borrows money than when an individual does—in fact, some states put no limit on the rate of interest a business may be charged. But friends and relatives aren’t likely to charge excessive interest rates, so usury laws are rarely a problem. Check the usury law of your state only if the rate the lender wants to charge exceeds 10%.

**TIP**

Choose a fair interest rate. The sensible way to approach interest is to choose a rate that’s fair and benefits everyone involved—slightly lower than one would pay a commercial lender and slightly more than the lender would earn in a safe investment (such as a money market fund).

**CAUTION**

A no-interest loan can have tax implications. If a generous family member is loaning you more than $10,000, the promissory note should call for interest that at least matches the Applicable Federal Rate (AFR). You’ll find the current AFR at www.irs.gov. Additional rules apply if a related party loans you more than $100,000. See a tax professional for details.
Personal Guarantee

If your business is organized as a sole proprietorship or general partnership, by definition you’ll be personally liable for repaying the business loan. But if your business is organized as a corporation or limited liability company, and you were to sign a promissory note on behalf of the corporation or the LLC, you would not be personally liable for repayment. The lender would only be able to go after your business's assets for repayment.

For this reason, a bank or other commercial lender usually requires you to personally guarantee repayment of a loan to your corporation or LLC, in which case you make yourself personally liable for the debt. If your business doesn’t repay the loan, the lender can sue you and go after your personal assets, as if you hadn’t organized as a corporation or an LLC in the first place.

RELATED TOPIC

Personal guarantees are discussed further in Chapter 1.

Of course, commercial lenders aren’t the only ones who want to be repaid. A financially savvy friend or relative may also ask you to personally guarantee the repayment of a loan to your corporation or LLC. Chapter 1 contains language you can add to a promissory note to personally guarantee a loan.

If your spouse is asked to guarantee repayment of a loan, be aware of the possible consequences. Your spouse’s personal liability added to your own will place at risk any property you and your spouse own jointly, as well as your spouse’s separate property and wages. Generally, a lender is more likely to require your spouse’s guarantee if you’re borrowing money for a sole proprietorship than if the loan is being made to a partnership, corporation, or limited liability company.

Equity Investment:
Another Way to Raise Money

New or expanding businesses that need cash sometimes seek equity investors who will buy a piece of the business. Investors stand to make money if your business succeeds and to lose money if it fails. The advantage to this arrangement is that, unlike borrowing money, you normally make no commitment to investors that they’ll get their money back if things go poorly. Of course, in exchange for this freedom from debt worries, there are significant disadvantages, since you relinquish (sell) a share of your business in exchange for the investment. If your business flourishes, your investors will own part of your success. And if your business prospers and you sell it someday, the investors will be entitled to a chunk of what you receive in proportion to their share in the business. In addition, your investor may have a say in how you run your business. (Depending on the arrangements you make, equity investors may or may not be entitled to participate in making business decisions.)

Special state and federal securities laws govern the sale of interests to these equity investors. If you’re interested in pursuing this route, you’ll need to learn more about securities laws requirements. Fortunately, there are generous exemptions that normally allow a small business to provide a limited number of investors an interest in the business without complicated paperwork. In the rare cases in which your business won’t qualify for these exemptions, you have to comply with the complex disclosure requirements of the securities laws—such as distributing an approved prospectus to potential investors. In this case, it may be too much trouble to do the deal unless a great deal of money is involved. You should probably consult a small business expert to make sure you comply with these often complicated laws.
In some cases, a personal guarantee may not be enough. For example, if you’re starting a new business, a lender may conclude that the business is not sufficiently creditworthy to qualify for a loan, even if you and your spouse personally guarantee repayment. The solution may be to ask a parent, aunt, uncle, or close friend—someone with greater financial resources than you—to guarantee repayment. If you do this, however, be sure to fully disclose all the risks to your friend or relative: A cosigner (also called a co-guarantor) must be told that he or she is on the hook to repay the loan if you and your business can’t. And a cosigner should understand that guaranteeing your loan could impair his or her ability to borrow money.

**Security Interest**

A lender may also want to obtain a security interest in the borrower’s business assets or other property, such as the borrower’s house or boat. Similar to a mortgage, a security interest gives the lender the right to seize and sell the property to pay off the loan if the borrower defaults (misses payments).

By contrast, if the borrower defaults on a loan for which the lender doesn’t have a security interest, the lender will have to sue the borrower in court, get a judgment, locate available assets, and seize the assets to collect what the borrower owes.

A friend or relative who lends money isn’t as likely as a commercial lender to ask for the loan to be secured with a security interest. Still, the borrower may decide that it’s only fair to include one, or that it’s a good enticement to offer the lender.

**SEE AN EXPERT**

Pledging real estate as security requires professional assistance. If you pledge your home or other real estate as security for a business loan, a security agreement won’t be adequate to protect the lender. A well-informed lender will ask you to sign a mortgage or a deed of trust to be recorded (filed) with the county records office to establish the lender’s interest in your real estate. Procedures for preparing and recording mortgages and deeds of trust are somewhat technical and vary from state to state; it’s wise to seek the assistance of a real estate lawyer.

**Get Permission to Borrow**

If your business is a corporation, the board of directors should adopt a corporate resolution approving not only the borrowing of money but also the pledging of corporate assets as security for the loan. And, even though it’s probably not required by your bylaws or state law, it’s a good idea to get written permission from any shareholders who are not also directors. This will forestall shareholder grumbling if the corporation can’t repay the loan and corporate assets are liquidated by the lender. Also, a commercial lender will want to see the board of directors’ resolution authorizing the pledging of assets as security.

The promissory notes in this chapter can be used for secured loans. In addition, use Form 4E: Security Agreement for Borrowing Money to secure the promissory note. For further protection, the security agreement acknowledges that the lender will prepare a second document called a Uniform Commercial Code (UCC) Financing Statement, which will be recorded (filed) at a public office to let third parties such as purchasers or other lenders know about the security interest. When the borrower pays off the loan, the lender must give the borrower an official discharge of the financing statement, which can be filed at the same place where the financing statement was filed. This document is explained further in the instructions for the security agreement.
the loan. A friend or relative who lends you money is less likely to insist on seeing it.

**RELATED TOPIC**

You can use Form 3H: Consent of Directors and Form 3G: Consent of Shareholders for this purpose.

Similarly, if your business is an LLC, get written permission from all of the members before borrowing money or pledging LLC assets as collateral for a loan. See the instructions for forms 3G and 3H in Chapter 3 for sample language that you can use.

**Acceleration Clause**

Acceleration allows the lender to demand payment of the entire loan amount if the borrower doesn’t make a required payment within a specified number of days after it becomes due. If the borrower still doesn’t pay, the lender can sue the borrower for the entire amount owed.

The promissory notes in this book include acceleration clauses that allow the lender to collect the entire amount before it is due. Without an acceleration clause, the lender would have to sue the borrower each time a payment was missed or wait until all installment payments had been missed to sue for the whole amount.

**Late Fee**

A lender may want to include a clause in the promissory note tacking on a late charge for payments not made on time. Our agreements do not call for payment of a late fee, and you should argue against adding one if you’re the borrower. Here’s why: If a payment is late, interest continues to run on the principal balance owed, meaning the lender is already being compensated for your use of the money over more time. A late charge means the lender is double-dipping.

**Prepayment**

Paying some of the loan principal before it’s due reduces the overall amount of interest on a loan. A borrower might do this by increasing each installment payment, making occasional additional payments, or paying the loan balance off early.

Some loans have prepayment penalties, meaning that if the borrower wants to pay off part or all of the loan before it is due, the lender can charge a penalty, usually 1% to 3% of the loan principal. The promissory notes in this chapter state that prepayment will be allowed without penalty. In other words, the borrower is allowed to pay off the loan early, without penalty.

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**CAUTION**

Monthly installment payments must always be made. Even if the borrower prepays some of the loan, regular monthly installment payments must still be made. Suppose that on June 1 you make your normal monthly installment payment of $200. To reduce the principal amount, you pay $1,000 extra and ask that it be applied toward principal. Even though you may think you’ve paid five months in advance, you haven’t. On July 1—and on the first day of each month after that—you still must make your normal monthly payment of $200 until the loan is paid off. In short, if you make extra payments toward principal, be sure you’ll still have enough cash on hand to make regular payments as they become due.

**Fees and Costs**

The promissory notes in this chapter require you to pay the lender’s costs and lawyers’ fees if the lender must sue to collect on the note.

**Signing and Storing Your Promissory Note**

Sign only the original promissory note and give it to the lender to keep. Keep a photocopy of the signed note (marked “COPY”) for your records.
The lender should return the original to you when you’ve paid the note off.

**Changing a Promissory Note**

Occasionally, you and the lender may want to change (amend) the terms of an existing promissory note. The best way to do this is to prepare and sign a new promissory note containing the new terms. You should never rely on oral understandings about your rights or obligations under a promissory note, where your money and credit may be at stake.

In the new promissory note, you can add the following language:

```
This promissory note replaces the $____ promissory note signed by Borrower on __________, 20__, and payable to Lender.
```

The lender should return the original promissory note to the borrower in exchange for the new note.

**RESOURCE**

For more information and forms for getting approval from corporate directors and shareholders for borrowing money and pledging assets, see *The Corporate Records Handbook: Meetings, Minutes & Resolutions*, by Anthony Mancuso (Nolo). For information and forms on getting approval from LLC members and managers for borrowing money and pledging assets, see *Your Limited Liability Company: An Operating Manual*, by Anthony Mancuso (Nolo).

**The Promissory Notes in This Chapter**

The main differences among the four promissory notes in this chapter concern how you’ll pay back the loan:

- **Form 4A: Promissory Note (Amortized Monthly or Annual Payments).** This note requires you to pay the same monthly or annual payment for a specified number of months or years until the loan is paid off. Part of each payment goes toward interest and the rest goes toward principal. When you make the last payment, the loan and interest are fully paid. In accounting jargon, this type of loan is said to be fully amortized over the period that the payments are made.

- **Form 4B: Promissory Note (Balloon Payment).** This note requires you to make equal monthly payments of principal and interest until the balance is due in one payment, called a balloon payment. This type of promissory note offers definite benefits to the borrower—primarily, lower monthly payments during the course of the loan, thus keeping cash available for other needs.

**EXAMPLE:** Phil needs some start-up money for his new business. Cousin Edna is willing to lend him $20,000 at 7% interest, but she’d like to have all the money back in two years when she plans to modernize her kitchen and bathroom. Phil and Edna agree that Phil will pay back $200 a month for two years. At the end of two years, Phil will have reduced the loan balance from $20,000 to $17,589.94. (The rest of his payments will have gone toward interest.) Phil will owe this balance to Edna in one balloon payment. Phil is comfortable with this arrangement. If he doesn’t have the cash to pay the balloon payment, he knows he can refinance his house with the bank to pay off Edna.

- **Form 4C: Promissory Note (Interest-Only Payments).** This type of note allows the borrower to repay the lender by making payments of interest at specified intervals, such as every month. During the repayment period, the borrower does not have to pay any principal. At the end of the loan term, you
## Amortization Chart for Monthly Payment

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<td>0.0258</td>
<td>0.0217</td>
<td>0.0190</td>
<td>0.0171</td>
<td>0.0153</td>
<td>0.0135</td>
<td>0.0105</td>
<td>0.0092</td>
<td>0.0079</td>
<td>0.0066</td>
<td>0.0054</td>
<td>0.0042</td>
<td></td>
</tr>
<tr>
<td>11.5%</td>
<td>0.0886</td>
<td>0.0608</td>
<td>0.0468</td>
<td>0.0385</td>
<td>0.0330</td>
<td>0.0261</td>
<td>0.0220</td>
<td>0.0193</td>
<td>0.0174</td>
<td>0.0156</td>
<td>0.0138</td>
<td>0.0108</td>
<td>0.0095</td>
<td>0.0082</td>
<td>0.0069</td>
<td>0.0057</td>
<td>0.0045</td>
<td></td>
</tr>
<tr>
<td>12.0%</td>
<td>0.0888</td>
<td>0.0610</td>
<td>0.0471</td>
<td>0.0387</td>
<td>0.0332</td>
<td>0.0263</td>
<td>0.0222</td>
<td>0.0196</td>
<td>0.0177</td>
<td>0.0159</td>
<td>0.0141</td>
<td>0.0111</td>
<td>0.0098</td>
<td>0.0085</td>
<td>0.0072</td>
<td>0.0060</td>
<td>0.0048</td>
<td></td>
</tr>
</tbody>
</table>
must make a balloon payment to cover the entire principal and any remaining interest. This type of note offers definite benefits to the borrower—significantly lower monthly payments during the course of the loan, thus keeping cash available for other needs. But the disadvantage is that you end up paying more interest because you are borrowing the principal for a longer period of time.

- **Form 4D: Promissory Note (Lump-Sum Payment).**
  With this type of promissory note, you pay off the loan at a specified date in the future in one payment, which includes the entire principal amount and the accrued interest.

  **EXAMPLE:** Renee borrows $15,000 from her former college roommate for her graphic design business. The loan is at 8% and is to be repaid in one payment in seven years. Unless Renee pays back the loan early, she will owe $23,400 when the seven years are up.

  **TIP**
  Promissory notes can help preserve friendships and family harmony. It’s smart to sign a promissory note, even if the friend or relative from whom you’re borrowing assures you that such formality isn’t necessary. Think of it this way: Documenting the loan can do no harm—and it can head off misunderstandings about whether the money is a loan or gift, when it is to be repaid, and how much interest is owed.

**Form 4A: Promissory Note (Amortized Monthly or Annual Payments)**

If you’ve ever taken out a mortgage or car loan, you’re familiar with how this type of repayment works. You pay off the loan in equal monthly or annual payments over a set time, usually a number of years. Each of your payments is partly applied to interest and partly to principal. As the amount you owe declines, the amounts of each payment that go to principal and interest changes (the principal portion gradually goes up while the interest portion goes down). This is called amortizing the loan.

If you know the principal amount, the interest rate, and the number of years that payments will be made, you can consult an amortization calculator or schedule to arrive at the monthly payment. To use a free calculator, go to www.nolo.com/legal-calculators, or you can use software like Intuit’s Quicken program.

If you don’t have immediate access to the Internet or software to calculate the amortization, the chart above can help you determine what amount needs to be paid each month to pay off a loan over time. Here’s how to use it:

**Step 1.** In the left-hand column of the chart, find your interest rate.

**Step 2.** At the top of the chart, find the period of time you’ll have to repay the loan—the period between the making of the loan and the date all principal will be paid.

**Step 3.** Find the figure where the two columns intersect. For instance, if the interest rate is 10% and the loan will be paid over five years, the figure at the intersection point is 0.0212.

**Step 4.** Multiply that figure by the principal amount of the loan. The product is the monthly payment, which includes principal and interest.

  **EXAMPLE:** Vladimir makes a loan of $10,000 at 10% interest. The loan is payable in monthly installments over five years. Vladimir multiplies 0.0212 by $10,000 to get $212, the amount of each monthly payment.
Instructions for Form 4A: 
Promissory Note (Amortized Monthly or Annual Payments)

All the forms in this book are provided in Appendix B and electronically on the Nolo website. To access the eforms online, use the link provided in Appendix A. As you read the instructions for Form 4A, you may want to refer to the form in Appendix B or open the eform so you can follow along.

1. Names

Insert the names and addresses of the borrower and lender. See Chapter 1 for a discussion of how to identify the parties in legal forms.

2. Promise to Pay

In the first blank, insert the principal amount of the loan. In the second blank, fill in the annual interest rate. For information on interest rates and usury laws, see the introduction to this chapter.

The phrase “For value received” is legal jargon meaning that you have received something—in this case, money—from the lender in exchange for your promise to pay money. It’s there because the law requires that for your promise to pay to be binding, you must receive something of value from the other party.

3. Installments

Insert the number of monthly or annual payments you’ll make to repay the loan and the amount of each installment. As noted above, the accompanying amortization chart and instructions allow you to quickly calculate the amount of each installment.

4. Date of Installment Payments

If you will be making monthly payments, insert the day of the month when payments will be made and the date the first payment is due. For example, if you borrow money on January 15, 2014, you might provide for payments to be made on the 15th of each month, with the first payment due on February 15, 2014.

If you will be making annual payments, insert the date when payments will be made and the date the first payment is due. For example, if you borrow money on March 15, 2014, you might provide for payments to be made on March 15th of each year, with the first payment due on March 15, 2015.

5. Application of Payments

You don’t need to insert anything here. Each payment automatically goes to pay accrued interest first. The rest goes toward the remaining principal. These allocations are easily handled by a free calculator (available at www.nolo.com/legal-calculators) or number-crunching software, such as Quicken. Basically, here’s how it works: Assume that the annual interest rate is 8% on a $5,000 loan. To determine the annual interest, you’d multiply the loan balance by the interest rate. If you were making monthly payments, you’d divide the annual interest by 12 to determine the monthly interest portion of the payment. To illustrate:

<table>
<thead>
<tr>
<th>Loan balance</th>
<th>$5,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>x .08</td>
</tr>
<tr>
<td>Annual interest</td>
<td>$400.00</td>
</tr>
<tr>
<td>Payments per year</td>
<td>+ 12</td>
</tr>
<tr>
<td>Interest for first month</td>
<td>$33.33</td>
</tr>
</tbody>
</table>

If you’re making payments of $200 each month, your payment for the current month would be applied as follows:

| Interest | $33.33 |
| Principal | 166.67 |
| Total | $200.00 |

That would leave a principal balance of $4,833.33 ($5,000.00 less $166.67) remaining on the loan. So next month, since the principal is less, the interest portion of your $200 payment will be a bit less and the principal portion will be a bit more.
6. Prepayment

You don’t need to insert anything here. This paragraph allows the borrower to prepay the money borrowed—that is, pay all or part of the principal in advance. By prepaying, the total amount of interest paid is reduced.

7. Loan Acceleration

Promissory notes typically provide that if a payment is late by more than a specified number of days, the lender can declare the entire unpaid balance due. This is called an acceleration clause. Fill in the number of days after the payment due date that will trigger acceleration. Thirty days is often appropriate when the lender is a friend or relative.

8. Security

Check the first box if the note is unsecured, meaning that the lender does not have a lien on or security interest in any property.

Check the second box if the borrower is giving the lender a security interest in business property. Insert the name of the business. Be sure to also enter into a security agreement with the lender. (You can use Form 4E: Security Agreement for Borrowing Money.) The lender can then file a Uniform Commercial Code (UCC) Financing Statement with the appropriate state or county office. When the borrower pays off the loan, the lender must give the borrower an official discharge of the financing statement, which can be filed at the same place where the financing statement was filed.

Check the third box if the borrower will give the lender a lien on real estate owned by the borrower or the borrower’s business. Choose whether this will be done by a mortgage or deed of trust. (The practice varies from state to state.) Finally, insert the legal description of the real estate as found in your deed or title insurance policy.

If you’re using the downloaded form, instead of marking the correct box, delete the security options you’re not using, so that only the appropriate sentence(s) remain in the document.

SEE AN EXPERT

Have a lawyer prepare the mortgage or deed of trust. Because of the technical intricacies of real estate titles, it’s best to have an expert draft the mortgage or deed of trust that will secure the loan. After the loan is made, it’s the lender’s job to see that the mortgage or deed of trust gets recorded at the appropriate county records office. When the loan is paid, the lender should remove the lien (security interest) by giving you a discharge of the mortgage or deed of trust that you can record where the original document was recorded.

9. Collection Costs

Nothing needs to be filled in here. This paragraph requires the borrower to pay the lender’s reasonable costs and lawyers’ fees if the lender takes the borrower to court to collect on the note and wins the lawsuit.

Standard Clauses

The remainder of the note contains the standard clauses regarding Notices, Governing Law, and Severability discussed in Chapter 1. (Note that the other standard clauses discussed in Chapter 1 generally do not apply to promissory notes and are not included in this form.) The only thing you’ll need to fill in here is the name of the state whose law will apply to the note in the paragraph “Governing Law.”

Signature and Guarantee

As discussed above, the lender may want the borrower to have a personal guarantor sign the loan, to be personally liable for repayment. If this is the case, at the end of the promissory note, add the appropriate guarantee language from the eform Guarantee.rtf.

Guarantee language. Guarantee language that you can copy and paste into these promissory notes is included in the eform Guarantee.rtf.
Only the borrower and guarantors, if any, sign the note. The lender does not sign it. (See Chapter 1 to read more about signing contracts.)

**Form 4B: Promissory Note (Balloon Payment)**

Suppose you borrow money and would like to pay it back over four years, but the burden of making installment payments sufficient to pay it off in that time would be too great. To allow you to conserve cash, the lender might agree to compute the monthly payments based on an eight-year amortization period—making the monthly payments substantially lower—but have you pay back the loan at the end of the four years. At the end of that period, you’d pay off whatever was still owing on the loan by making a lump-sum, or balloon, payment. Form 4B is designed for this type of loan.

**Example:** Phyllis will borrow $20,000 from her uncle Ted to start a transcription service for doctors who dictate their medical charts. They agree that Phyllis will repay the loan by making monthly payments over a four-year period and that the yearly interest rate will be 8%. Using an amortization calculator, Phyllis and Ted determine that it would take monthly payments of $488.26 to pay off the loan in full by the end of the fourth year. But this worries Phyllis, since in the first few months making payments of that size would pinch the tiny cash flow of her new business. To make things easier for Phyllis, she and Ted agree to the following: Phyllis will pay $282.73 a month—the amount it would take to amortize the loan over an eight-year period. At the end of four years, Phyllis will make a lump-sum payment of $11,864.27 to pay off the remaining principal balance.

**TIP**

Amortization computations may vary. The figures in the above example were derived using Quicken’s amortization feature. If you use the chart provided earlier in this chapter, you’ll find that the computations are rounded off: The monthly installments for the four-year period are calculated at $488; the eight-year figure is $283, with a balloon payment of $11,900.

**RESOURCE**

Find free amortization calculators. Nolo offers free loan calculators at www.nolo.com/legal-calculators. Look under the header “Personal Financing” to figure out how much loan payments will be, how long it will take to pay off a loan, or to determine a loan rate.

**Instructions for Form 4B: Promissory Note (Balloon Payment)**

All the forms in this book are provided in Appendix B and electronically on the Nolo website. To access the eforms online, use the link provided in Appendix A. As you read the instructions for Form 4B, you may want to refer to the form in Appendix B or open the eform so you can follow along.

1. **Names**
   
   Insert the names and addresses of the borrower and lender. See Chapter 1 for a discussion of how to identify the parties in legal forms.

2. **Promise to Pay**
   
   See instructions for Paragraph 2 of Form 4A.

3. **Monthly Installments**
   
   Insert the number of monthly payments you’ll make to repay the loan and the amount of each installment.
As noted above, the accompanying amortization chart and instructions allow you to quickly calculate the amount of each installment. The amortization period used to calculate payments will be longer than the actual period over which the borrower will repay the loan. (Otherwise, there would be no balloon payment to be made at the end of the amortization period—the loan would be paid off.)

4. Date of Installment Payments

Insert the day of the month when the regular monthly payments will be made and the due date of the first payment. For example, if you borrow money on January 15, 2014, you might provide for payments to be made on the 15th day of each month, with the first payment due on February 15, 2014.

In the final space, insert the date by which you’ll make the balloon payment covering the entire balance of principal and interest.

5. Application of Payments

You don’t need to insert anything here. See the instructions for Paragraph 5 of Form 4A for how payments are allocated between principal and interest.

6. Prepayment

See the instructions for Paragraph 6 of Form 4A. You don’t need to insert anything here.

7. Loan Acceleration

See the instructions for Paragraph 7 of Form 4A.

8. Security

See the instructions for Paragraph 8 of Form 4A.

9. Collection Costs

Nothing needs to be filled in here. See the instructions for Paragraph 9 of Form 4A.

Standard Clauses

The remainder of the note contains the standard clauses regarding Notices, Governing Law, and Severability discussed in Chapter 1. (Note that the other standard clauses discussed in Chapter 1 generally do not apply to promissory notes and are not included in this form.) The only thing you’ll need to fill in here is the name of the state whose law will apply to the note in the paragraph “Governing Law.”

Signature and Guarantee

See the instructions for Form 4A.

Form 4C: Promissory Note (Interest-Only Payments)

You and the lender may agree that you’ll make monthly payments of interest only, and then pay off the entire principal in one lump sum at a date some months or years down the line. Form 4C is designed for this purpose. The advantage of this method is that the periodic payments you make will be lower than if you were to make payments that included both interest and principal. The disadvantage is that since you’re borrowing the principal for a longer time, you’ll be paying more interest.

**EXAMPLE:** Peter borrows $20,000 at 8% interest from a family friend, Tracy, to expand his vinyl record business. Tracy will need the entire amount back by the end of four years to make a down payment on a vacation cabin she plans to buy. Using an amortization calculator, Peter figures out that if he were to pay back the debt in equal installments each month for four years, each payment would need to be $488.26—a bit more than he can handle right now. But if he pays interest only, his payments will be only $133.33 a month. Peter and Tracy agree to this arrangement, giving Peter four years to raise the $20,000 that will be needed to pay back the entire principal. Peter isn’t worried because he firmly believes his business will be strong enough by then that he’ll have no problem refinancing through a bank loan, if necessary.
Note the higher cost to Peter of doing it this way. He’ll be making 48 payments of interest totaling $6,400 plus the repayment of the $20,000—which adds up to $26,400. If, instead, he were to amortize the loan over four years by making 48 monthly payments of $488.26 each, his total cost would be $23,436.48, which is nearly $3,000 less. Of course, the interest on business loans is a tax-deductible expense, which cushions the impact a bit.

**TIP**

**Interest-only payments afford the borrower maximum flexibility.** If a borrower gets a lender to agree to the interest-only method and then finds herself in the happy position of having a lot of cash on hand, she can prepay some of the principal, thus reducing the interest payments. But if cash flow isn’t so great, she’s under no pressure to pay any part of the principal until the end of the loan period, at which point she may have other alternatives, such as borrowing the necessary payback amount from a commercial lender.

### Instructions for Form 4C: Promissory Note (Interest-Only Payments)

All the forms in this book are provided in Appendix B and electronically on the Nolo website. To access the eforms online, use the link provided in Appendix A. As you read the instructions for Form 4C, you may want to refer to the form in Appendix B or open the eform so you can follow along.

1. **Names**

   Insert the names and addresses of the borrower and lender. See Chapter 1 for a discussion of how to identify the parties in legal forms.

2. **Promise to Pay**

   See the instructions for Paragraph 2 of Form 4A.

3. **Interest Payments**

   Here you provide the repayment schedule. Check only one box: annual, monthly, or other (eform users may delete the unused text).

   Check the first box if you’ll pay interest annually and insert the date of each annual payment—for example, “January 1.” In the next blank, fill in the year you’ll make the first interest payment. For the last blank, you’ll need to calculate the amount of the interest payment. The following example assumes simple interest.

   **EXAMPLE:**
   The borrower borrows $10,000 at 8%.
   Interest is $10,000 x .08 = $800
   Each year, the borrower will make one interest payment of $800.

   Check the second box if you’ll make regular monthly interest payments. In the first blank, insert the day of the month—for example, the 15th day of each month. In the next blank, fill in the month that interest payments will begin—for example, January 2014. The lender may prefer monthly payments, since requiring monthly payments gets the borrower in the habit of paying regularly. For the last blank, you’ll need to calculate the amount of the interest payment. The following example assumes simple interest.

   **EXAMPLE:**
   The borrower borrows $10,000 at 8%.
   $10,000 x .08 = $800
   $800 divided by 12 = $66.67 per month
   Each year, the borrower will make 12 interest payments of $66.67 each.

   Check the third box if you plan to pay interest at intervals other than annually or monthly, such as the 15th day of January, April, July, and October, beginning April 15, 20xx. Use the blank to specify the details.
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Samples

... quarterly on the 15th day of January, April, July, and October, beginning April 15, 20xx. The amount of each interest payment will be $200.

... semiannually on the 1st day of February and October, beginning February 1, 20xx. The amount of each interest payment will be $400.

Follow this example to calculate the amount of the interest payment. (The example assumes simple interest.)

EXAMPLE:
The borrower borrows $10,000 at 8%.
$10,000 x .08 = $800
$800 divided by 4 quarterly payments = $200 per quarter
$800 divided by 2 semiannual payments = $400 twice a year
Each year, the borrower will make four interest payments of $200 each or two interest payments of $400 each.

8. Collection Costs

Nothing needs to be filled in here. See the instructions for Paragraph 9 of Form 4A.

Standard Clauses

The remainder of the note contains the standard clauses regarding Notices, Governing Law, and Severability discussed in Chapter 1. (Note that the other standard clauses discussed in Chapter 1 generally do not apply to promissory notes and are not included in this form.) The only thing you’ll need to fill in here is the name of the state whose law will apply to the note in the paragraph “Governing Law.”

Signature and Guarantee

See the instructions for Form 4A.

Form 4D: Promissory Note (Lump-Sum Payment)

If you and the lender prefer to keep things really simple, Form 4D may fit your needs. Here you agree to pay off the money you borrowed, plus interest, in one single payment. This works best for a short-term loan or possibly a loan from an affluent parent or grandparent to a child where the promise to repay is seen as an expression of the younger person’s intent—not something that the lender would ever really enforce in court if the payment were delayed.

TIP

A will or trust can address fairness issues within a family. A large loan from a parent to a child can cause friction among siblings—especially if the parent dies before the child fully repays it. One solution is for the parent to provide in a will or living trust that any unpaid loan will be treated as a partial advance payment of that child’s inheritance.
Instructions for Form 4D:
Promissory Note (Lump-Sum Payment)

All the forms in this book are provided in Appendix B and electronically on the Nolo website. To access the eforms online, use the link provided in Appendix A. As you read the instructions for Form 4D, you may want to refer to the form in Appendix B or open the eform so you can follow along.

1. Names

Insert the names and addresses of the borrower and lender. See Chapter 1 for a discussion of how to identify the parties in legal forms.

2. Promise to Pay

See the instructions for Paragraph 2 of Form 4A.

3. Payment Date

Check the first box if the loan will be due on a particular date, and insert the date by which the borrower will repay the entire amount of the loan plus interest.

Check the second box if the loan will be due after the occurrence of a particular event, and insert a description of the event (for example, borrower's receipt of a $10,000 Small Business Administration loan). Also insert a date by which the loan will be repaid in case the particular event does not occur. Make sure that the date is far enough in advance to allow enough time for the event to take place. The agreement provides that the loan will be due after the occurrence of the event, or on the alternate date you choose, whichever is sooner (in the agreement this is described as “the earlier of” the occurrence or the alternate date).

EXAMPLE: On May 1, 2014, Tony agrees to lend Maggie $10,000 until she receives the proceeds of another loan that she hopes to get from the Small Business Administration. The parties agree that Maggie will repay the loan either when she gets the funds from the SBA or by October 1, 2014, whichever happens first.

The promissory note does not state the amount of the lump-sum payment; the exact amount should be determined on the payment date. However, you can estimate what the payment will be by multiplying the loan amount by the interest rate, and then multiplying that number by the number of years the loan is out. The following example assumes simple interest.

EXAMPLE:
The borrower borrows $10,000 at 8% for three years.

$10,000 x .08 = $800

$800 x 3 = $2,400 total interest

$10,000 + $2,400 = $12,400 lump-sum payment

The borrower will make one lump-sum payment of $12,400.

4. Prepayment

See the instructions for Paragraph 6 of Form 4A. You don’t need to insert anything here.

5. Security

See the instructions for Paragraph 8 of Form 4A.

6. Collection Costs

Nothing needs to be filled in here. See the instructions for Paragraph 9 of Form 4A.

Standard Clauses

The remainder of the note contains the standard clauses regarding Notices, Governing Law, and Severability discussed in Chapter 1. (Note that the other standard clauses discussed in Chapter 1 generally do not apply to promissory notes and are not included in this form.) The only thing you’ll need to fill in here is the name of the state whose law will apply to the note in the paragraph “Governing Law.”
Signature and Guarantee
See the instructions for Form 4A.

Form 4E: Security Agreement for Borrowing Money

Those lending money to your business may feel more confident about the loan if they are given a security interest in the assets of the business. Then, if you don't repay the loan as promised, the lender can take the property you've pledged, sell it, and use the proceeds to at least partially repay the borrowed amount.

Before completing and signing a security agreement for a business loan, it helps to know how the law classifies property.

Real Estate or Real Property refers to land and the buildings attached to land. To grant a lender a security interest in (or lien on) real estate you own, you’d sign a mortgage or deed of trust. The lender would then record (file) the mortgage or deed of trust with a county land records office where it would become a matter of public record.

Personal Property includes all property that’s not real estate. It can be property you use for personal purposes, such as your car, boat, clothes, or saxophone, as well as property used in or owned by your business, such as a business truck, machinery, a copy machine, a computer, or furniture. Personal property is of two types:

- Tangible Personal Property—property you can actually see and touch, such as a car or desk.
- Intangible Personal Property—property that’s an abstract legal right, often represented by a document or certificate. It includes a bank account, certificate of deposit, stock in a corporation, the right to collect rent under a lease, accounts receivable, and intellectual property (a copyright, trademark, or patent).

Although it’s possible for a business or an individual to pledge intangible personal property as security for a loan, it’s far more common—and legally simpler—to pledge real estate or tangible personal property. Form 4E can be used where you’re pledging some or all of your business’s tangible personal property as security.

See a lawyer if you’ll use real estate or intellectual property as security for a loan. This form is intended only for tangible personal property. As explained in the introduction to this chapter, if you pledge your home or other real estate as security for a business loan, a security agreement won’t be adequate to protect the lender. A well-informed lender will ask you to sign a mortgage or a deed of trust, which can then be recorded (filed) with a designated county official to establish the lender’s security interest in the real estate. Because title to real estate is a highly technical matter beyond the scope of this book, you should seek the assistance of a real estate lawyer before signing a mortgage or deed of trust. For similar reasons, you should consult an intellectual property lawyer for help in pledging intangible personal property, such as a copyright, trademark, or patent, as security for a loan.

Instructions for Form 4E: Security Agreement for Borrowing Money

All the forms in this book are provided in Appendix B and electronically on the Nolo website. To access the eforms online, use the link provided...
in Appendix A. As you read the instructions for Form 4E, you may want to refer to the form in Appendix B or open the eform so you can follow along.

CAUTION

Get permission from directors, shareholders, and members before pledging assets. As explained in the introduction to this chapter, if your business is a corporation or an LLC, the board of directors or members should adopt a resolution approving not only the borrowing of money but also the pledging of company assets as security for the loan. And it’s a good idea to get written permission from shareholders who are not directors or members who are not managers as well.

1. Names

In the first blank, fill in your name. In the second, fill in the lender’s name.

2. Grant of Security Interest

You may need to check more than one box (eform users can include just the appropriate clauses and delete the rest).

You’ll probably want to select the first option, which refers to some or all of the tangible personal property that the borrower’s business currently owns. The specific items of property will be listed in an attachment to your agreement. If you check the first box, also fill in the name by which your business is known.

The lender may also want a security interest in any other property you add to the business, including replacement inventory. In that case, check the second box as well.

Check the third box if you’re going to pledge tangible personal property that you own personally or if you’ll pledge a single item of business property—a car, for example—rather than all of the business’s assets. (As noted in the introduction to this chapter, you should pledge enough property to cover the loan, but not more.) Next, describe the item you’re pledging.

Samples

20xx Ford Ranger, license number A2345678, Vehicle Identification Number JKLM1234567890.

Three Acme natural-gas-powered heat lamps, serial numbers: 1234567890; 2234567890; and 3234567890.

Some kinds of assets—often those that are licensed by the state, such as cars and boats—require the lender to take a security interest in the property by listing its name on the certificate of title instead of filing the conventional UCC Financing Statement discussed above. Contact the appropriate state agency for the procedure and forms to accomplish this.

3. Security for Promissory Note

Fill in the date of the promissory note, the amount borrowed under the promissory note, and the interest rate. There’s no need to list the payment schedule.

4. Financing Statement

You don’t need to insert anything in this paragraph. It confirms that the lender will file a financing statement—a Uniform Commercial Code form (called Form UCC-1) that’s filed with a governmental agency to let the public know that the property the borrower is using in its business is subject to the lender’s lien. Anyone checking the public records—a bank’s loan department, for example—will learn that someone has a prior lien on the property described in the notice. This limits the borrower’s ability to fraudulently sell the property to someone else or to offer it as collateral for another loan, pretending that it belongs 100% to the borrower.
Most states accept a nationally standardized UCC-1 form, like the sample included below, but not all. Check your state’s secretary of state website or call the office to obtain the proper form and learn the filing fees.

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[67x750]| LEGAL FORMS FOR STARTING & RUNNING A SMALL BUSINESS

**CAUTION**

Remember to get a discharge. When you’ve paid off the loan, you’re entitled to get a document from the lender verifying that there’s no longer a security interest in the pledged property. If you forget to get this document and record it at the same office where the financing statement was filed, you can run into a snag when you go to sell the property or your entire business. That’s because to a potential purchaser prudently doing a UCC search, it will appear that the property is still subject to the lender’s lien.

5. **Use and Care of the Secured Property**

Nothing needs to be inserted here. This paragraph spells out the borrower’s duty to safeguard the property so that the lender has something of value to sell in case the borrower defaults.

6. **Borrower’s Default**

This paragraph says the borrower is in default—meaning that the lender can sue the borrower for repayment or return of the goods—if the borrower doesn’t make required payments or doesn’t promptly correct any violations of the requirements listed in the preceding paragraph.

In the first blank, fill in the number of days after which the borrower will be in default under the terms of the promissory note—that is, how long after the borrower has failed to make payments that the lender can sue the borrower for repayment. This should be the same number of days stated in the promissory note itself.

In the second blank, fill in the number of days the borrower has to correct a violation of the borrower’s obligations regarding the use and care of the secured property—such as failing to maintain it in good repair—before the borrower is in default under the security agreement. Generally, a borrower might have anywhere from five to 60 days to correct a violation.

7. **Lender’s Rights**

Fill in the name of the state where the property is located.

This paragraph summarizes the lender’s rights under the Uniform Commercial Code if the borrower defaults on his or her obligations under this security agreement. Specifically, the lender is allowed to seize the secured property and sell, lease, or otherwise dispose of it.

8. **Notice to Borrower**

Fill in the location where the lender should send the borrower a notice if the borrower is in default and the lender plans to sell, lease, or otherwise dispose of the property. Note that the agreement provides that the lender must give the borrower at least ten days’ notice before taking action with respect to the property. (This gives the borrower the chance to pay off the debt in full before the property is taken or turned over to someone else.)

**Standard Clauses**

The remainder of the agreement contains the standard clauses we discussed in Chapter 1. The only thing you’ll need to fill in here is the name of the state whose law will apply to the contract in the paragraph called “Governing Law.”

**Signature**

Fill in the required information. See Chapter 1 to read more about signing contracts.

**Attachment to Security Agreement**

If you check the first box under Paragraph 2 (“The tangible personal property owned by Borrower’s business … as listed in attached Attachment 1”), you must fill in the attachment and attach it to the security agreement.
# Sample UCC Financing Statement

**UCC FINANCING STATEMENT**

**FOLLOW INSTRUCTIONS (front and back) CAREFULLY**

<table>
<thead>
<tr>
<th>Field</th>
<th>Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a. ORGANIZATION'S NAME</td>
<td>Star Lighting, LLC</td>
</tr>
<tr>
<td>1b. INDIVIDUAL'S LAST NAME</td>
<td></td>
</tr>
<tr>
<td>1c. MAILING ADDRESS</td>
<td>555 Jefferson Avenue</td>
</tr>
<tr>
<td>1d. SEE INSTRUCTIONS</td>
<td></td>
</tr>
<tr>
<td>1e. TYPE OF ORGANIZATION</td>
<td></td>
</tr>
<tr>
<td>1f. JURISDICTION OF ORGANIZATION</td>
<td></td>
</tr>
<tr>
<td>1g. ORGANIZATIONAL ID #, if any</td>
<td></td>
</tr>
<tr>
<td>2a. ORGANIZATION'S NAME</td>
<td></td>
</tr>
<tr>
<td>2b. INDIVIDUAL'S LAST NAME</td>
<td></td>
</tr>
<tr>
<td>2c. MAILING ADDRESS</td>
<td></td>
</tr>
<tr>
<td>2d. SEE INSTRUCTIONS</td>
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<td>2e. TYPE OF ORGANIZATION</td>
<td></td>
</tr>
<tr>
<td>2f. JURISDICTION OF ORGANIZATION</td>
<td></td>
</tr>
<tr>
<td>2g. ORGANIZATIONAL ID #, if any</td>
<td></td>
</tr>
<tr>
<td>3a. ORGANIZATION'S NAME</td>
<td>Olde Lighting, Inc.</td>
</tr>
<tr>
<td>3b. INDIVIDUAL'S LAST NAME</td>
<td></td>
</tr>
<tr>
<td>3c. MAILING ADDRESS</td>
<td>123 Eastern Drive</td>
</tr>
<tr>
<td>4. The FINANCING STATEMENT covers the following collateral:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>All furniture, fixtures, equipment, and inventory of Debtor. Also, any tangible personal property (including replacement inventory) that Debtor now owns or later acquires in connection with Debtor's business known as Star Lightening located at 555 Jefferson Ave., Berkeley, CA. Also the proceeds of all insurance policies that now or later cover the secured property.</td>
</tr>
</tbody>
</table>

**International Association of Commercial Administrators (IACA)**

**FILING OFFICE COPY — UCC FINANCING STATEMENT (FORM UCC1) (REV. 05/22/02)**
1. **Names**

Insert the names of the borrower and the lender.

2. **Terms of Attachment**

Insert the date of the security agreement. Then list the tangible personal property that the borrower’s business owns that is being pledged as security for repayment of the loan.

**Sample**

All furniture, fixtures, and inventory of Borrower. Also any other tangible personal property that Borrower now owns in connection with Borrower’s business known as Star Lighting located at 555 Jefferson Ave., Berkeley, CA. Also the proceeds of all insurance policies that now or later cover the secured property.
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