Financing Your Farm Operation Through Personal Loans: A Toolbox for Creating a Promissory Note

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UNDERSTANDING THE ESSENTIALS OF PERSONAL LOANS

Answering the Basic Questions

Do you plan to get personal loans to finance your farm operation?

Farmers often take out personal loans from friends or family members to help them finance their farm operation, whether to purchase farmland, buy equipment, or to fund general operating costs. This is can be a good option. Unlike institutional banks, family or friends will typically not make you jump through a lot of hoops to “qualify” for a loan or pay hefty loan initiation fees. However, farmers should still take the arrangements seriously. No matter how informal the arrangement or friendly the lender, farmers should have a promissory note in place for every loan they take out.

What are promissory notes?

A promissory note is the document necessary to formalize a loan arrangement. Basically, it is a straightforward written contract between the lender and the borrower that sets out the terms of the loan arrangement—particularly when and how the money will be paid back—and explains the rights and obligations of each party if things don’t go as planned. Promissory notes are relatively simple documents. It’s well worth the time and effort to have one in place whenever a loan is obtained to support a farm operation.

What is the difference between a loan agreement and a promissory note?

Historically, loans included both a loan agreement and a promissory note, but recently the two have been merged into a single document. This is basically because people realized that having two separate documents caused needless paperwork. The loan agreement used to include all the details about installment payments and both the lender and the borrower had to sign it, while the promissory note was a much shorter document where the borrower promised to pay the full amount and only the borrower had to sign it. Today the two names—loan agreement and promissory note—are used almost interchangeably, but the promissory note is the standard lending contract used between family and friends.
What are the benefits of the promissory note?

Having all of the agreed-to terms in writing provides evidence of the loan arrangement. This has several benefits. First and foremost, this serves to solidify the terms and get the parties on the same page. No one wants money to sour friendships or family relationships, but unfortunately it happens all the time. Formalizing the agreement and clarifying the terms for repayment can help prevent misunderstandings and disputes. And, if disputes do arise, the parties can simply go back to the agreement and will most likely be able to resolve the issue without much fuss, while hopefully keeping their friendly or familial relationship intact.

In addition, having a promissory note in place can help prevent some key legal issues from coming up. It can alleviate certain tax issues for both parties; for example, it could help prevent the IRS from declaring the arrangement a gift and potentially charging the lender a hefty gift tax.

It can also help alleviate certain securities laws issues; for example, it could help prevent the SEC from coming in and saying that the borrower should have complied with certain securities laws and regulations.

What are the main components of the promissory note?

A promissory note answers five main questions about the loan arrangement.

The first three deal with the basics:

1. **How much money is being loaned?** This is what’s considered the “principal” amount of the loan, or basically how much money was received.

2. **Who’s lending the money?** This is legally known as the “Holder” of the promissory note—he holds the promise or IOU statement.

3. **Who’s borrowing the money?** This is legally known as the “Maker” of the promissory note—she’s the person that makes the promise or IOU statement. The borrower listed on the note could be the farmer personally. However, if the farm operation has formed a separate business entity, and the money is being used to support the farm operation, the borrowing party in the promissory note should be the entity itself. This is because to help maintain the integrity of the entity in the eyes of the law, the business entity’s financial matters—including debt from a loan—need to be kept separate and distinct from the personal financial affairs of the owner(s).
The fourth and fifth deal with loan repayment:

4. **How and when will the money be repaid?** This part of the agreement will specify the timeline for when and how the money will be paid in full as well. Are payments due in installments, such as monthly, quarterly, or annually, or are they due all at once as a lump sum payment, say in two years? Are some or all of the payments made with in-kind products or services, such as produce or value added farm products? Will there be interest charges? If so, how much? As explained above, to protect the lender from being subject to a hefty gift tax, the promissory note should require interest charges at or above the latest minimum IRS-set interest rate.

5. **What happens if the money is not repaid as agreed?** This is an essential part of the promissory note, and is also likely the hardest to even think about let alone come up with a way to handle. While we can all hope that things will go as planned, we all know that issues and crises happen that may prevent a farmer from making a payment on time or completely following through with the terms of the loan. Setting clear guidelines and expectations for what happens in such scenarios can go a long way in helping maintain cordial and respectful relationships between family and friends if and when things go wrong.

The checklist and sample promissory note that follows provide more detail on each of these five components of a promissory note. If you are thinking that this seems quite straightforward, you are right! Typically, promissory notes are quite short and range between one or two pages. The sample promissory note we’ve included here may seem quite a bit longer, but that’s because it provides various alternatives and annotations to explain each provision.

**Why is it important to create a customized promissory note?**

One of the benefits of a promissory note is that it is quite flexible, so the provisions can be tailored to the precise needs and desired arrangement of the parties for the most part. While it may be tempting to just cut and paste the provisions included in the sample provided here or one found on the web, it’s best to think through your specific situation and create an agreement that’s best suited for you, your farm operation, and the friend or family member that is lending you money.
Finding friendly loans: the rise of peer-to-peer loans

If farmers plan to scale up their operations and need loans in amounts greater than their family and friends can provide, there are options from the public at large. Peer-to-peer loans are becoming quite popular these days. These are loans from strangers that can be accessed without going through a financial institution such as a bank. Peer-to-peer lending is also known as crowdlending or crowdfunding. If this is the route your farm seeks, be sure to use one of the many credible peer lending sites to facilitate the loan, as additional disclosure rules and security laws may apply. These sites should include all the necessary legal paperwork that you’ll need to be sure to have in place.

How to Use This Guide

Farm Commons focuses on creating flexible, adaptable tools that empower farmers to move forward in addressing their legal concerns. Farmers (and business owners of all types) are sometimes under the misimpression that legal matters can be addressed by simply using the “correct” form or language. This often isn’t the case. This toolbox is designed primarily to help farmers build their own strategy to avoid legal problems through good communication, which is also good legal protection should a problem materialize. This toolbox IS NOT legal advice specific to any circumstance and should not be used as such.

The tools we provide are meant to help farmers who are seeking personal loans to help finance their farm operation or who are in the process of creating a promissory note. The checklist and sample promissory note include plenty of options and alternative ways to draft provisions in a promissory note to get your imagination flowing. The story of Mother Earth Farms LLC is woven throughout the guide to illustrate the importance of going through the process of negotiating the terms up front. It also serves to help the reader sense what it would actually be like to have the tough conversations with a friend or family member upfront.

Also, be sure to review the special legal section at the end. In What’s the difference between a gift and a loan and why does it matter? you’ll learn more about how you can prevent your friend or family member who is lending you money from having to be subject to hefty gift taxes. The other special section, Is your promissory note a security and why does it matter?, will help you navigate ways to prevent
your promissory note from falling within the legal definition of a “security,” which you’ll most likely want to do. State and federal securities laws can be very timeconsuming and expensive to deal with if you have to comply.

After opening this toolbox, farmers should:

1. Understand the importance of having a promissory note in place for all personal loans they receive for their farm operation
2. Know the basic elements of a thorough promissory note
3. Gain a sense of how to adapt promissory note elements for different situations
4. Have the resources they need to begin a promissory note adapted to their own unique situation
A Deal Between The Earth Siblings—Danny and Susie

Have you ever met a brother and sister who are so different, you can’t imagine how they came from the same family? Well, that’s exactly how people described Danny and Susie Earth. The Earth siblings were brought up on Mother Earth Farm, a small dairy farm in Sun State.

Susie was the spitting image of her mother, Louise, and took to farming in much the same way. Susie grew up in the quaint farmhouse on five acres of rolling farmland, and she always expressed an interest in continuing the family’s small dairy cow business long into the future.

Danny, on the other hand, showed no inclination towards farming, nor a desire to develop one. He brushed off the cows in favor of a law career, ending up serving as in-house counsel for a fast food company. Talk about a departure from his roots! The only thing he helped out with was setting up the farm business as Mother Earth Farm, LLC. But despite their differences, the Earth siblings remained close as they grew up.

Susie takes over Mother Earth Farm

As Danny began his legal ventures, Susie joined her mother in running Mother Earth Farm. In 2012, their father Charlie passed away suddenly. Louise decided to retire from farm work, finding it just not the same without her partner by her side. She remained living with Susie on the farm property.

Susie was able to support them by starting to sell their milk to a local cheese maker. She became interested in the art of cheese making, and realized that she could greatly increase the amount of money they brought into the farm if she were to start making the cheese herself. She already had multiple restaurants and local stores owned by friends and long-time customers that would buy her product if she made it. She decided it was time to expand Mother Earth Farm’s operations.

Susie needs money to purchase some more property

Adjacent to the farm property was an additional two acres of land. The land used to be an alfalfa farm, but the new owners had no interest in cultivating it and were looking to sell it off. It would be perfect for Mother Earth Farm’s expansion – and even had a small building on site that Susie could convert to a commercial kitchen to make her cheese. The only problem? Susie didn’t know where she was going to
come up with the $20,000 to purchase the land.

**Danny steps in to help and offers to loan the LLC the money**

Before Susie went to the bank for a loan, which seemed like a huge hassle, she decided to call up Danny and explain the situation. Danny was more than happy to help out his sister expand their family business and support their ageing mother. He was not in a financial position where he could outright gift Susie the money, but he agreed to give Susie the loan for the land. His only hesitation was that he read many cases in law school where dealings with money caused problems between family members. To be safe and avoid any fights, Danny suggested that they use a promissory note to set out all the details and requirements of the loan so that they can focus on being siblings, rather than lender and borrower. He also suggested that they enter the promissory note between him and Mother Earth Farm, LLC and not Susie herself. After all, the money will be used for the business and not for Susie’s personal affairs. Danny explained that it’s important to keep these things separate. Susie agreed, and Danny began to take them through the process of discussing the details of the promissory note. Their plan was to then consult with a business attorney to draft up the official note.

**Negotiating the Terms of the Promissory Note**

**Interest charges and repayment plan**

Danny mentioned that he talked to some co-workers who told him that the IRS is always skeptical of loans between friends and family and tries to tax them as gifts. To avoid this, he thinks it is important to use the minimum IRS-set interest rate, which is 3% per year. He felt a little strange about charging his sister interest, but they wanted to go about this the right way.

The next item to discuss is how the LLC will pay back the loan. There are a few different options for this: installment payments, a lump sum payment, a combination of the two, or a lump sum payment in-kind (meaning the payment would be in goods or services, rather than cash). After going through the benefits and drawbacks of each option, and deciding that $20,000 worth of cheese would be too much for Danny to handle, the Earth siblings decided that an installment with a lump sum payment is the right way to go. This option allows for the fluctuation in income that the farm has depending on the season. The smaller installments will allow Susie to lower the amount of the loan slowly over time, and when she makes a big sale she can pay off the entirety of the loan. Danny was careful to point out that in order for the promissory note to be
effective, Susie would have to be sure about when she will be able make the lump sum. Susie was confident that she will be able to do so in three years.

**Accelerating clause and collateral**

Danny and Susie ran through a couple other scenarios, hashing out what might happen if Susie wants to pay the loan off early, or in the opposite scenario, can’t pay it off by the time she thought she could. Tensions rose during these conversations, and Susie realized how important it is to be talking about these details beforehand. She specifically got defensive when Danny brought up the idea of including an acceleration clause in the note—if Susie is later than 30 days on the loan or the LLC becomes insolvent, then the entire amount of the loan becomes due right away. Susie thought this sounded harsh and was offended that her brother would impose such strict terms on her. Danny tried to calm Susie down by explaining that this is just a protection in case Susie continually misses her payments. Danny would have to choose to enforce the acceleration clause, and if he doesn’t accelerate than the note would just continue as a contract between Danny and the LLC. Susie agreed and trusts her brother would use his discretion and not be so harsh if Susie got into a bind.

Next, they discussed whether the loan will be collateralized to make it a secured loan. Danny explained that most commercial loans require the borrower to put something up—such as land, equipment, or a car—as collateral to secure the loan. Should Susie miss a payment, Danny could get his hands on the collateral—but only take the value of what is owed on the loan and Susie would get the rest. Danny suggested that they make this a secured loan, and use the property that Susie was purchasing as collateral. He explained that otherwise a court could conclude that the promissory note is a “security,” and Susie would have to comply with all kinds of complex state and federal securities laws. Danny assured her that it would only happen if she couldn’t make the payments on time. Susie agreed that this is fair. After all, while she hopes it doesn’t happen, if a scenario does arise when she can’t make the payments, it likely means that things aren’t going so well. It may be better to just sell the property so she can make due the payments she would owe to her brother and invest the rest back into the farm business.

**Next Steps**

Having talked through some of the more contentious and awkward details, Danny and Susie were ready to bring this information to a businesses attorney to draft their note. The following annotated agreement is what they end up with.
Checklist: Creating a Promissory Note
Introduction

This checklist highlights key issues that farmers should consider when taking out a personal loan from a friend, family member, or even a stranger to buy land, finance farm equipment, or support general operational needs for the farm operation. Going through this checklist and answering the tough questions will be of great benefit to all parties involved. The brainstorming and negotiation process can help clarify how various scenarios will be handled, set shared expectations, and prevent confusion and disputes down the road.

The next step is to put it all in writing in an official agreement—the promissory note. A promissory note can be a simple and straightforward legal contract, and farmers can certainly try drafting it themselves. The other option is to bring your responses and thoughts to the issues and questions in this checklist to a qualified attorney who can draft the promissory note for you. By doing the legwork, you will make the process much more efficient for the attorney and less expensive for you.

This checklist is designed to be used with our other resources provided in this guide, including the Overview of Promissory Notes section and following Sample Promissory Note with Annotations that works in conjunction with the story of the loan between Susie on behalf of Mother Earth Farms LLC and her brother Danny. Also be sure to check out the special legal sections to prevent issues with gift taxes and securities laws issues—What’s the difference between a gift and a loan and why does it matter? and Is Your Promissory Note a Security and Why Does It Matter?

Summary Checklist

☐ How much money is being borrowed?
☐ Who is lending the money?
☐ Who is borrowing the money?
☐ How and when will the money be repaid?
☐ Will there be interest charges?
☐ What is the time period of repaying?
☐ How often and in what form will payments be made?
CHECKLIST

Can the borrower pay off the loan early?

What will happen if the borrower can’t make payments on time or at all?
  • Are there penalties for late payments?
  • If the borrower fails to make a payment, can the lender ask for the full amount right away?

Will the loan be secured by an asset owned by the borrower?

Checklist with Explanations

How much money is being borrowed?

Formalizing the arrangement in a promissory note provides you with the opportunity to analyze your farm’s financials and determine how much you really need over a set period of time. For example, if you’re borrowing money to purchase farmland, do you need the full amount, just the down payment, or only part of the down payment?

Like any small business owner, a farmer should strive to not to take on too much debt. At the same time, she needs to be sure she won’t run into cash flow issues when paying bills, making payroll, and having enough left over to pay for capital expenditures and unexpected costs such as repairs on a month-to-month basis, including during the off season. This can be a challenging balancing act. However, these are all important things to consider when determining how much money to borrow. By taking the time to diligently figure out precisely—or at least close to—what you actually need, you’ll help build a sense of respect and trust with your lender. No one likes to be the one who’s constantly being asked for more money. Likewise, no one likes to be asked for more money than what’s actually needed.

Whatever amount is decided and agreed to will need to be set forth in the promissory note. The actual amount being borrowed is called the “principal.”

Who is borrowing the money?

The borrower is often referred to as the “Maker” in the promissory note. There are a couple of key issues to consider here.

• Is the borrower the business entity or the individual(s)?
If the farm operation has a formal business entity, such as an LLC or a C corporation, than it’s best to have the entity named as the borrowing party on the promissory note. This is because to protect and maintain the integrity of the
business entity, it’s essential to keep the business’ financial matters—including debts—separate from the financial matters of the owners. In addition, this provides added assurance to the friend or family member who’s lending the money that the individual won’t instead cash the check to fund her holiday vacation! If you don’t have a business entity, then the borrowing party in the promissory note would be the individual(s) involved in the farm business.

With that said, loans to business entities can raise a high degree of suspicion that the financial transaction falls within the legal definition of a security—or an investment in a company for an expected return on profit. Loans to individuals raise less suspicion, but it can still be an issue. Be sure to review the section on security law issues at the end of this guide—Is my promissory note a security and why does it matter? This section explains why and how to avoid your promissory note being deemed a security.

• Is the borrower one or all of the individuals involved in the business?

If there are multiple individuals involved in your farm operation—whether a married couple, a formal general partnership, or a casual venture between multiple farmers—it’s up to you to decide whether just one, some, or all will be named on the promissory note. The person(s) named will be on the hook for making the payments on time. If they default or miss a payment, they could be sued. Nevertheless, even if a partner is not formally named on the promissory note, a court could still conclude that she is on responsible. This is because under certain circumstances a court could find that a couple or more farmers who work together consistently to achieve a shared purpose may cross the line into forming a general partnership, even if they didn’t officially try. If this happens, then all of the individuals involved are jointly and severally liable for any promises or commitments that any one of the others makes. This can include a situation where one partner enters a loan arrangement with a promissory note. The others may be on the hook even if their name is not on it. The key here is that if you are taking out a loan to work on a project with other farmers, or you are working with a farmer that is taking out a loan to work on a project with you, be sure you work together to negotiate the terms of the arrangement. And be aware that you or others may be responsible even if your or their name is not formally listed as a party on the promissory note.

Who is the lender?

The lender is the person offering the money and is often referred to as the “Holder”
in the promissory note. One key thing to consider here is whether the lender needs to be concerned about a potential gift tax. The gift tax applies if someone gives money or something of value (i.e. real property such as land or a house or personal property such as equipment, tractors, computers, etc.) to someone else and in return the giver receive nothing or less than full value of what was given. While it may be tempting for a friend or family member to offer an interest-free loan, or even not require the full payment in return, the IRS will deem these situations a gift that may subject the lender to a hefty gift tax.

Note that there are some key exclusions to the gift tax. To learn about exclusions and more about the gift tax, see the special legal section *What's the difference between a gift and a loan and why does it matter?*

- **How and when will the money be repaid?**
  - **Will there be interest charges?**
    
    The parties will need to negotiate whether interest will be charged. If so, what will be the rate? And, at what interval will interest rates be calculated, monthly, annually, or by another interval? Interest rate accrual calculators are available online, which can be useful to figure out how much interest will add up over the period of the loan. Simply search "interest rate calculator." As further explained in section 5 of this guide, to protect the lender from being subject to a gift tax, the promissory note should require interest charges at or above the latest minimum IRS-set interest rate.

  - **What is the time period of repaying?**

    The length of the loan is significant to the lender; he will want to know by when he’ll get his full payment back. It is also significant to the borrower; she’ll need to figure out by when she can actually come up with the money. The borrower must be sure not to overcommit to a short time frame, as this could really get them in a bind. A better option may be to stretch the commitment out longer, and then provide the option to pay in full early, if and when you can. However, the longer you stretch it out, the more interest will accrue. These numbers can be alarming at first glance. In our example, Susie (on behalf of Mother Earth Farms LLC) takes out a loan from her brother Danny for $20,000 for a three-year term at three-percent interest per year. The LLC will end up paying a total of $21,224.16 over the course of the loan—$20,000 in principle and $1,224.16 in interest. If it were stretched out longer, interest charges would be even higher.
Determining the ideal timeline for paying a loan off can be a challenging balancing act. Solid financial planning, including putting together a monthly cash flow analysis, is essential for determining when and whether you can make the payments when due.

- **How often and in what form will repayments be made?**

The parties have quite a bit of flexibility to decide how the repayments will be made. Examples include installment payments, lump sum payments, in-kind payments, or a combination of two or more. We’ll discuss each of these a bit.

Installments are interval payments such as once a month, semi-annually, once a year, and so on. This may be a good option for farms that have consistent cash flow and/or want to spread their payments out evenly. A lump sum payment is a one-time payment at the end of the loan term. This may be good for farmers that are starting out and want to retain cash flow early on to get things going. However, it is risky as things may go south and regardless of what happens, you’ll have to come up with the money all at once. To address this, you could have a combination of installments and then a larger lump sum payment at the end. This would allow the amount to be spread out, and because there’s a lump sum at the end, the installments will be less than if it were all equal installments. The parties would need to negotiate how much the lump sum would be, as well as how much the installments are—these amounts would need to be based on both the principal amount of the loan and any interest charges.

Another option is to pay in-kind, which is calculated in the value of products or services. In-kind payment could include any farm product of value such as CSA shares, produce, value added-products etc. If you choose this route, be sure to agree on a clear mechanism for calculating the value of the product and include this in the promissory note so everyone is clear on the terms. Is it the going rate at the farmer’s market that year? The going rate at the grocery store? Or another specified amount? You’ll also have to assess what’s practical. Likely the lender won’t want $20,000 in cheese, and, even if so, the farmer may not be able to follow through on such a large quantity. One way to get around this is to require that some of the payments be in cash (whether in installments or a lump sum) and others in-kind.

The sample promissory note that follows provides sample provisions for of these options and other ideas to help you craft an ideal repayment plan for your situation.

- **Can the borrower pay off the loan early?**

Early payments in full or in part are considered prepayments. Sometimes lenders
like to charge prepayment fees or penalties or even outright prohibit prepayment. This is typically because if the lender gets a large chunk of money all at once, it could increase his tax basis. Lenders also often want to count on the maximum benefit or “return on investment” of interest charges over the full course of the loan. If a borrower pays off the loan early, less interest will accrue. Basically, prepayment penalties or fees favor the lender and are quite unfavorable for the borrower. In our example, if Susie or Mother Earth LLC comes up with the money early on, she would be stuck paying the interest charges or incurring a prepayment fee. Farmers should be wary of prepayment fees or prohibitions and try to negotiate the option to make early payments without any charge or trouble.

What will happen if the borrower can’t make payments

If the borrower fails to make a payment when due, it is referred to as a “default” on the loan. While this is a touchy subject, especially between friends and family, this is one of the most important aspects of the promissory note. Anything can happen, and it’s best to address the tough issues and worse case scenarios up front so the parties all know what to expect and the issue can be resolved smoothly. The parties have several options.

• Are there penalties for late payments?

One thing to consider is whether to charge penalties or fees for late payments. For example, you could charge a fee of 5% if the borrower does not make a payment by the 10th day after it is due—or even on the day it’s due. The late fee could increase as the payment is later or later. This is just one option to incentivize borrowers to pay on time.

• If the borrower fails to make a payment, can the lender ask for the full amount right away?

Often promissory notes have what’s called an acceleration clause, which says that if the borrower defaults and fails to pay by a certain time then the lender can ask for the entire amount due immediately. If the borrower doesn’t pay up, the lender can take the borrower to court to get a judgment for the rest of the money. Typically, the acceleration requires the lender to initiate the acceleration clause upon the borrower’s default. If the lender decides not to do so out of kindness or something else, then the contract goes on as normal.

Will the loan be secured by an asset owned by the borrower?

A loan is either secured (collateral is attached) or unsecured (no collateral is
Collateral is anything of value that the borrower owns that can be taken by the lender if the borrower cannot afford to pay back the loan. In effect, it offers the lender another layer of security to ensure that she will get her money back. Examples of collateral include real property (i.e. farmland or houses) and personal property (i.e. anything other than land such as cars, farm equipment, computers, etc.). If the lender requires collateral, the lender has what’s considered a security interest in the collateral until the loan is paid off. This security interest is basically a right to seize the property if the borrower is in default or the loan is not paid off.

In our example, the collateral attached to the loan is a piece of farmland. If Susie (on behalf of Mother Earth Farms LLC) defaults, her brother Daniel could foreclose on the property to recover the balance owed on the loan. Any remainder from the proceeds of the sale of the land would go back to Mother Earth Farms LLC. If a promissory note is unsecured (no collateral is attached), then the lender’s only recourse is to go through the normal debt collection process in court.

One benefit of the secured loan is that it will help assure that your promissory note will not be deemed a “security” that is subject to federal and state securities laws. For more on this, read section 6: Is your promissory note a security and why does it matter? But, note that having a secured loan can add another layer of complexity. For a secured loan, the promissory note will need to provide an adequate description of what the collateral is so there’s no question or dispute down the road. The parties may also decide to enter a separate security agreement which will specify in greater detail the asset given as collateral and what action the lender can take to seize the property upon default. In addition, while not legally required, lenders often take an additional step when business assets are pledged as collateral for a loan. If it is personal property (i.e. anything other than real estate), lenders would file a standard UCC (Uniform Commercial Code) form with the state where the collateral is located. The standardized form used in all states is commonly referred to as the “UCC-1.” This is called “perfecting” the interest. It basically lets the public know that the lender has a legal interest in the collateral and will be first in line against other creditors that may also have an interest in it. If the collateral is real property, the lender would need to prepare and file a deed or trust, mortgage, or other required document with the recording office in the county where the real property is located in order to formalize the lender’s interest in the property.

All of these are steps traditionally taken by institutional banks and other professional lenders of commercial loans to businesses. They are not necessary for loans between family and friends. However, if your family member or friend that
is lending you money has any concern about repayment, these are some of the actions he or she may want to take to protect him or herself.

Keep in mind that using a promissory note and security agreements can restrict your ability to obtain additional financing for your business, especially if the lender files a UCC-1. Institutional banks or other savvy investors may be unwilling to lend funds to the farm operation knowing another lender has priority in your business property.

There is no right or wrong way to go about this process. What we’ve presented here are all just things to consider and negotiate based on the needs of the lender, the relationship between the borrower and the lender, and the financial circumstances of the farm operation.

**Conclusion**

While this all might seem complex, it does not have to be. At a minimum, the farmer should at least have a written promissory note for all loans entered into with friends and family that have the basic terms – the parties, the amount, the timeline, and the repayment terms. Issues like secured and unsecured loans, acceleration clauses, prepayment penalties, and so on can be helpful to discuss but they are not essential to include if only seems to complicate matters or if the parties together decide they aren’t concerned about these nuances. A promissory note can be as short as a couple of paragraphs. Ultimately it’s just helpful to put your heads together and be sure you know what each other expects. This will help prevent any disputes and help resolve any issues down the road, which is ultimately the fundamental purpose of the promissory note.
Annotated Promissory Note
Promissory Note

Principal amount: $20,000.00

For Value Received, the borrower, Mother Earth Farms LLC (the “Maker”), promises to pay to Danny Earth (the “Holder”), the principal sum of $20,000 and any interest, pursuant to the terms and conditions set out in this document.

Interest
Interest shall accrue from the date of this Note and be paid at the rate of three percent (3%) per year.

1. A promissory note is the official legal agreement parties enter to formalize a loan. Farmers should have a promissory note for every loan they get, including, or even especially, from family and friends. Promissory notes are relatively simple documents—basically, the promissory note must show the loan amount, when it will be paid, the rate of interest, and any collateral or security (such as a car or farmland) if applicable.

2. The principal is the amount that is being borrowed and that needs to be paid back. It is also the amount that any interest charges will be based upon.

3. This section is known as the promise to pay and lays out the amount owed and who the parties are. The maker of the loan is the borrower and the holder is the person who lends the money. Note that here the borrower is the farm operation entity, Mother Earth Farms LLC, and not Susie Earth herself. If the farm operation has formed a business entity, it’s best to have the loan be in the name of the entity in order to keep the business’ finances separate from its owners’ personal finances. However, even if the loan is in the business entity’s name, many lenders require that the individual owner(s) personally guarantee the loan. Here, Danny could require his sister Susie to personally guarantee the loan and if Mother Earth Farms LLC fails to pay the balance owed, Danny could seek the funds from Susie personally. A personal guarantee is particularly common for unsecured loans, which are loans where no collateral such as a car, land, or house, is pledged by the borrower.

4. If the loan is between family members or friends, it may be tempting to charge less interest than a loan from a bank would. However, the IRS typically concludes that interest free or low interest loans from friends and family members are really gifts that may be subject to the gift tax. The best way to avoid this is to have a written promissory note and for the lender to charge at least the minimum IRS-set interest rate. The IRS posts rates on its website monthly. As of December 2015 the rate is 2.57%. For more about the gift tax read the section of this guide titled What’s the difference between a gift and a loan and why does it matter? Note that interest
**PROMISSORY NOTE**

**Payments: Installment With Lump Sum Payment**

Maker will pay thirty-five (35) payments of $400 due on or before the fifteenth day of each month beginning in January 2016. The final payment of the remaining amount including applicable interest shall be paid on or before December 31, 2018.\(^5\)

**Alternative 1: Installments**

Maker will pay this note in thirty-six (36) equal installment payments of $589.56 to the Holder on or before the fifteenth day of each month beginning in January 2016 and ending no later than December 2018. Interest charges will be recalculated as necessary based on the principal owing and the full pay off date if earlier than December 2018.\(^6\)

**Alternative 2: Lump Sum Payment**

Maker will pay one lump sum payment to the Holder including any applicable interest on or before December 31, 2018.\(^7\)

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5 The parties can negotiate how and when the money will be paid back. We’ve included a few options here. The first is to make smaller regular payments—i.e. monthly, quarterly, annually, etc.—and then a larger payment at the end. This is a good option for a farmer who is starting a new farm operation or is purchasing new farmland. The catch is that the farmer will have to find a way to make the large lump sum payment at the end, which may present a challenge. How will you come up with the money if your farm operation is not profitable or you need to spend your cash elsewhere? A more consistent payment plan, perhaps stretched out over a longer period, may be a better option. Solid financial planning, including preparing a monthly cash flow analysis, profit and loss statement, and an analysis of working capital (i.e. the capital used in your day to day operations, which is measured by current assets minus current liabilities) will help you determine how fast or slow to pay off a loan.

6 The equal installment payment option provides a level of consistency, which many farmers may prefer. It’s like the phone or cable bill— you know what it is and you just pay it. This is a good option for farmers that have a consistent cash flow and prefer to spread out their payments equally over the course of the loan agreement.

7 The lump sum option means that the borrower needs to make a single payment in full by a
Alternative 3: Payment In Kind

Maker will make payments in dairy and cattle products (comprising of a mixture of cheese, milk, and beef) with a total market value of approximately $589.56 per month beginning in January 2016. Maker will provide Holder an availability sheet on or before the first of each month, Maker shall submit her order by the seventh of each month, and Maker shall make the products available for pick up by the fifteenth of each month unless otherwise approved by Maker. The valuation of the cheese, milk, and beef products will be according to the average price Holder sells similar products at the local farmers’ market(s) in each year. Interest charges will be recalculated as necessary based on the principal owing and the full pay off date if earlier than December 31, 2018.8

Prepayment

The Maker has the right at any time to prepay this Note in whole or in part without any penalty.9

8 A payment in-kind loan is used when the borrower intends to pay back the holder in goods or services rather than cash. This sample agreement is written for our story of Mother Earth Farms LLC, which has a cattle and dairy operation. Of course, the dairy products and beef could be replaced with any product on your farm. You could also come up with another definition of market value—such as the going price at the local grocery store or even set a firm price such as $3 per pound of tomatoes. Note that the total amount owed includes the principal amount of the loan as well as the 3% annual interest. Yet another option would be to have a loan where part of the payment is made in-kind. For example, let’s say Danny more realistically wants $100 a month in cheese, milk, and beef. The remaining balance could be paid off according to one of the other three options—installments with lump sum, equal installments, or lump sum.

9 This means that if Susie, on behalf of Mother Earth Farms LLC, gets the cash necessary to pay off the loan at some point earlier than December 2018, she can pay her brother back with no penalty and be done with the loan. This clause works with any of the payment options. Sometimes lenders like to charge a prepayment fee or penalty, or even outright prohibit prepayment. We discuss reason why in the checklist included in this guide. Be sure to review this part of the promissory note carefully, and be aware of any restrictions or fees for early payment.
**Application Of Payment**

Payments will be applied first to interest and then to principal.  

**Late Payment Charge**

If any installment is not paid within ten (10) days after it becomes due, the Maker agrees to pay a late charge equal to five percent (5%) of the late payment to cover the extra expense involved in handling late payments. This is in addition to and not instead of any other rights or remedies the Holder may have.

**Acceleration**

If either of the “Events of Acceleration” occurs, the Holder has the right to declare that the entire balance of unpaid principal and any accrued interest is due immediately. The occurrence of either of the following will constitute an “Event of Acceleration” by the Maker under this Note:

a. If Maker is more than thirty (30) days late in making any payment; or  
b. If Maker becomes insolvent.

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10 This means that for each payment made under the loan, the money will first pay off any interest charges that have accrued and then it will go to paying down the principal or amount of the actual loan. This is particularly relevant when there’s a high interest rate and the loan is for quite a long term. At first, a large chunk of the payment will go toward just the interest. Over time, the principal will gradually start to decrease.

11 It may be unpleasant to think about the consequences of not paying the loan from friends and family on time, but planning for this possibility can help make it less stressful and awkward if and when it happens. Including a late payment charge such as the one included here provides the borrower, here Susie (on behalf of Mother Earth Farms), an added incentive to pay on time. It also saves the lender, here Danny, from the headache and frustration of not getting any upside if his sister Susie continues to pay late.

12 An acceleration clause requires that the borrower pay off the loan immediately if certain conditions occur. It’s up to the parties to negotiate what conditions would trigger acceleration, or whether to even include an acceleration clause. Here, as this clause is written if Susie (on behalf of Mother Earth Farms) is over 30 days late on a payment, or if Mother Earth Farms LLC files for bankruptcy, Danny could choose to “accelerate” the loan. This means he could require the balance of the loan to be paid back in full immediately. Note that in the previous section, we give the borrower some flexibility in paying back the loan if the payment is made within 10 days of the normal due date. At this point a late fee of 5% is incurred on the amount owed. Now, if the payment is 30 days late, Danny could require Susie to pay the loan balance...
Collateral

The Maker agrees that until the principal and interest under this Note are paid in full, that this note will be secured by the farmland that the borrower is purchasing with the money that is subject to this loan, described as:

Common address: 1234 Zinnia Land, Zinc, Sun State, 55555.

Legal Description: Lot 6,7, and the South ½ of Lot 3, West 60 feet of South ½ of Lot 4, West 60 feet of Lot 5 and Lot 8, Block 20, OLD SURVEY, Zinc, Coral County, Sun State.

in full immediately. This is just one way of designing what happens if payments are late. Please consult the checklist section of this guide to learn more about other options tied to the loan, it is known as a secured loan. ments are late for a number of days late. For example, if the payment is more Note that as this provision is written, the acceleration or requirement for immediate pay off does not happen automatically. It’s up to Danny to choose this result. If he does not, the promissory note would just continue as if nothing happened.

A loan is either “secured” (collateral is attached) or “unsecured” (no collateral is attached). Collateral is anything of value that the borrower owns and pledges to make part of the debt to the lender if for whatever reason the borrower cannot afford to pay the money back. Examples of collateral include houses, land, cars, or anything else with a value equal or greater to the amount of the loan. If the lender requires collateral it’s called a “secured loan.” In effect, the lender gets what’s called a “security interest” in the property or item used as collateral until the loan is paid off. This means that if and when the borrower is in default on the loan, the lender could take the property or item pledged as collateral and sell it off to get the balance owed. Basically, secured loans are less risky for the lender as they offer the lender, here Danny, another layer of security to ensure that he will get his money back. If a promissory note is “unsecured” (no collateral is attached), then instead of taking the collateral, the lender must go through the normal debt collection process in court. Learn more about securing loans and how they may entangle you in securities laws in the section of this guide titled Is your promissory note a security, and why does it matter? This section will help you decide whether a secured or an unsecured loan is best in your situation. The following three provisions give examples of options for both secured and unsecured loans.

In our example, Susie (on behalf of Mother Earth Farms LLC) is using the money loaned by Danny to purchase a 2-acre parcel of land adjacent to the farm that is worth $20,000—or the full amount of the loan. Let’s say that Danny requires that this farmland be attached as collateral. This would be pretty common and standard and it would function similar mortgage with a bank, yet without all the formality. Here, the collateral is specified in enough detail
Alternative 1

Maker agrees that until the principal and interest under this Note are paid in full, this Note will be secured by a security agreement and Uniform Commercial Code Financing statement giving the Holder a security interest in the equipment, fixtures, inventory, and accounts receivable of the business known as Mother Earth Farms LLC.¹⁵

Alternative 2: Unsecured

This is an unsecured note.¹⁶

so the parties know what is being pledged—the land being purchased—and the description includes both the common address and legal description. So let’s say Mother Earth Farms LLC misses several payments and Danny activates the acceleration clause—or declares that the full balance must be paid immediately. If Mother Earth Farms LLC fails to make the payment in full, Danny could initiate the foreclosure process on the land to recover the unpaid amount. Other examples of collateral could include certain pieces of farm equipment, or even farm animals such as “six Ayrshire cattle.” Collateral for a loan can be any commodity or assets of your farm operation that has a discernable value. Make sure to specify how many and which items are collateral if you choose to list specific equipment or other assets your farm operation owns and be sure to provide enough level of detail so it’s absolutely clear what is being pledged as collateral. Note that when a loan is secured, the lender may want to take additional steps to secure his interest in the collateral. Learn more in the previous section, Checklist: Creating a Promissory Note.

¹⁵ This option illustrates a very broad clause for a “secured loan” that puts all the business assets on the line as collateral for the loan. So if Susie (on behalf of Mother Earth Farms LLC) fails to make a payment, Danny could come after any and all of the assets of Mother Earth Farms LLC to recover the amount of the loan. If the parties choose this option, the lender would have to file a standard financing form—commonly referred to as the UCC-1—with the state agency managing UCC filings in the state where the business is located. This is a standard procedure in the world of commercial loans and is quite simple to do.

¹⁶ This option means that there is no collateral for the loan. Watch out here, as having an unsecured loan with a business entity raises suspicion that this transaction falls within the definition of a “security” and is subject to federal and state securities laws. For more on that, see the following section—Is your promissory note a security, and why does it matter? One other point to consider is that if the borrower is a business entity, such as in this case, and the business has no assets or does not want to pledge any asset as collateral, the lender may
Expenses

In the event that any payment under this Note is not paid when due, the Maker agrees to pay, in addition to any remaining principal and interest, reasonable attorney’s fees that do not exceed a sum 15% of the outstanding balance still owed on the Note, plus all other reasonable expenses incurred by the Holder in exercising any of its rights and remedies upon default.

Applicable Law

This Note shall be governed by, and construed in accordance with, the laws of the State of Sun.

Maker: ____________________________          Date:_______________________

Mother Earth Farms, LLC

Holder: ____________________________         Date:_______________________

Sister Earth

Witness: ___________________________         Date:_______________________

Print Name:_________________________

Witness: ___________________________         Date:_______________________

Print Name:_________________________

require the business owner(s) to personally guarantee the loan. In our example here, Danny may require Susie, as the owner of Mother Earth Farms LLC, to personally guarantee the loan. Farmers should be wary to sign a personal guarantee—by doing so, Susie would be putting all of her personal assets on the line, such as her car, house, and even future wages.

17 This is a standard term that says that Mother Earth Farms LLC will be responsible for additional fees Danny incurs if he has to go out of his way to collect late payments.

18 This is a standard clause that specifies that if any disputes arise, they will be governed by the state that the parties choose. In this case Mother Earth Farms LLC is located in the fictional State of Sun and the parties have agreed that the laws of Sun will be the applicable law.
What’s the difference between a gift and a loan and why does it matter?

What is a “gift” according to the IRS?

Sometimes friends and family want to loan money without expecting the entire amount back. The IRS typically views this sort of transaction as a gift and could impose a hefty gift tax on the giver. The gift tax applies if someone gives money or something of value (i.e. cash, real property, equipment, etc.) to someone else and the giver receives nothing or less than full value in return.

The gift tax may apply whether the giver intends the money to be a gift or not. The definition of a gift includes any transaction where less than full value is paid in return, so the gift tax could be applied to interest-free loans from friends and family. That’s because the “market rate” of lending money comes with a cost in the form of interest charges. So while it may be tempting to charge a friend or family member no interest or even less interest than a loan from a bank would, the IRS will pretty much always deem interest-free loans as a gift subject to the gift tax. The best way to avoid this is to have a written promissory note in place and for the lender to charge the minimum IRS-set interest rate. As of December 2015, this rate is 2.61%.

Exclusions to the gift tax: when does the gift tax really matter?

Note that there are some key exclusions to the gift tax. First, each person can give away up to $14,000 a year (as of 2015) to as many people as he or she wants. Note that the giver-receiver relationship is each considered separate. So let’s say there’s a husband and a wife who have two kids. The husband could give each of the kids up to $14,000 each year without being subject to the gift tax. The wife could do the same. So each kid could get up to $28,000 a year from his or her parents without either of the parents having to pay a gift tax.

Also, each person has a lifetime exemption from the gift tax, which is currently $5.43 million. This is the total amount that can be given away by an individual over his or her entire lifetime to any number of people that will be free from gift taxes. Until this amount is exhausted, the giver will not be required to pay a gift tax. So let’s say that the husband gives his kids each $20,000 in a given year. This amount
is above the $14,000 mark and is therefore subject to the gift tax, but the husband still won't owe a gift tax unless he's exceeded his $5.43 million lifetime amount. Note, however, that any amount gifted will reduce the amount that can be given away by the individual at death that will be free from estate taxes. In effect, the lifetime gift tax exemption is directly tied to the federal estate tax exemption.

The takeaway is that the gift tax is for the most part an issue for individuals with quite a bit of money or who expect to have a lot of money to bequeath at the end of their life. This may or may not be an issue for the lender in your situation.

Keeping records of gifts or loans could impact the farm operation’s taxes

Either way, it’s important for the farmer to properly account for the money as it comes in. Is it a gift or is it a loan? If it’s a gift, the amount would be placed on the asset side of the farm operation’s balance sheet. If it’s a loan, the amount would be placed on the liability side. If the person lending the money thinks it is a loan but you have not accounted for it as such, then it may cause issues for them down the road with the IRS. No one wants to be audited. In addition, whether you account for the money you receive as a loan (debt) or as a gift (asset) could have an impact on the amount of federal and state taxes your farm operation will owe in a given year. Having a promissory note in place that includes interest charges provides evidence that it is, in fact, a loan that is accounted for as debt to the farm operation and not a gift that is accounted for as assets.
Is your promissory note a “security” and why does it matter?

What’s the significance of a “security”?

The legal definition of a security can be quite broad! Before we get into the details, why is this such a big deal? If an investment you receive falls within the definition of a security, it will be governed by extensive federal and state securities rules and regulations that can be rather complex. It can be very expensive and time consuming to comply with securities laws. If you don’t comply when you have to, you risk being sued—which could result in you losing all the funds you received as an investment and even incurring fines. If you prefer to avoid this mess, the best route is to learn what a ‘security’ is and be sure your promissory note or other investment contract does not fall within its scope.

Why are there securities laws?

Securities laws serve to protect the ordinary or amateur investor. Surely you’ve heard of Ponzi schemes and other devious plots to get a bunch of people to invest in something with promises of great returns. The investors later find out that there was actually nothing to invest in; the orchestrator absconded with all the money and now lives in the Cayman Islands where he spends his days sipping fruity cocktails. The securities laws are meant to prevent such schemes of deception and fraud and to provide investors who’ve been taken advantage with some recourse to get their investment back. As much as there’s a lot for small business owners to complain about in the arena of securities laws, keep in mind that they are meant to ensure integrity and safety in certain investment transactions that are prone to fraud.

What is a “security”? 

Over the years, many capital raising schemes have been crafted by folks seeking money in attempts to avoid securities laws, which are notorious for being complex and expensive. The courts don’t look too fondly on such schemes and have devised their own way of determining whether such schemes are in fact “investment contracts” that are subject to federal securities laws.
Crowdfunding

The most recent innovative scheme that has evolved in an attempt to avoid securities laws is crowdfunding. The SEC, the courts, and entrepreneurs are currently battling it out to figure out whether certain crowdfunding investments in start-up companies are subject to state and federal securities laws. The SEC recently made some revisions to federal securities laws to make certain crowdfunding transactions exempt, and some states are following suit. This is a great example of how the law evolves to address the changing landscape in culture, the economy, and society—albeit slowly.

Before going too much further, we’ll introduce one other legal term that is used in securities law—the “instrument.” This is not a violin or a guitar. It’s the legal document that sets the terms of the investment—how much money is involved, what does the investor get in return, under what conditions, what if the receiver of the money doesn’t abide by the terms, and so on. Used here, an instrument is basically an investment contract. This could be in the form of a stock certificate, a promissory note, a mortgage, etc. The courts don’t really care what the document itself is called. The ultimate question they ask is whether the terms of the investment instrument you’re using—no matter what its title is—falls within the definition of a security.

The official legal definition of a security

The official definition of a security, from the Securities Exchange Act of 1934, is:

Any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance, which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.
Okay, so that’s not helpful. This is why the courts have stepped in to interpret what it all means.

**The Howey Test—the expectations of the investor**

The leading case on the definition of a security is the U.S. Supreme Court case, SEC. v W.J. Howey Co. Here, the court developed what is now known as the Howey test. The determinative factor of this test is what the investor was offered or promised in return for his or her investment. In the court’s language, a security is:

A contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.

Basically, under the Howey test, an instrument is a security if the investor is led to believe that he’ll get a return on his investment. Notably, the promised return may be fixed or variable and may be marketed as low-risk or even guaranteed.

When making this determination, courts frequently turn to the promotional materials connected to the instrument, which could include emails or other correspondence between the parties. If these materials or exchanges promise things like high returns or even guaranteed income, the court will almost certainly deem the instrument a security that is subject to the federal securities regulations.

**The Family Resemblance Test for promissory notes—fairness to the investor**

Under the Howey test, pretty much every promissory note that charges interest would be deemed a security. Realizing promissory notes are quite common and can often be very low risk to the investor, federal courts have taken their analysis a step further when dealing with promissory notes and apply the Family Resemblance Test. This test has four steps.

1. **What are the motivations of the parties?**

If the borrower’s primary purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the lender is primarily interested in the profit the deal is expected to generate, the instrument will likely be deemed a security. However, if the note is entered into to help the borrower purchase a minor asset for her business, to alleviate some cash-flow difficulties, or to advance some other commercial purpose, the note is less likely to be deemed a security. The lender is seen as simply helping the borrower out without much benefit or great advantage on his part.
2. **What is the plan of distribution?**

   The court then looks to the ‘plan of distribution.’ For example, if the borrower plans to sell or trade the note to someone else—as if it is like stock in the company—then it will be deemed a security. If the borrower plans to simply keep it for herself and pay it off under the terms, it will not be deemed a security.

3. **What are the expectations of the investors or lenders?**

   If the investors have reasonable expectations that this is a securities transaction whereby they have some legal protections, then it will likely be deemed a security. For example, if the lender can prove that he reasonably expected that the borrower would disclose highly relevant information—including other debts or cash flow issues that the lender has that may impact whether the borrower is able to make the principal and interest payments on time—the court may deem the note to be a security.

4. **Are there any other regulatory schemes involved?**

   Finally, the courts examine whether some other regulatory scheme significantly reduces the risk of the instrument. This could include notes that are subject to federal deposit insurance and ERISA (Employment Retirement Income Securities Act). Note that these regulations come into play in pension funds and institutional bank transactions. So this is not likely a relevant factor in determining whether promissory notes between friends, family members, or even strangers are securities.

   Another way of looking at this is to ask yourself, is the investor in your farm operation investing or lending you the money with the primary goal of making some money in return—such as guaranteed interest charges on a promissory note? Or, is he lending you the money because he has the money on hand and believes in what you’re doing; he simply wants the money back within a reasonable time with some reasonable interest charges on top to compensate him for his decision not to invest in something else where he could make a higher return? If it’s more like the former, it’s likely a security; if it’s more like the latter, it’s likely not a security.

   **So what does this all mean for the farmer seeking a loan from a friend or family member?**

   You may be asking, what does this mean for me? Well, what it really comes down to is fairness and expectations of the lender. If the farm owner who’s “borrowing” money is intending to defraud the friend or family member whose lending or
investing in the farm business and that friend or family member is relatively unsophisticated when it comes to financial affairs or is otherwise unable to protect themselves—such as an elder who suffers from Alzheimer’s or a three-year old child who inherited a lot of money—then the court may find a way to conclude that the promissory note was a security.

**What happens if the court determines your promissory note is a “security”?**

The implications of this is that the court could order you to give all the money back and you could face hefty fines; you could even face imprisonment if you willfully intended to defraud your friend or family member. Scary stuff you definitely want to avoid.

**What can you do to prevent your promissory note from being deemed a “security”?**

Again, whether the court will deem a promissory note a security really comes down to fairness. With this in mind, there are some things you can do to ensure fairness for your lender, which will help build your case that the note is not a security. Basically, if a promissory note for a business operation is not a security, the courts will generally call it a commercial loan. Commercial loans typically have some characteristics and mechanisms to protect the lender. In this way, modeling your promissory note after a commercial loan can be a helpful way to ensure your note will not be deemed a security.

For example, commercial loans are typically provided by one or just a few lenders that the borrower approaches directly. They are not typically sought through public solicitation to a bunch of random strangers, by knocking on doors, or rallying people from off the street. In addition, commercial lenders generally require the loan to be collateralized, or secured by a valuable asset that you own outright such farm equipment, a house or farmland, a tractor or a car, and so forth. This is called a secured loan, as opposed to an unsecured loan where there’s no collateral. A secured loan reduces the lender’s risk by providing the added protection of being able to acquire the asset identified in the promissory note as collateral if the borrower defaults or fails to make the payments on time. While the courts haven’t definitively said that any of these measures are guaranteed to make your promissory note not a security, they can certainly help.
“If your instrument falls within the federal definition of a security you’ll have to comply with federal laws and if it falls within your state’s definition of a security you’ll also have to comply with your state’s securities laws.”
Conclusion

The bottom line is that you should be sure to research both the federal and your state's securities requirements before entering a promissory note or other investment instrument to ensure that it will not be deemed a security. That is, unless you don't mind complying with the securities laws. If you do decide to enter a note or other transaction that will likely be deemed a security, or are uncertain, be sure to consult with a competent securities attorney in your state. Federal and state securities laws can be VERY complex. Many exemptions are available, particularly for small businesses raising capital from just a few competent and credible investors and especially if they are all intra-state transactions that don't involve a lot of money (i.e. involving investors in just your state and not multiple states). But it can be very tough and risky to navigate the criteria and requirements for the exemptions all on your own.
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