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Promissory Notes for Small Businesses

Common Types of Repayment Schedules

If you want to borrow cash to fund your business activities, a commercial lender will require you to sign a promissory note, generally the lender's own form. A promissory note records a promise to repay a debt or a loan in accordance with specific terms – usually at a definite time, through a quantified series of payments or on demand. The party making the promise to repay is called the debtor or borrower, and the party making the loan is called the creditor or lender. Even funds borrowed from a friend or family member should be recorded in a promissory note to avoid confusion and misunderstandings about whether the money is actually a gift or a loan, the terms of repayment, and the interest rate. Promissory notes have a similar legal effect to that of contracts, in that the borrower is legally bound to hold to its promise as recorded in the promissory note. A default, or failure to make payments as specified in the promissory note, can result in several unwanted consequences such as a lawsuit or damage to the borrower's credit.

There are several ways to structure the repayment terms of a promissory note, each with its own advantages and disadvantages. The legal and practical terms of promissory notes can vary considerably, so it is crucial that you pick a repayment form that works best for you and your business. Below are four of the most commonly used repayment forms used by small businesses:

1. ***Equal Monthly Payments with a Final Balloon Payment***

This type of loan requires the borrower to make low equal monthly payments made up of both principal and interest for a relatively short period of time. After the last monthly payment, the borrower must make a final balloon payment consisting of the remaining principal and interest. Although this type of repayment schedule enables the borrower to keep more cash available for other needs during the term of the loan, that final large balloon payment must be kept in mind.

2. ***Interest-Only Payments with a Final Balloon Payment***

With an interest-only loan, the borrower makes regular interest-only payments over a specified number of months or years. The principal amount of the loan remains the same throughout, and at the end of the term the borrower makes a balloon payment of the entire principal amount plus any remaining interest. An obvious advantage to this repayment form is that regular payments are low and the terms generally allow the borrower to repay some principal if there is extra cash on-hand. However, the principal amount is borrowed for a longer period of time, so the borrower ends up paying much more interest over the loan's term.

3. ***Amortized Payments***

With an amortized payment loan, the borrower pays the same amount each month for a period of months or years, but each payment includes a portion of principal and a portion of interest. Once the last payment is made, the principal and interest are fully repaid. The advantage to this type of repayment form is that there is no balloon payment to be made at the end of the term, but the monthly payments will be higher than an interest-only loan.

4. ***Single Payment of Principal and Interest***

This type of loan requires the borrower to pay off the entire loan at once, at a specified future date. The payment includes the entire principal amount plus all accrued interest. These types of loans are generally short-term and/or from a lender who is not particularly concerned about on-time repayment, usually a friend or relative, rather than a commercial lender.

Consult with your attorney to determine what the best repayment schedule is for you. Other issues you should consider are whether and how the loan will be secured and ensuring that the interest rate complies with state usury laws (the laws defining the maximum interest rate a borrower is allowed to be charged). Have your attorney carefully review the promissory note and all other loan documents to ensure that you are able to comply with the terms and you are not waiving any of your legal rights.