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LEGAL

THE EFFICACY OF PROMISSORY NOTES

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1.0. Introduction

Promissory Notes are credit instruments typically used in connection with sales financing and debt finance. Although the legal parameters of promissory notes developed in common law, they have been statutorily regulated for some time and are governed by the Bills of Exchange Act ("**the Act**")[1].

Notwithstanding its longevity in our statute books, it appears that its usefulness as a financial instrument both from a creditor, as well as a debtor's perspective has gone largely unnoticed. This is despite the fact that it can serve as a veritable instrument for raising debt finance by individuals and corporate entities, as well as a source of investment income for investors with an above average risk appetite.

This article analyses Promissory Notes and gives a brief outline of its key features, as well as regulatory considerations.

What is a Promissory Note?

A Promissory Note is an unconditional written promise by one party (the maker) to pay money to another party (the payee or the bearer) on a specific date, or on demand[2]. Promissory Notes are commonly used in business transactions involving a debtor-creditor relationship. A typical scenario is where one party lends money to another party, whereupon the Promissory Note is used to document the promise by the latter to repay the loan. A Promissory Note is also useful where a party purchases goods on credit from its suppliers and promises to pay at a later date.

2.0. Features of a Promissory Note

The Promissory Note has some unique features as a financial instrument, the most important of which are provided below:

i) **It is legally binding**: A Promissory Note, once signed by the maker, becomes a legally binding instrument evidencing the maker's promise to pay a certain sum of money to the payee or bearer. What this means is that the payee or bearer possesses a legal right to recover the debt owed by the maker. This is however subject to the Promissory Note being adequately stamped at the Stamp Duties Office; failing which the Promissory Note will be rendered unenforceable by virtue of Section 42 of the Stamp Duties Act Cap S8 Laws of the Federation of Nigeria (LFN) 2004 which provides as follows:

> *"every person who issues, endorses, transfers, negotiates, presents for payment, or pays any bill of exchange or promissory note liable to duty and not being duly stamped, shall be guilty of an offence and the person who takes or receives from any other person any such bill or note either in payment or as a security, or by purchase or otherwise, shall not be entitled to recover thereon, or to make the same available for any purpose whatever".*

Promissory Notes may be enforced through the institution of debt recovery procedures such as insolvency/ winding up proceedings (where the maker is a company), summary judgment procedure and bankruptcy proceedings (where the maker is an individual). In this regard, the Supreme Court, in the case of Bank of **Baroda v. Iyalabani Company Limited**[3], held that the acceptor of a bill of exchange can be sued by the holder for non-payment.

ii). **It can be collateralized**: It is also possible to obtain security for the obligations covered by the Promissory Note such that where the maker defaults, the payee or bearer can simply enforce the security to recover the sums owed[4].

iii). **It is transferable**: Depending on the intention of the parties, a Promissory Note may be drafted in such a way as to allow the bearer to further transfer the benefit of the Promissory Note to a third party. The general rule is that the Promissory Note is transferable unless there are specific provisions therein which prohibit the transfer of same or which indicate an intention that the Promissory Note should not be transferable[5]. The Act provides for the transferability of a Promissory Note, as well as the manner in which it may be transferred[6]. Thus the initial bearer of a Promissory Note, where in need of funds, may decide to transfer his title to a third party[7].

The transfer of the Promissory Note has no effect on its enforceability and the maker will still be liable to the last holder as if such holder were the one to whom the original obligations were owed in the first place[8].

3.0. Who can issue a Promissory Note?

There are no restrictions regarding who may or may not issue a Promissory Note. In fact, we note that it is not unusual for financial institutions (most especially banks) to require their debtors (both corporates and individuals) to issue Promissory Notes to cover the sums owed. Thus, the financing mechanism afforded through the issuance of Promissory Notes is available to everyone.

4.0. Who can buy a Promissory Note?

Just as there are no restrictions in the Act as to who may or may not issue a Promissory Note, there are also no restrictions in terms of who may or may not purchase a Promissory Note and as such, potential issuers can sell the Promissory Notes to any interested investors (whether corporates or individuals). However, it is to be noted that whilst the Act itself does not place restrictions on who may or may not buy the Promissory Notes, certain sector specific regulations may prohibit industry participants from purchasing Promissory Notes, unless the Promissory Notes meet certain eligibility requirements. For example, the Regulation on Investment of Pension Fund Assets 2017 prevents Pension Fund Administrators (PFAs) from investing in 'debt

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1 Bills of Exchange Act CAP.B8, LFN Vol.1 2010
2 Section 85(1) of the Act
3 (1995) LPELR-SC. 194/1988
4.See section 85(3) of the Act.
5. Section 8 of the Act
6. Section 31 and 32 of the Act
7It is even possible that the third party can himself transfer the Promissory Note to another party who may himself carry out a further transfer, and so on, provided that there are no provisions in the document limiting these subsequent transfers. Obviously, these subsequent transfers will be done at a discount to the value stated on the Promissory Note but still, this feature gives the payee or bearer comfort to know the Promissory Note can be cashed in should there be a need to do so.
8 Section 38 of the Act

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instruments' issued through private placement arrangements not approved by the Securities and Exchange Commission (SEC). Thus, companies looking to attract funds from the PFAs must first obtain the approval of the SEC to issue Promissory Notes.

5.0. Regulatory Considerations

From a regulatory standpoint, the issuance and purchase of a Promissory Note could potentially fall within the regulatory purview of the Central Bank of Nigeria ("CBN") due to the lender-borrower relationship created. It is to be noted that Section 2(1) of the Banks and Other Financial Institutions Act Cap B3 LFN 2004 ("**BOFIA"**) provides that no person shall carry on any banking business in Nigeria except it is a company duly incorporated in Nigeria and holds a valid banking license issued under the Act. 'Banking Business' is defined widely in Section 66 of the BOFIA to include, *inter alia* the **'provision of finance'**.

However, in **Bovoa v. FRN & Anor**[9], the Court of Appeal pronounced that the phraseology "granting loan without license'' . . . is neither derived from Section 2 (1) nor 2 (2) of the BOFIA as to make it an ingredient of the offence under the said Act; nor can the term be subsumed under the expression 'provision of finance' as an element of banking business as defined in section 66 of the BOFIA. Thus, it is our opinion that the issuance and purchase of Promissory Notes, without a banking license, *will not* contravene the relevant sections of the BOFIA.

With regard to the SEC, Promissory Notes will be regarded as securities under the Investments and Securities Act[10]. However, whether or not they fall within the regulatory purview of the SEC (and thus required to be registered) will be determined by the status of the issuer of the Promissory Note and to whom the Promissory Notes are being offered. Where the issuer is a public company, the Promissory Notes to be issued will have to be registered with the SEC before being sold[11] whilst if the issuer is a private company/individual, the Promissory Notes will not be required to be registered with the SEC, provided that the Promissory Notes are not being issued to the public.

6.0. Benefits of the Promissory Note

i) **Issuer**: From an issuer's standpoint, the issuance of a Promissory Note can allow the issuer to craft its own 'debt offering', taking into consideration its unique commercial situation and subject in all cases, to regulatory considerations.

With the Promissory Note, debt finance can be sourced from strangers who are willing to take solace in an enforceable instrument in the event of a default by the issuer on its obligations. This effectively removes one of the major barriers to debt financing and thus exposes the issuer to a larger source of funds than typically available.

In addition, unlike bonds and/or commercial papers, they do not have to be listed on a securities exchange such as the FMDQ OTC or the Nigerian Stock Exchange, thus saving the issuer the compliance requirements and costs associated with the raising of funds through those mediums. The process for issuing a Promissory Note is relatively simple. The issuer simply draws up the notes and then 'issues' them to anyone interested in purchasing them, plain and simple.

ii) **Payee/Purchaser**: From a purchaser's standpoint, the Promissory Note will enable the purchaser to generate income on passive funds available at his/her disposal. Whilst the Promissory Note is not risk free like Treasury Bills or other government bonds, the higher returns may compensate the purchaser for the increased risk, coupled with the fact that a Promissory Note may be secured. Furthermore, with the enactment of the Secured Transactions in Movable Assets Act 2017, personal properties of the issuer may be taken as security for the obligations contained in the Promissory Note.

The Secured Transactions in Movable Assets Act 2017 applies to security interests in movable assets created by an agreement that secures payment or any other obligation. It is important to ensure that the agreement - in this case the Promissory Note - clearly defines the personal or movable asset secured. This is done by stating the kind, category, year of manufacture and other specifics. The high point of securing a movable asset is that the security interest shall extend to the identifiable proceeds of the collateral even where the agreement had been silent on this fact. It must however be noted that the security interest herein described remains unperfected until same has been registered at the Collateral Registry where the details and specifications of the security will be received and recorded under the supervision of a registrar appointed by the CBN.

With the Promissory Note, both the note itself as well as the security backing it are legally enforceable[12] and where the purchaser is in immediate need of funds, same can be transferred to a third party. Undoubtedly, there may exist some liquidity/disposal challenges for holders of Promissory Notes, like most other unlisted securities. However, the key point is that there is a prima facie right to transfer the instrument whilst issues concerning liquidity can be surmounted subsequently.

7.0. Other Considerations

Whilst the Promissory Note can be used to document a promise to repay a debt however incurred (either as a loan, or as result of a receivable), it is to be noted that it is not typically as detailed as a loan agreement. Thus, where the sums involved are substantial, it may be in the best interests of the lender to adopt a loan agreement to document the parties' respective rights and obligations. Nevertheless, the Promissory Note does offer an advantage over the loan agreement in that it can be used to document a debt obligation arising out of a supply or service rendered as opposed to money advanced, i.e. 'non-loan' related debt obligations.

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9 (2017) LPELR – 43006 (CA)
10 Under section 315 of the Investments and Securities Act (ISA), 'securities' is widely defined to cover: (a) debentures, stocks or bonds issued or proposed to be issued by a government; (b) debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate; (c) any right or option in respect of any such debentures, stocks, shares, bonds or notes; or (d) commodities, futures, contracts, options and other derivatives, and the term securities in this Act includes those securities in the category of the securities listed in (a) – (d) above which may be transferred by means of any electronic mode approved by the Commission and which may be deposited, kept or stored with any licensed depository or custodian company as provided under this Act.
11 Section 54 of the ISA; Rule 279 SEC Consolidated Rules.

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8.0. Conclusion

In our view, a Promissory Note is a very useful financial instrument which has been greatly overlooked. As explained above, it is a legally binding instrument which operates somewhere between the informality of an I Owe You (IOU) or a simple acknowledgment of debt and the more sophisticated loan agreement. Key to the utility of the Promissory Note is its transferability from one purchaser to another. It also affords an issuer the opportunity to have its own unique 'mini-offering' without having to incur the costs associated with more sophisticated issues on a securities exchange. It is for this purpose we recommend that small scale private companies/startups consider the use of Promissory Notes as a means of debt financing to scale up their operations.

For any comments and additional information on the issues discussed, please contact any of the under-listed persons:

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