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It Is Ok to Be Noteless

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In the days leading up to the closing of a credit facility, it is not uncommon for the administrative agent to ask each lender a simple question, "do you need a note?" For many lenders, the response is in the affirmative, but such an answer sometimes seems to be given out of instinct and without a thorough contemplation of the potential headaches that are being obtained. An understanding that the note may need to be amended, must be retained for future return to the borrowers, and may impose taxes that could change the direction of future responses.

In most instances, the form of note is a minimally negotiated exhibit to the credit agreement that contains a few key elements – a recitation of the amount of the loans made, a reference to the credit agreement, the fact that the note requires the payment of principal, interest and fees, a waiver of demand or presentment for payment (if the lender's counsel is astute), and a signature by the borrower. A so-called grid note is customarily used in a revolving credit facility. Under a grid note, the face of the note specifies a dollar amount that corresponds to the commitment of the lender, but the text of the note provides that the true amount payable is the aggregate of all the loans actually advanced to the borrower and outstanding. Details of the loans made can be set forth in one or more schedules (or grids) attached to the note. To deal with the possibility that a borrower may object to the amount entered on the grid, the credit agreement (and the note) usually provides that the failure to make entries on the grid will in no way increase, reduce, or diminish the applicable borrower's obligations under the note.

Apart from the benefits of an acknowledgment by the borrower of its obligations, there are other motivations to evidence loans with a note. Section 3213 of the New York Civil Practice Law and Rules (CPLR) provides that a note that is "an instrument for the payment of money only" is entitled to summary enforcement, which is effectively an expedited proceeding to obtain a judgment from a court. Not all notes qualify as instruments for the payment of money "only," although case law indicates that the fact that the note references another agreement (most likely the credit agreement) or that the interest rate must be determined externally (such as if it accrues at SOFR or the alternate base rate as set forth in the credit agreement), does not prevent the note from being an instrument for the payment of money only. See *Cmty. Nat'l Bank & Trust Co. of N.Y. v. I.M.F. Trading, Inc.*, 561 N.Y.S.2d 578 (App. Div. 1st Dep't 1990). Whether an aforementioned grid note would qualify as an instrument for the payment of money is unknown (no reported cases address this situation to date). However, much of academia supports a conclusion that presenting external evidence to prove the amount of interest should not disqualify a note from Section 3213 treatment and external evidence should be permissible to prove the amount of the principal owed by a borrower.

This is another historical reason to obtain notes. Most notably is the ability to pledge notes to a Federal Reserve Bank at its discount window pursuant to Regulation A of the Federal Reserve Board. The discount window is an easy way for a bank to obtain short-term, seasonal, or emergency funds, and traditionally was available only if the bank could pledge a physical note to the relevant Federal Reserve Bank. However, the discount window policies were revised in the late 1990s and noteless loans now also qualify for pledging to the Federal Reserve. As a result, the need to hand over a physical note is no longer necessary. It should be stated that there may, nevertheless, be a continuing advantage to physical notes under Regulation A. A pledge to the Federal Reserve of a physical note can be perfected by a mere delivery of the note. On the other hand, a pledge of a noteless loan to the Federal Reserve requires the filing of a Uniform Commercial Code financing statement against the pledgor. Some lenders like the certainty of physical delivery and for this reason insist upon obtaining a physical note.

However, the willingness of the Federal Reserve to discount noteless loans has resulted in a common practice of not requesting a note or at least requiring a lender to affirmatively request a note. This is the so-called “note-option” structure whereby the lenders (at least those that are comfortable without a note) rely instead upon the credit agreement itself to evidence the borrower’s obligation to repay the loans. However, some banks are constrained by internal policies that require all loans to be evidenced by notes and thereby removing any discretion to act otherwise.

As noted above, notes often have an amount completed with the applicable lender’s commitment. This begs the question of what happens if such lender’s commitment changes over time via an amendment, a facility reduction, assignment, or otherwise. The answer often is a need for an amended note. This can be avoided by not including a specific commitment amount on the face of the note and relying on generic language that the note represents the principal amount of each loan from time to time, together with all accrued interest thereon, made by the lender to the borrower signing the note under the credit agreement. The effect is the same, but the need for amended notes based on changes to a lender’s commitment is avoided.

Most credit agreements provide that if the commitments are terminated or the applicable lender is no longer serving in that role, any note executed for such lender’s benefit must be returned to the borrower. For deals that have a long tenor or are heavily laden with documentation, there is a significant chance that the note will be misplaced and cannot be timely returned to the applicable borrower. In such case, the borrower is within its rights to request a lost note affidavit. This request results in more time and cost spent remediating a situation created by a simple request for a note when the transaction closed years prior.

The effect of requesting a note can have monetary implications as well. Notes can, in some jurisdictions, be subject to stamp taxes, which are taxes imposed upon the instrument itself or the execution thereof. The most glaring example of this is Florida’s Documentary Stamp Tax. A number of devices are used to avoid or minimize these taxes, such as to execute the notes outside the taxing jurisdiction (this is frequently done in the case of the Florida Documentary Stamp Tax by executing documents aboard a boat in international waters or during a quick trip to south Georgia). In cross-border transactions, it is customary to have local counsel opine that no stamp taxes are payable in connection with the credit agreement or the execution of a note.

It is also worth pointing out that the rules regarding execution of notes vary widely across non-U.S. jurisdictions. As such, it is always appropriate to ask non-U.S. counsel to advise on any jurisdictional rules that might not be intuitive. For example, an entity formed or organized under the laws of Jersey is limited to a small number of notes that can remain outstanding at any given time without running afoul of regulatory requirements. In situations involving a large syndicate, the entity may not be able to provide a note to all lenders.

In the end, the answer to the first question posed above has consequences that may not become apparent until much farther down the road. Although unlikely in a true subscription facility context, the answer could have monetary implications as well. The lender’s internal policy may necessitate the need to have a note in such lender’s files, but when given a non-compelled response, perhaps relying on the credit agreement is a better option with fewer future headaches.