FIELD LAW

Business Group

The Advisor

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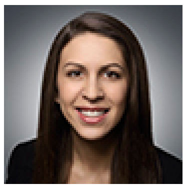
Promissory Notes: Who are you Promising to Pay?



By Katherine Rubin

Promissory notes are often issued in the course of business arrangements and financial transactions to record indebtedness and financial obligations. People who use these instruments, however, should be aware of the specialized nature of promissory notes.

A promissory note is an unconditional promise to pay made by one person to another, which must be signed by the person giving the promise. The indebtedness contemplated in the promissory note may be repaid either on demand or at a fixed time in the future, depending on the specific wording of the note. Promissory notes are governed by federal legislation, specifically, the *Bills of Exchange Act*, RSC 1985, c. B-4.

The *Bills of Exchange Act* provides that promissory notes, along with bills of exchange and cheques, are negotiable instruments. "Negotiable" means that the title to the promissory note can be transferred by the original creditor who holds the note to a third party, without the consent or knowledge of the debtor who gave the note. This concept may be more familiar in the context of a cheque, which is another negotiable instrument. A cheque may be made payable to Person A, who endorses it for transfer to Person B. Person B then becomes the person entitled to receive the amount of the cheque. The endorsement of the cheque is the negotiation.

A promissory note can be used in a business transaction as a means of evidencing indebtedness, for example, as part payment on an asset or share purchase or to evidence a corporate loan from a shareholder. The relationship between the original creditor and the debtor is often governed by a broader personal or contractual relationship. However, if the promissory note is negotiated to a third party, that "new" creditor may acquire the promissory note free from contractual rights or other obligations that existed between the original parties.

This results in at least two risks:

- As noted, a buyer may give a promissory note to a seller for part of the purchase price in a sale transaction. Suppose the buyer, for example, has a claim against the seller due to a misrepresentation or breach of contract by the seller under the sale agreement. If the seller demands payment of the promissory note, the buyer may be able to "set off" its legal claim under the sale agreement against amounts owing to the seller under the note. However, if the seller transfers the note to a third party, that third party is typically entitled (with some narrow exceptions) to payment from the buyer free from any rights the buyer has against the seller, and may enforce payment. The result is that the buyer has no right of set-off and must pay the amount of the promissory note to the third party. The buyer must separately pursue the seller for any loss due to the misrepresentation or breach of contract.

- In most cases, a promissory note is construed to be separate and apart from the contract or other rights or relationship that exists between the original parties. A third party who holds a "demand" promissory note may therefore be able to demand payment at any time (subject to the specific terms of the promissory note), even where the agreement between the original parties limited or otherwise directed "if" or "when" the demand for payment would be made.

The risks can be managed by using the following tips:

- Be cautious of "demand" promissory notes, where payment could be demanded at any time.
- Draft the promissory note in such a way that makes it non-negotiable. Then, the promissory note will only operate to evidence indebtedness and an obligation to repay the original creditor.
- Seek legal advice to ensure that the promissory note is appropriate to the transaction and properly addresses unforeseen legal risks.

Promissory notes can be a useful means of documenting financial obligations, but care must be taken to avoid unintended results.

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