

Notes

The Basic Facts about Notes

If you look up “Note” in the dictionary you will find many meanings attached to this four letter word. In the real estate industry, however, the Note invariably is “a written promise to pay a debt”. In this article, references to the “Note” are based on a Note generated under California laws.

There are two basic types of Notes that can be used to outline a debt: an **unsecured** Note, or a **secured** Note. One prime example of an unsecured Note is our everyday check drawn from our checking account.

There are normally two parties in an unsecured Note and three in a secured Note:

- The “**Payor**” is the person who is paying the money (or Borrower)
- The “**Payee**” is the person who is getting the payment (or Lender)
- The “**Trustee**” is the neutral 3rd party under a secured Note who will issue the release of the loan once it is paid off

Whichever type of Note is being used there are certain requirements that must be incorporated into this instrument. It must be:

1. In writing
2. Have an amount
3. Have a date on the instrument
4. Have a date for payment
5. There must a person it is to be paid to (Payee)
6. There must be a person who is paying (Payor/Maker)
7. Both the Payor and Payee must be legal entities **
8. The instrument must be signed by the Payor

** Legal entity – an entity whose existence is recognized under State and Federal laws. Example – a natural person or an incorporated organization. Not a legal entity – d/b/a(s) “doing business as”

Some of the other items that can be put on the Note, depending on the conditions, are as follows:

1. Interest rate if charged
2. When interest starts
3. How are payments to be made
4. Starting date
5. Ending date or term of the Note (how long it is for)

An **unsecured** Note, like a check, is not backed by any type of security besides the Payor's own personal integrity and ability to pay. If the Payor should not pay, the Payee's only avenue of collection would be by going to court.

A **secured** Note is one that is given with the specific intent of backing it by real estate owned by the Payor. If the Note does not get paid, the Payee can foreclose on the real estate. With this type of a Note, there are other conditions required under California laws:

- A Deed of Trust (or Trust Deed) which puts the loan on the Payor's property must accompany the Note. (*Be sure to read the article on "Deeds of Trust", for all the basic facts*)
- The Note and Deed of Trust must have a "Trustee" – a disinterested third party who is called upon to issue the Reconveyance when the loan is paid in full
- Certain agreed upon clauses must show in the Note as well as the Deed of Trust
- If Payor does not pay, the Payee can start foreclosure proceedings, whether judicial or non-judicial, to recoup on the debt

There are different types of secured Notes. The most commonly used are:

- **Installment Note** – most common, where monthly payments are a set amount for principal and interest throughout the term of the Note
- **Interest only Note** – monthly payments are interest only and principal is paid only at maturity
- **Straight Note** – payment of interest and principal are due at one time in one lump sum

Besides the interest rate and the term of the loan, there are other conditions that can be negotiated between parties and incorporated into the Note. Here are the most common:

- Late charge – a certain amount or percentage of monthly payment is due if paid late
- Due on Sale clause – the loan must be paid in full if property transfers ownership
- Prepayment penalty – penalty to be paid if loan is paid off early
- Subordination clause – allows this loan to be subordinated to a new loan to be made in the future

There are many variables, requirements and conditions to consider for each Note and for each clause to put in it. One error may invalidate part of the Note or even the whole, and may not be caught until years down the line at a crucial moment. The preparation of a Note requires knowledge of the section of laws that govern it. Depending on the type of transaction and property, the laws can be found either in the California Business and Professions Code or the Civil Code. One should always obtain their own independent legal counsel to review the Note and make sure that it properly reflects the agreement and will stand up in a court of law.

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