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Contracts, Notes, and Guaranties

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INTRODUCTION

When running a farming business, the operator enters into numerous financial agreements. He may lease land or equipment. He may borrow money from a bank or other lenders to acquire land, livestock, machinery, or equipment. He may purchase land on a contract for deed. He may cosign or guarantee another's commitments. Each of these arrangements involves a contract of some kind.

ELEMENTS OF A CONTRACT

A contract is a binding agreement between two or more parties that is enforceable by law. For an agreement between two parties to be legally enforceable, four requirements must be met:

The parties must be identifiable and competent.

Unless both parties to a contract are known, there is no method of determining who is obligated to meet the terms of the contract. In addition, a party to a contract must be of legal age, over eighteen in Minnesota, and may not be suffering from a mental disability.

The subject matter of the agreement must be legal and not violate public policy.

A contract whose subject matter is illegal or against public policy will not be enforceable. For example, the law imposes certain limitations on the amount of interest that can be charged on certain types of loans. A loan agreement with an interest rate in excess of the legal maximum rate is not a legal contract because the subject matter is not legal.

There must be a mutual agreement.

The parties to a contract must mutually agree to the terms of the contract. Mutual agreement is evidenced by an offer and an acceptance of the offer. The lack of mutual agreement will render the contract unenforceable. For example, in a contract for the sale of a "mustang," if the buyer believes he is buying a car and the seller believes he is selling a horse, there is not mutual agreement and the contract will likely be unenforceable assuming neither party was aware of the other party's mistaken belief.

There must be consideration given.

Consideration may consist of money, goods, or services, or merely the promise of future consideration. Essentially, consideration is something given in exchange for something else.

Generally, the agreement does not need to be in writing in order for the contract to be enforceable. However, there are a few important exceptions to this general rule.

To be legally enforceable, the following contracts must be in writing:

1. Contracts that cannot be completed within one year;

2. Contracts for transfers of interests in real estate, including the lease of land, for more than one year;
3. Contracts to sell goods valued at $500 or more;
4. Contracts to lease goods with total payments of $1,000 or more;
5. Credit agreements; and
6. Loan guaranties.

It is good practice to be sure all your contracts are in writing, even if it is not legally required. Without a document memorializing the contract, it may be difficult to enforce the contract or even determine the terms in the future. Having a written contract helps avoid misunderstandings and confusion in the event that a dispute develops later.

The general principles of contract law, discussed above, form the basis for the various contracts that a farmer may enter into during the course of operating a farm business. Several different types of contracts are discussed below.

PROMISSORY NOTES

One type of contract that is used in nearly all transactions in which a farmer borrows money is a promissory note, which is the borrower's written promise to repay a loan. A typical promissory note also includes all the terms and conditions of a loan. In some cases, such terms may be complex and lengthy. When that is true, a loan agreement may be used to further explain the terms and conditions of the loan.

Interest Rates

All promissory notes must state the amount of the loan and the interest rate, which may be either fixed or variable. Fixed interest rates are typically set and do not change over the life of the note. Variable, or floating, interest rates move up and down based on changes of an underlying index rate over the life of the note. Variable interest rates have become common in recent years; however, even where a fixed rate loan is involved, the promissory note may provide that if the borrower fails to make the payment specified by the loan agreement, a different interest rate may be charged. Notes may also provide that if payments are delinquent, late payment charges may be incurred.

Repayment Schedule and Default

The promissory note should set forth in a clear fashion the repayment schedule adopted by the parties. It should specify the amount of each payment, when it is to be made, and where it is to be made. A borrower needs to be sure he understands these terms completely, since even a minor deviation may constitute a default. The borrower should be particularly aware of the clauses in a promissory note that address the lender's rights upon default, for they can have drastic consequences for the defaulting borrower.

Costs of Collection

Most promissory notes contain a provision that obligates the borrower to pay, in addition to all principal and interest provided in the note, all costs of collection in the event legal action must be undertaken by the lender to collect the balance due under the note. A typical clause reads as follows:

> The borrower shall pay all costs of collection of this promissory note including, but not limited to, attorneys' fees, paid or incurred by the lender on account of such collection, whether or not suit is filed and whether or not such costs are paid or incurred, or to be paid or incurred, prior to or after the entry of a judgment.
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> The Minnesota Supreme Court has ruled that a person who agrees to pay

> attorneys' fees in a contract is entitled to a jury trial to determine both his obligation to pay such fees and the amount he may be required to pay.

Acceleration Clause

Besides increased costs, the failure of a borrower to make all payments as required by the promissory note may result in the acceleration of the loan itself. Most promissory notes contain an acceleration clause, which states that the lender can demand that the loan be paid in full if the borrower fails to make the required payment. A typical acceleration clause reads as follows:

> If any required payment under this note is not paid when due, or if an event of default occurs, the entire outstanding principal balance hereof plus accrued interest thereon shall, at the option of the lender, be immediately due and payable without notice of demand.

Prepayment

Promissory notes should state whether the borrower may prepay all or any part of the loan. Some lenders do not allow prepayments or may impose a fee if prepayment is allowed.

Secured or Unsecured Loans

Finally, the promissory note should specify whether the loan is secured or unsecured. A loan is unsecured if there is no collateral or property of the debtors that secures repayment of the note. If the loan is unsecured, the lender has no priority over other creditors if the borrower defaults. If it is secured, the lender has a claim to certain property owned by the borrower that has been pledged to the lender as collateral. For a more detailed discussion of the legal aspects of such grants of security, see two other fact sheets in this series, *Mortgages and Contracts for Deed* and *Security Interests in Personal Property*.

TYPES OF PROMISSORY NOTES

Several types of promissory notes can be used, depending on the situation.

Simple Note

A simple note is unique in that repayment of the loan is in one lump sum at the end of the note. No periodic payments of interest or principal are contemplated with a simple note. As a result, such notes are generally used for a relatively short period of time.

Demand Note

A demand note provides that a lender may demand repayment at any time. A demand note is therefore very risky for the borrower since the lender may call for payment without any further demand upon the borrower. However, the holder of a demand note must act in good faith when making a demand for payment.

Installment Note

An installment note provides for periodic payments of principal and interest that will reduce the loan balance to zero by the end of the time period specified in the note. In some cases, an installment note may call for a balloon payment prior to the date by which the full amount of the loan would have been paid off if the payments had continued. Such a note combines the features of an installment note and a simple note. The reduction in principal through the use of periodic payments over a period of time is generally referred to as amortization of the loan.

Open-Ended/Revolving Note

An open-ended, or revolving, note is used when a line of credit is arranged by the parties. Under such an arrangement, the borrower establishes a line of credit with the lender in the amount set forth in the promissory note. The borrower may obtain draws, or advances, under the promissory note up to, in the aggregate, the maximum amount specified in the promissory note and may make additional withdrawals against this line of credit after he has repaid a portion of the amount previously borrowed, or advanced. The advanced and unpaid principal balance of the promissory note may not exceed the maximum amount specified in the promissory note. The open-ended note allows the borrower more freedom in the use of borrowed funds. Farmers often use such revolving loans in obtaining operating funds for a production cycle.

THIRD-PARTY AGREEMENTS

Occasionally a lender may require that someone besides the borrower sign the promissory note. Such requirements may be imposed in cases where the borrower has little additional property that can be used by the lender to secure of repayment. If someone other than the borrower cosigns the note, he or she can be sued for payment if the borrower defaults. The cosigner remains responsible for repaying the loan as long as the borrower and lender operate under the original agreement.

If, rather than cosigning the note, the third party guarantees payment of the loan, the guarantor agrees to pay the lender if the borrower does not. Occasionally a lender requires a guarantor or cosigner to pledge separately owned property as collateral. A guaranty is the separate promise of the guarantor to pay the obligations of another. Most guaranties do not require the lender to first seek payment from the borrower before looking to the guarantor for payment. As a result, it is essential that the cosigner or guarantor be fully aware of all the facts and circumstances surrounding the loan.

REGULATION OF PROMISSORY NOTES

Many states, including Minnesota, have enacted laws that limit the rate of interest a lender can charge. Parties to a contract cannot avoid the maximum interest rate by merely agreeing to a higher interest rate in their contract. The maximum rate of interest that can be charged by a lender in Minnesota depends on the purpose for which the loan is made, the identity of the parties, and the amount of the loan. For example, the interest rate on an agricultural loan in the principal amount of less than $100,000 is limited to no more than 4.5% in excess of the 90-day discount rate of commercial paper published by the Federal Reserve Bank of Minneapolis.

The Federal Truth in Lending Act was enacted to provide borrowers with meaningful disclosure of credit terms and to protect consumers against inaccurate and unfair credit billing practices. The act imposes detailed reporting requirements on lenders. Agricultural transactions, however, are fully excluded from the act.

For more information:
extension.umn.edu/agriculture/business