To Be Argued By:
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U.S. District Court, Southern District of New York
Docket No. 1:17-cv-01775-ALC
U.S. Court of Appeals for the Second Circuit, Docket No. 18-3023-cv

Court of Appeals

STATE OF NEW YORK

ADAR BAYS, LLC,

Respondent,

—against—

GENESYS ID, INC.,

Defendant-Appellant.

BRIEF FOR RESPONDENT

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I. QUESTIONS PRESENTED

1. Whether a stock conversion option that permits a lender, in its sole discretion, to convert any outstanding balance to shares of stock at a fixed discount should be treated as interest for the purpose of determining whether the transaction violates N.Y. Penal Law § 190.40, the criminal usury law.
2. If the interest charged on a loan is determined to be criminally usurious under N.Y. Penal Law §190.40, whether the contract is void ab initio pursuant to N.Y. Gen. Oblig. Law § 5-511.

II. STATEMENT OF THE CASE

The matter before the Court arises from GeneSYS, ID, Inc.'s (formerly known as "RX Safes, Inc.") ("Appellant" or "GNID") breach of a $35,000.00 8% convertible redeemable note (the "Note") issued to Adar Bays, LLC ("Respondent" or "Adar").

GNID is a sophisticated, publicly traded entity that accepted Respondent's money and issued the Note under the supervision of counsel – not just any counsel, but Mr. Mark Basile, managing partner of the firm representing Appellant herein. Appellant was fully aware of the terms of the Note, yet shirked its obligations thereunder at the first opportunity, and has since been arguing that the Note's terms

are usurious. Appellant's feigned victimization, misplaced analogies, and outright misstatements of law cannot be grounds for the windfall that Appellant seeks.

At each step of background and analysis contained in Appellant's Brief (the "App. Brief"), Appellant's arguments are flawed. With regard to the first question before the Court – whether the conversion right contained in the Note constitutes interest for the purposes of a usury determination – Appellant goes to great lengths to liken the instrument to a warrant or a stock option, then proceeds to explain why those instruments can be valued at the time of contracting and make the transaction before the Court usurious. However, the convertible note herein is neither a warrant nor an option.

A key difference between those instruments analyzed by Appellant and the Note is that neither a warrant nor a stock option has value independent of its exercise, whereas the Note does. Until a warrant or stock option is exercised, it provides no means for the holder to receive value. The Note, on the other hand, provides for repayment of principal and interest if the conversion right is not exercised. Thus, courts and the Internal Revenue Service ("IRS") value warrants and stock options under the presumption that they will be exercised because they have no value unless exercised. Such a presumption cannot be made with the Note because it is entirely feasible, and indeed has often proven true with other convertible notes before State

and Federal Courts of New York, that no conversions will ever be made, and the holder merely seeks repayment of principal and interest.

Further, Appellant carefully steps around saying that the alleged "interest" earned by Respondent from the conversion rights are charged to Appellant. That is because Appellant cannot say that the shares of stock have the same value to Appellant as they do to Respondent for a number of reasons. First, Appellant cannot sell the shares on the open market without violating Securities and Exchange Commission ("SEC") regulations, making the market price irrelevant to Appellant. Second, Appellant, at the time when these events transpired, was a closely held corporation, with the majority of voting shares being held by the very same individuals who were responsible for issuing the Note. Those same individuals, including counsel herein, had the authority to vote to increase the authorized shares of the corporation, essentially giving them the power to "print the money" to repay the Note.

Next, Appellant intentionally mischaracterizes the speculation that led over twenty state and district court judges to reject these usury arguments. The speculation is compound, consisting of whether the conversion right would be exercised, whether the shares could be sold, whether the shares would be sold, whether the corporation's stock would still be listed on the exchange, whether the corporation would be current in its SEC filings, whether there would be demand for

the stock, whether the price would drop in the three days between the notice of conversion and the delivery of the shares, whether there would be shares available, and whether the corporation would simply cancel the reserve or refuse the conversion. Instead, Appellant states simply "if the court understood how the fixed discount worked, it would not be concerned with the stock price." App. Brief at 11. That, aside from belittling the court, addresses only one element of the speculation – the value of the stock – and disregards all others.

Last, Appellant intentionally misstates the various holdings in relevant matters, attacks them, then relies on a series of irrelevant, inapposite, and out of date matters from across the country, in hopes of battering the Court into submission to Appellant's line of thought.

With regard to the second question before the Court - if the interest charged on a loan is determined to be criminally usurious under N.Y. Penal Law § 190.40, whether the contract is void *ab initio* pursuant to N.Y. Gen. Oblig. Law § 5-511 – Appellant asks the Court to write into the statute a provision which was specifically excluded by the legislature.

There can be no dispute that the legislature contemplated the difference between corporations and individuals in § 5-501 et seq. First, it specifically excluded corporations from relying on the statute. Second, the sequence of statutes clearly indicates that the more sophisticated the party, the less protection is needed.

For instance, an individual accepting a loan under $250,000.00 is provided the protection of a 16% interest rate and the remedy of voiding the loan. On the other hand, if the loan is greater than $250,000.00, the 16% civil usury cap does not apply, and the 25% criminal usury cap is in effect. Further, because a corporation is presumed to be more sophisticated than an individual, the entirety of § 5-501 et seq is unavailable, and the interest cap is 25%. Even more telling, for an individual accepting a loan in excess of 2.5 million dollars, even the 25% civil usury cap is unavailable. Given these delineations, it cannot be presumed that the legislature intended for the civil remedy to remain available to corporations when the entire defense of the statute is not available.

Accordingly, it is respectfully requested that this Court answer each question in the negative.

III. FIRST QUESTION:

Whether a stock conversion option that permits a lender, in its sole discretion, to convert any outstanding balance to shares of stock at a fixed discount should be treated as interest for the purpose of determining whether the transaction violates N.Y. Penal Law §190.40, the criminal usury law.

1. Short Answer

At the time of contracting, when a usury determination must be made, the conversion right is too speculative to include in an interest calculation. At the point of conversion and delivery of the shares, the only time at which the speculation is

somewhat resolved, the transaction changes from a loan to an equity investment and is no longer subject to a usury defense. Therefore, there is no point in the life of the transaction where the conversion right can be considered interest.

2. State and District Court Findings

Appellant's argument is one that has been made to and rejected by over a dozen district courts and at least once in the Supreme Court of New York. While obviously not controlling, the analysis provided by these courts is sound, and this Court should adopt the same approach. See e.g., *EMA Fin., LLC v. AIM Exploration, Inc.*, 2019 WL 689237 (S.D.N.Y Feb. 19, 2019); *Union Capital, LLC v. Vape Holdings Inc.*, 2017 WL 1406278 (S.D.N.Y. Mar. 31, 2017); *Beaufort Capital Partners, LLC v. Oxysure Sys. Inc.*, 2017 WL 913791, (S.D.N.Y. Mar. 7, 2017); *Adar Bays, LLC v. Genesys Id, Inc.*, No. 17-cv-01175 (ALC), 341 F. Supp. 3d 339 (S.D.N.Y. 2018); *LG Capital Funding, LLC v. Aim Exploration, Inc.*, 2018 WL 4119149 (S.D.N.Y. Aug. 29, 2018*); LG Capital Funding, LLC v. One World Holdings, LLC*, 2018 WL 3135848 (E.D.N.Y. June 27, 2018*); LG Capital Funding v. Vapor Grp, Inc.*, (E.D.N.Y. June 28, 2018); *LG Capital Funding, LLC v. 5Barz International, Inc.*, No. 16 Civ. 2752(NRB), 307 F. Supp. 3d 84 (E.D.N.Y. 2018); *LG Capital Funding, LLC v. Windstream Technologies*, 2018 WL 4119158 (S.D.N.Y. Aug. 29, 2018); *Adar Bays, LLC v. 5Barz Int'l, Inc.*, No. 16 CIV. 6231 (NRB), 2018 WL 6991041 (S.D.N.Y. Dec. 20, 2018); *Adar Bays, LLC v. Aim*

Exploration, Inc., No. 17 Civ. 1290(VM), 285 F. Supp. 3d 698 (S.D.N.Y. 2018); *EMA Fin., LLC v. Joey New York, Inc.*, 2019 WL 4600863 (S.D.N.Y. Sept. 22, 2019*); Coastal Inv. Partners, LLC v. DSG Global, Inc.*, 2018 WL 2744719 (S.D.N.Y. June 06, 2018); *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 WL 7429581 (N.Y. Sup. Ct. Nov. 23, 2015) (Hereafter, "*Union* et al").

Three matters in the Southern District Court of New York and in the New York Supreme Court laid the framework for the application of principles established over years of usury analysis to convertible instruments similar, if not identical, to the Note at issue in the present matter, which has been followed and developed in the line of case law referred to *supra* as *Union et al.*

First, the New York Supreme Court, in *LG Capital Funding, LLC v. Sanomedics Int'l. Holdings, Inc.*, 2015 WL 7429581 (N.Y. Sup. Ct. Nov. 23, 2015), analyzed a usury defense when plaintiff brought an action against a corporation based upon similar convertible notes. The *Sanomedics* notes provided for a conversion price equal to 55% of the average of the lowest three trading prices for the ten prior trading days, only marginally different terms from the Note's terms herein. The defendant argued that the notes were usurious and unenforceable based on this conversion provision. The court first found that the notes were not usurious on their faces because they provided for 8% and 10% per annum interest rates. *Id.*

Next, the court stated:

> It is further noted that 'usury laws apply only to loans or forbearances, not investments. Although the initial transactions were loans, which were clearly not usurious, as plaintiff notes, the Securities Purchases Agreement provided that, upon conversion, [Defendant] was selling securities . . . to it as an 'investor.' The conversion to stock would convert plaintiff from a lender to an investor with the right to share in the profits and losses of [Defendant] . . . . While a loan may not be disguised as an investment as a cover for usury . . . upon conversion at Plaintiff's election [Defendant's] debt to plaintiff [would] become an investment, upon which plaintiff took the risk that the stock could become completely worthless. Where the transaction provides for the purchase of shares of stock and the price of stock fluctuates so that it is unclear if the interest rate would exceed the legal rate of interest, no usury exits. *Id.* at 29-30.

Reaching a similar conclusion, the Hon. Richard J. Sullivan, then of the Southern District Court of New York and now of the Second Circuit, applied the same established usury principals to a similar scenario as here in *Union Capital, LLC v. Vape Holdings Inc.*, 2017 WL 1406278 (S.D.N.Y. Mar. 31, 2017). The convertible note in *Union* provided for a principal amount due one year from issuance, 8% interest thereupon, 24% interest in the event of default, and a conversion right. It also stated that "[t]he Holder of this Note is entitled, at any time, to convert all or any amount of the principal face amount of this Note then outstanding into shares of the Company's common stock . . . at a price . . . for each share equal to 58% of the **<u>lowest trading price</u>** of the Common Stock . . . for the thirteen prior trading days . . . ." *Union Capital, LLC v. Vape Holdings Inc.*, 2017 2017 WL 1406278 *1 (S.D.N.Y. Mar. 31, 2017). Thus, the only substantive

differences in the conversion rights to those herein are the amount of the discount and the duration of the "look-back" provision. With regard to this conversion right, Judge Sullivan stated:

> [Defendant] argues that, in considering the effective interest rate, the Court should also include the potential profit [Plaintiff] might reap by converting shares at a 42% discount. The Court disagrees. [Plaintiff] simply held an option to convert shares, and it could have elected to obtain repayment in cash, which would clearly not have been usurious. Moreover, even if [Plaintiff] chose to convert the loan principal into shares, any potential profit [Plaintiff] might realize would still be dependent on the market price at the time of conversion and so, therefore, would be too uncertain to incorporate into an interest rate calculation. Furthermore, even if the discount rate could be considered, a usury defense could no longer be applied against the loan once the Note principal was converted into equity in [Defendant]. Accordingly, [Defendant] cannot meet its heavy burden in impeaching the transaction for usury.

Id, at 12-13 (internal citations omitted).

Similar analysis was applied by the district court in *Beaufort Capital Partners, LLC v. Oxysure Sys.*, 2017 WL 913791, (S.D.N.Y. Mar. 7, 2017). The notes at issue in *Beaufort* provided that "'at any time after the Maturity Date . . . this Note, including interest and principal, shall be convertible into shares at the higher of (a) $.0004; or (b) the amount that is a 30% discount' from the average closing price." *Id*, at*6 (S.D.N.Y. 2017). Like Appellant, "Oxysure argue(d) . . . that a 30% discount in the equity conversion effectively increases the interest rate on the notes to a level that is usurious." *Id.* at 6-7. The Hon. J. Paul Oetken first found that because the

conversion right only applied after an event of default, the usury defense could not apply. Judge Oetken continued:

> Even focusing on the post-maturity interest rate . . . , the usury defense would likely nonetheless fail because it relies on the debt-to-equity conversion feature of the notes. The conversion feature allowed Beaufort to redeem the Notes for equity at a discounted price after the maturity date. However, though the initial transaction took the form of a loan, upon conversion to equity, the loans likely have the character of an equity investment, and are thus no longer vulnerable to a usury defense. Thus Oxysure's reliance on the discounted equity conversion in calculating the applicable interest rate for its usury defense is misplaced. *Id.*

Following the decisions in *Sanomedics, Union,* and *Beaufort*, the district court in this matter and numerous other district court decisions have agreed with and added to these principals. See *LG Capital Funding, LLC v. Aim Exploration, Inc.*, 2018 WL 4119149 (S.D.N.Y. Aug. 29, 2018) ("While 'the initial transaction took the form of a loan, upon conversion to equity, the loans likely have the character of an equity investment, and are thus no longer vulnerable to a usury defense."); *LG Capital Funding, LLC v. 5Barz International, Inc.*, 307 F. Supp. 3d 84, 98 (E.D.N.Y. 2018) ("The weight of authority indicates that once the holder of a convertible note exercises conversion rights, the converted portion of the loan takes on the character of equity, not debt, and is thus no longer susceptible to a usury defense.").

Having seen the same argument rejected several times, defendant corporations pivoted to arguing, as Appellant does here, that the conversion right is calculable as interest at the time that note is issued, rather than once the nature of the transaction

shifts to an investment. The district court addressed and rejected this argument on multiple occasions, based on both the uncertainty of profits and the uncertainty of exercisability. With regard to the uncertainty, the Hon. Edgardo Ramos in *EMA Fin., LLC v. AIM Exploration, Inc.*, 2019 WL 689237 (S.D.N.Y Feb. 19, 2019) stated:

> In the instant case, EMA possessed a right to receive shares of AIM-Inc. common stock *in lieu of* monetary payment, not *in addition* to monetary payment. And, notwithstanding Defendants' arguments, the case law in the District is uniform in holding that the value of conversion discounts should not factor into the usury analysis. The reason for this holding is straightforward: The value of the conversion discount simply is too uncertain to include in a usury analysis. For one thing, "even if [EMA] chose to convert the loan principal into shares, any potential profit [EMA] might realize would still be dependent on the market price [of the shares] at the time of conversion and so, therefore, would be too uncertain to incorporate into an interest rate calculation. Of course, as some courts have observed, 'assuming full liquidity and immediate disposition, the profit realized from the purchase of stock at a fixed percentage discount at a fixed overall purchase price should generally be the same regardless of the undiscounted price of the stock. However, stock is not necessarily fully liquid and it cannot always be disposed immediately. Furthermore, there is no guarantee that [EMA] could realize a fixed profit by reselling the stock since it is possible that the price of the stock would decrease immediately following the submission of a notice of conversion.
>
> *Id*, at *19-20

In this matter, the Hon. Andrew L. Carter reached the same conclusion, but rather than focusing solely on profits from the conversion, focused on the uncertainty of Respondent's willingness or ability to exercise the right altogether. Relying on the long-standing principal that "a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest," *Phlo v.*

Stevens, 2001 WL 1313387 (S.D.N.Y. Oct. 25, 2001) (citing *Lehman v. Roseanne Investors Corp.*, 106 A.D2d 617, 618 (2d Dep't 1984)), Judge Carter recognized that "[t]he conversion right was simply too uncertain at the time of contracting."[1] *Adar Bays, LLC v. GeneSYS ID, Inc.*, 341 F. Supp.3d 339, 356 (S.D.N.Y 2018). The court acknowledged that plaintiff "could have elected to obtain repayment in cash, which would clearly not have been usurious," and that "Defendant could become delinquent in its filings, become delisted, experience sudden decreases in its stock price, experience no demand for its stock, or simply cancel the reserve or refuse a conversion." *Id.* Thus, like in *Phlo*, "it was not clear than any effective interest rate in excess of 25% would ever have to be paid." *Phlo v. Stevens*, 2001 WL 1313387 *5 (S.D.N.Y. Oct. 25, 2001).

When viewed in totality, these principals lead to the conclusion that there is no point in the life of the transaction where the conversion right, discount, or value can be considered interest for the purposes of a usury determination. At the time of contracting, the conversion right and the impact of its discount is too uncertain to include as effective interest, and at the point of conversion, the nature of the transaction changes from a loan to an equity investment, the risk of holding the

[1] Respondent was not consulted with regard to the compilation of the Appendix in this matter. As Appellant failed to include the District Court decision that was appealed, will provide reporter citations.

equity falls to the stockholder, and the transaction is no longer susceptible to a usury defense.

Appellant's argument is self-conflicting. It places heavy emphasis on that interest must be measured at the time on contracting, yet the conversion right cannot be exercised, or "taken," at the time of contracting by the very terms of the Note. It cannot be understated that despite Appellant's insistence that the discount contained in the conversion right is guaranteed to such a degree that it warrants treatment as being charged at the time of contracting, Appellant admits brazenly that it terminated its transfer agent "to avoid an election for conversion to stock."

3. <u>Appellant's Argument</u>

Rather than address these courts' findings head on, Appellant creates a series of false equivalencies and straw men, then argues the merits of those premises. Appellant begins with a false premise; namely, that the conversion right guarantees that Respondent "receives" 54% greater value than the amount converted. As numerous courts have held, there is a glut of intervening factors that make this statement untrue. Next, Appellant emphasizes the statutory framework's use of the word "property" to provide a baseline for its subsequent argument, but it is, in essence a red herring. Third, Appellant relies on numerous inapposite cases. Appellant's failure to acknowledge the difference between repayment with stock in addition to money and repayment with stock in lieu of money is telling. Next,

Appellant argues that the Note is akin to a warrant or option, and that because those instruments are valued at the time of issuance, so too should the Note. Fatal to this argument is that the Note is not akin to a warrant or option, making Appellant's pages of tenuous analogies irrelevant. Finally, Appellant attempts to undermine relevant district court holdings by misstating their findings and attacking the misstated logic.

i. The Conversion Right Itself is Not Guaranteed to be Exercised, so the Return Thereupon is Not Either.

Appellant argues that "the minimum value the lender gains by taking repayment in stock *never varies*." App. Brief at 18. Appellant and/or its counsel have peddled this argument before over a dozen judges and none have agreed for four reasons. First, it is not even guaranteed a noteholder would choose to exercise the conversion right, so it cannot be guaranteed to add any value whatsoever. Second, even if a noteholder desired to exercise it, there are numerous intervening circumstances where it would be unable to do so or where it would be illogical to do so. Third, and important to note throughout all of Appellant's arguments, is that the value of the stock to Respondent on the open market is not the same as the value of the stock to Appellant. Thus, the value of the stock cannot be considered "charged interest" to Appellant. Finally, Appellant fails to even acknowledge the volatility of the penny-stock market, making it almost a certainty that the price of the stock when

a notice is submitted will not be the same as the price of the stock when the shares are delivered within the three business days allowed per the terms of the Note.

Appellant's insistence that some sort of return is guaranteed is an effort to circumvent the long-standing principal in usury law that "a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest." *Lehman v. Roseanne Investors Corp.*, 106 A.D.2d 106, 108 (2d Dep't 1984)(citing *Hartley v. Eagle Ins. Co. of London, England*, 222 N.Y. 178, 184). Accordingly, Appellant forgoes entirely to consider the possibility that a noteholder may not exercise the conversion right and may simply collect repayment on the maturity date, as is often the case. *See eg., LG Capital Funding, LLC v. Wowio, Inc.*, 2018 WL 2224991 (E.D.N.Y. 2018); *LG Capital Funding, LLC v. Worthington Energy, Inc.*, 2018 WL 1370266 (E.D.N.Y. 2018).

Similarly, despite various Judges reaching this conclusion, Appellant refuses to acknowledge the intervening circumstances which could, and one of which did in this case, lead to an inability of a noteholder to convert. As the Hon. Andrew L. Carter noted in this matter, "[t]he conversion right was simply too uncertain at the time of contracting. As courts have noted, a myriad of circumstances could decrease the price of stock [or make the conversion right moot], including that '[d]efendant could become delinquent in its filings, become delisted [from the exchange], experience sudden decreases in its stock price, experience no demand for its stock,

or simply cancel the reserve or refuse a conversion." *Adar Bays, LLC v. GeneSYS ID, Inc.*, 341 F.Supp.3d 339 (S.D.N.Y. 2018). Thus, it is nothing more than a possibility that a noteholder would: (a) exercise the conversion right, (b) be able to exercise the conversion right, and (c) receive a return on the conversion after the sale of the shares in excess of the permissible interest rates.

Third, even when a conversion is honored, the shares delivered, and the noteholder receives a certain value, it is inappropriate to consider that value to have been charged to the issuer. Throughout Appellant's arguments, it relies on the premise that the value of the shares to Respondent – the market value – is the same as the value to Appellant. That is untrue. A publicly traded corporation, with limited exceptions not applicable here, cannot legally sell its common stock on the open market. Therefore, why would the Court presume that the difference between the market price and the discount price constitutes an amount charged to Appellant. It is akin to the valuation of goods to a wholesaler versus the value to a retailer. Suppose a wholesale table manufacturer sells its tables to a network of retailers at a price of $1,000.00 for 10 tables. The retailers then sell tables individually to consumers at a price of $200.00 per table. The wholesaler has no retail website, no established consumer delivery logistics, and no storefronts. In other words, it cannot sell individual tables to consumers. The value of the tables, then, is different for either party: the wholesaler can only value the tables at the $100.00 per table price, and the

retailer can value the tables at the $200.00 per table price. Here, Appellant is the wholesaler, unable to obtain the same market price for the stock that Respondent would be able to, so it cannot claim the same value.

It is equally important to note that Appellant, at least at the time of the events underlying this action, was a closely held corporation. The same individuals that authorized the issuance of the Note – the majority shareholders – had the voting power to increase the number of authorized shares. Therefore, while admittedly a base analogy, Appellant had the ability to print the money with which it could repay the Note, making any direct comparison of the values of the shares to Appellant and Respondent inappropriate.

Last, as shown through Appellant's own stock price from November 28, 2016 to February 14, 2017 (A-64-66), its stock price (and the price of most penny stocks) was exceptionally volatile. During that period, the stock price fluctuated nearly 400%, ranging from a low of $.012 per share to a high of $.046 per share. *Id*. Indeed, in a matter of just three full trading days, from November 29, 2016 to December 5, 2016, the stock fell from $.046 to $.021 per share – a 54% decrease. *Id*. As Appellant was given three trading days to deliver stock pursuant to a conversion, it is far from a guarantee that Respondent would see any value from a conversion.

ii. The Legislature’s Use of the Word “Property” is Not Relevant to the Questions Before the Court, Because No Stock is Transferred at the Time of Contracting.

Appellant’s next argument focuses on the wording of N.Y. Penal Law § 190.40, and its inclusion of the word property. While ultimately irrelevant because all cases relied upon by Appellant involve the actual transfer of tangible property, or the transfer of stock in addition to repayment (as opposed to in lieu), each case relied upon by Appellant is easily distinguished from the questions presented herein. It is also worth noting that N.Y. Penal Law § 190.40 was changed to its current verbiage and sub-divided classes in 1976, making the relevance of the bulk of Appellant’s relied upon case law, questionable, particularly the various matters from the 19th century. *See* McKinney’s Penal Law §190.40 Commentary.

Appellant begins by stating that *Diehl v. Becker*, 227 N.Y. 318, 319 (1919) held that “a contingent right to profits was valuable, was compensation for the loan, and raised the interest rate to a usurious level.” App. Brief at 22. This generous interpretation of the Court’s holding is inaccurate. The relevant portion of this 1919 holding states “**Payment of principal and interest did not end all obligations under the contract**. If ever thereafter borrower sold his patents, the bonus became due. It is true he might not sell them. But in any event the plaintiff was entitled to his principal and interest **and in addition thereto his acquired this contingent right.**” *Diehl v. Becker*, 227 N.Y. at 326. (emphasis added). This is plainly

distinguishable from the present matter before the Court, because (a) repayment here does end all obligations under the contract, and (b) as Appellant admits, "each conversion extinguishes the debt as to the amount conversion" (App. Brief at 14), meaning the transfer of stock is made in lieu of repayment, not in addition to repayment like the profits in *Diehl*.

Next, Appellant takes the Court back to the 1839 case of *Cleveland v. Loder*, 7 Paige Ch. 557 (N.Y. 1839) to cherry pick a quote that stands in stark contrast to a contemporary principal of usury jurisprudence. Appellant quotes "[w]henever the lender stipulates even for a chance of an advantage beyond the legal interest, the contract is usurious . . ." *Id.* However, beginning as early as 1918, this Court has recognized that "an agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not ipso facto usurious, because of the possibility that more than the legal interest will be paid." *Hartley v. Eagle Inc. Co. of London, Eng.*, 222 N.Y. 178, 184 (1918). As a result, the numerous New York District Courts addressing Appellant's arguments and applying New York law cite to the proposition from *Lehman v. Roseanne Investors Corp.*, 106 A.D.2d 617, 618 (2d Dep't 1984) which states "there is a strong presumption against the finding of usurious intent and . . . a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest." As made clear above, each aspect of the conversion right, from the exercise itself, to the

availability of shares, to the price of the shares following exercise, is uncertain, making it no more than a mere possibility that Respondent would receive more than a legal rate.

Appellant's reliance on *Moore v. Plaza Commercial Corp.*, 9 A.D.2d 223 (1st Dep't 1959) falls in line with its willful disregard for the difference between delivery of shares in addition to repayment versus delivery of shares in lieu of repayment, like *Funding Group* and *Hillair* discussed in Section (iii) below. It cannot be said that the delivery of additional and distinct property should be viewed identically to the delivery of property in lieu of repayment of cash.

Next, Appellant relies on a series of cases in an effort to lay the foundation for its arguments regarding valuation of the conversion right but misses the mark. First, Appellant cites to the 1875 case of *Quackenbos v. Sayer*, 17 Sickels 344, and the 1852 case of *Schermerhorn v. The American Life Insurance and Trust Company and others*, 1852 WL 5992 (N.Y. Sup. Ct. Sept. 6, 1852). Each involved the valuations of bonds exchanged instead of cash for mortgages owed. Neither is relevant, as there was no speculation required as to: (a) whether the exchange would ever happen (i.e. would the conversion right be exercised); (b) whether the bonds would be available (i.e. would the shares be available); (c) what the bonds would be worth if/when they were transferred (i.e. what would the shares be worth when

transferred); or (d) whether there would be a buyer for the bonds (i.e. would there be enough trade volume to liquidate the shares).

Next, Appellant relies on two cases for the proposition that "where the loan contract expressly designates the property to be taken by its monetary value, no such finding would be necessary." In *Funding Group, Inc. v. Water Chef, Inc.*, 852 N.Y.S 2d 736, the Supreme Court found that the loan carried "an interest rate of 10% per month (120% per annum), plus an incentive fee of $7,500.00 (243% of the loan) amount to combined interest payments at an annual interest rate of 363%." Likewise, in *American E Group, LLC v. Livewire Ergogenics, Inc.*, 2019 WL 3553293 (S.D.N.Y Aug. 5, 2019), the Southern District Court found that a note provided for repayment of principal and 20% interest, as well as "additional consideration for the loan through the issuance of stock" worth, at the time of contracting, $50,000.00. In both cases, the delivery of stock was immediate and certain, and its value was calculable at the time of contracting because stock was in fact transferred at the time. As will be discussed in the next section, these cases are also off-point because they involve delivery of stock in addition to repayment of principal and interest.

iii. None of the Cases Cited by Appellant Support its Argument.

The majority of the cases relied upon by Appellant for the proposition that the "value of securities received as consideration for a loan must be included in the

interest calculation" are inapposite here because: (a) the shares are delivered at the time of contracting and/or, (b) the shares are given in addition to repayment of principal and interest.

In *Funding Group*, the transaction at issue was a $25,000.00 loan, with interest of 10% per month, with "additional shares of convertible preferred" stock "as an incentive . . . to undertake the transaction." The stock was not granted in lieu of repayment and was delivered immediately upon entering into the transaction.

Appellant's reliance on *Alpha Capital Anstalt v. BioMetrix, Inc.*, 2010 WL 238706 (N.Y. Sup. Ct. Jan. 06, 2010) is strange, and its summarization of the findings borders on misrepresentation. The *BioMetrix* decision simply denied a motion for summary judgment in lieu of complaint, stating "although ultimately plaintiff may succeed on its claim for recovery, at this juncture, the Court finds summary judgment premature." There was no reference to the "options" being "deep 'in the money,'" no finding as to the value of what was paid "up-front," and no implication whatsoever that the "effective interest was quite possibly usurious."

Appellant's characterization of *Cleveland* as "similar to this case" is equally troubling. Not only has the main principal underlying this 1839 been overturned by the case law of the last century (see, *Lehman v. Roseanne Investors Corp.*, 106 A.D.2d 106, 108 (2d Dep't 1984); *Hartley v. Eagle Ins. Co. of London, England*, 222 N.Y. 178, 184)), the speculation related to whether the stock would be

exchanged present herein was not present there, as the stock was transferred upon execution of the agreement. While certain aspects of the wisdom of the Chancery Court of New York in 1839 may hold true today, the fact alone that Appellant was required to dig into such annals of case law to find cases that only tangentially support its arguments speaks for itself.

Leavitt v. DeLauny, 4 NY 364, (1850), in which the Court found the transaction to be "free from usury," does not stand for the principal that Appellant implies. *Leavitt* discusses various types of transactions prevalent in the mid-nineteenth century and the elements that do and do not render them usurious. Cleverly, Appellant isolates a single quote that favors it, then qualifies it as those circumstances "***potentially*** running afoul of the usury statute" – a statute that did not exist in 1850.

The lender in *Moore v. Plaza Commercial Corp.*, 9 A.D.2d 223 (1st Dep't 1959) was entitled to repayment of principal and interest, and to sell and retain half of the profits from certain shares of stock held as collateral for the loan. In *Sabella v. Scantek Med., Inc.*, 2009 WL 3233703 (S.D.N.Y. Sept. 25, 2009), the Southern District Court of New York denied summary judgment on the affirmative defense of usury based on questions of fact remaining related to transactions that provided for repayment of loans *in addition to* the issuance of large volumes of common stock. And in *Hillair Capital Invs., L.P. v. Integrated Freight Corp.*, 963 F.Supp.2d 336

(S.D.N.Y. 2013), the Southern District Court found that "[d]efendants effectively undertook four transactions: they took out two loans, and they also twice sold stock to [p]laintiff;" therefore, the "value of the sold stock . . . [was] critical to calculating the initial loan amount and thus the interest rate." *Id.* at 340. Each is markedly different than the facts herein and, while Appellant continues to draw this inapt comparison, Respondent will not belabor the point – shares in addition to repayment must be treated differently than shares in lieu of repayment.

iv. Appellant's Valuation is Unsupported at Law.

1. Appellant's Argument and Three Fatal Flaws

Appellant next takes the Court on a meandering journey through its various theories on valuing the conversion right. Appellant's argument regarding valuation tracks as follows. First, Appellant relies on various real estate matters for the proposition that the Note should be given a fair market value at the time of contracting. Next, Appellant cites to two cases in which securities were exchanged at the time of contracting for the proposition that the market price is the fair market value. Third, Appellant likens the Note to a simple stock option or a warrant, then refers to the tax treatment of those two instruments, arguing that the Note should be treated the same.

There are numerous flaws at each step of this argument, which will be addressed in turn, but there are three major flaws that undermine Appellant's entire argument.

First is Appellant's insistence that the Note is analogous to a warrant or stock option. This is simply untrue. A stock option or a warrant holds no value that is not inextricably linked with their exercise because in such instruments, generally, there are no buy-back or repayment obligations. Simply, if the holder exercises the warrant or option, the holder receives securities and can do with them what it pleases. Contrast this with the Note at issue. If the holder opts not to convert or is unable to convert for the various reasons discussed above, the issuer is obligated to repay the principal and interest upon maturity. The consequence of this distinction at law is that a warrant or option carries with it a presumption of exercise, because there is no other reason to hold such an instrument. A convertible note, on the other hand, does not merit such a presumption because it is equally reasonable to believe that a holder will avoid the risk of taking on an equity investment and simply seek repayment of principal and interest. Appellant all but admits this important distinction, stating "convertible notes 'are similar to bonds with warrants in that the investor is purchasing the equivalent of a bond with an option,'" App. Brief at 4, yet goes on to rely only on matters involving warrants or options, not bonds with warrants or bonds with options. Therefore, at each occasion where Appellant relies on matters

involving options or warrants, the court or legislature is assuming that the holder will, in fact, exercise the option or warrant, and valuing them on that basis.

Second, and related to the first, is Appellant's insistence that at the time of contracting, it should be assumed that the conversion right will be exercised for the entire principal balance of the Note. Not only does this assumption entirely disregard the "myriad" of circumstances in which a noteholder would not or could not convert, the values and figures that Appellant puts before this Court would require the entire balance of the Note to be converted, not merely the tranches with Appellant alleges to be part of Respondent's "business model." App. Brief at 15.

Finally, is Appellant's presumption that the shares have the same value to Appellant as they do to Respondent. As indicated above, Appellant cannot sell the shares on the open market without violating Securities and Exchange Commission regulations, making the market price irrelevant to Appellant. Second, Appellant, at the time when these events transpired, was a closely held corporation, with the majority of voting shares being held by the very same individuals, including counsel herein, who were responsible for issuing the Note. Those same individuals had the authority to vote to increase the authorized shares of the corporation, essentially giving them the power to print the money to repay the Note.

2. Appellant's Supporting Case Law and Statutes are all Off-Point

Appellant cannot point to a single instance where a conversion right provided in a convertible note is valued the way Appellant suggests, despite these instruments having existed for decades, so Appellant is forced to analogize to stock options, and warrants, which is not appropriate.

This difference between these instruments manifests itself in the treatment of warrants and options by courts and the IRS, as Appellant points out. Because neither instrument has value independent of its exercise, it is presumed at the time of contracting that it will be exercised and valued accordingly. On the other hand, because the Note has a returnable value independent of the exercise of the conversion right, it cannot be presumed that the right will be exercised. Thus, in each matter relied upon by Appellant, the Court should note that the instrument or stock at issue has no value independent of it being sold or exercised.

In an effort to not belabor the points, each case relied upon or statement made by Appellant will be categorized into one or more of three categories: (1) those referring to stock or other property exchanged at the time of contracting; (2) those referring to stock options, or warrants; and (3) conclusory, unsupported and illogical statements.

a. Cases Involving the Value of Property Actually Exchanged or Conveyed.

The following cases are each irrelevant because they each involve property that was actually transferred or conveyed prior to or upon contracting. Valuing those items is both obvious and simple. Here, however, Appellant is asking the Court to presume that property will be exchanged at a later date despite it being equally likely that the holder would simply collect principal and interest on the maturity.

Comm. of Unsecured Creditors of Interstate Cigar Co. v. Interstate Distribution, Inc. (In re Interstate Cigar Co.), 285 B.R. 789, 801 (Bankr. E.D.N.Y. 2002) and *In re Coated Sales, Inc*., 144 B.R. 663, 668 (Bankr. S.D.N.Y., 1992) each involve the value of various tangible assets that were subject to bankruptcy proceedings.

U.S. v. Cartwright, 411 U.S. 546 (1973) discussed the tax treatment of 8,700 shares of three mutual funds exchanged at the time of contracting. *Collins v. C.I.R.*, 3 F.3d 625 (2d Cir. 1993) determined that stolen betting tickets had value for tax purposes. *C.I.R. v. Spreckels*, 120 F.2d 517 (9th Cir. 1941), *Kohn v. C.I.R.*, 16 T.C. 960 (1951), and *Onondaga Sav. Bank v. Cale Devel. Co*., 63 A.D.2d 415 (App. Div. 4th Dept. 1978) each involve the valuation of real estate at the time it is acquired for the purposes of taxation.

Interestingly, *Halsey v. Winant,* 233 A.D. 103, which Appellant claims to "comput[e the] value of privately-held stock" and hold that "a creditor takes property in satisfaction of an antecedent debt, the property must be no more than a 'fair equivalent' of what is owed" was reversed by this Court in *Halsey v. Winant*, 258 N.Y. 512. This Court held, *inter alia*, that "the price at which a person takes an option, especially under circumstances where he is involved in a highly speculative transaction . . . , is no reliable criterion of value" and that "[i]n taking the stock, . . . defendant . . . took all the risks, and to say under those circumstances that the price which it paid was unfair consideration seems to be an improper conclusion." Thus, while the circumstances of *Halsey* remain markedly off-point from those herein; the sole case that Appellant relies on that might relate to the present matter was not only reversed by this Court, but also seems to stand for the proposition that when such speculation and risk is involved in an actual transfer of stock, it is inappropriate to value it at the time of contracting.

b. Cases Involving Stock Options or Warrants

As discussed above, it is not appropriate to value a convertible note using the same presumptions as used when valuing stock options or warrants, because a holder of a convertible note is equally likely to collect principal and interest as it is to exercise the conversion right. Nonetheless, Appellant devotes several pages of its

brief to cases, statutes, and encyclopedias relating to warrants or stock options and still fails to adequately show that its proposed valuation is legally sound.

United States v. Ostrander, 999 F.2d 27 (2d Cir. 1993) is a criminal matter dealing with whether a portfolio manager's taking of warrants violated various SEC regulations on investment companies.

Reznik v. Swartz, 303 F.3d 147 (2d Cir. 2002) analyzed whether a corporation was required to disclose the value of stock options in its proxy statements and found that failure to disclose any purported value was not a violation of any SEC regulation.

Wisconsin Central Ltd. v. United States, 138 S. Ct. 2067 (2018) discussed whether stock options given to railroad employees constitute taxable "money remuneration" under the Railroad Retirement Tax Act and held that in the statute at issue, "the term 'money' unambiguously excludes stock." *Id.* at 2069.

Comm'r v. LoBue, 351 U.S. 243 (1956) involved the question of when to tax stock options. While Appellant would agree with the dissenting Justice Harlan and cites His Honor's analysis, the majority held that "the taxable gain . . . should be measured at the time the options were exercised and not the time they were granted," the opposite of what Appellant proposes herein.

Comm'r v. Smith, 324 U.S. 177 (1945) also seems to stand against Appellant's position, as the Supreme Court stated "the option when given did not operate to

transfer any of the shares of stock of the employer to the employee" and "as the option was not found to have any market value when given, it could not itself operate to compensate respondent."

Last, Appellant's reliance on *Michaelsen v. New York State Tax Commn.*, 67 N.Y.2d. 579, 583-84 (1986) embodies the flaws throughout Appellant's arguments. First, for taxation purposes, there is no need to assume exercise, as the analysis is retroactive – the opposite of a usury analysis. Second, *Michaelson* shows why the different presumptions carry with stock options and with convertible notes. An option is not taxed until exercised, and a value is attributed to the issuance of the option solely to provide a benchmark for a taxable gain. The Note, on the other hand, could see two types of taxable gain – the interest earned on principal or the capital gains earned on the ultimate sale of stock if, and only if, the conversion right is exercised.

c. <u>Conclusory, Unsupported, and Illogical Statements</u>

Interspersed with Appellant's off-point case law are multiple statements that each should raise red flags for the Court.

First, Appellant makes two conflicting points that cannot stand together and undermine much of the case law even further. In an effort to align its argument with the long-standing principal that interest for the purposes of a usury determination, must be calculated at the time of contracting, Appellant states that the "proper

measure of property conveyed is the 'book value of the assets as of the date of the transfer, not an amount based on the value the transferee actually received for disposal of the assets in question at some later date . . .'" App. Brief at 27. Next, it states that "[w]hen the property to be valued 'consists of securities traded on a stock market, the general rule is that the average exchange price quoted on the valuation date furnishes the most accurate, as well as the most readily ascertainable, measure of fair market value." *Id.* However, the latter proposition stems from two cases in which stock was actually transferred at the time of contracting. Here, at the time of contracting, the conversion right is simply a right that may or may not be exercised, so it is entirely inappropriate to value it in the same way the SEC values the delivery of stock.

Further, despite the *Reznik* holding clearly standing in contrast, Appellant concludes with the blanket statement that "tax laws, securities and generally accept accounting standards [sic] all require companies to report compensation with stock options and to provide estimates of the 'grant date present value of options so conferred" citing statutes relating to executive compensation, taxation, and money laundering. App. Brief at 28. Absent from Appellant's brief, however, is a single instance of analysis by a court, or a single reference in a statute to this type of instrument. Even the Securities and Exchange Commission, which, as Appellant points out, is aware of these instruments, has taken no action toward valuing these

instruments as Appellant suggests, likely because it is illogical to value something as though a contingency which may not happen has happened.

v. Appellant's Summary of the District Court's Decisions are Intentionally Incorrect, and its Analysis thereof is Irrelevant.

Next, Appellant turns to the analysis of two of the dozens of Federal Cases which rejected Appellant's arguments, mischaracterizes their holdings, then argues that these mischaracterized holdings were incorrect. Beginning with *Phlo Corp. v. Stevens*, 2001 WL 1313387 (S.D.N.Y. Oct. 25, 2001), Appellant claims that Courts following *Phlo* misinterpret the holding to mean that "any options, apparently as a matter of law – are too speculative to be included in the calculation of interest for the purposes of a usury analysis" and directs the Court to *Alpha Capital Anstalt v. BioMetrix, Inc.*,[2] 2010 N.Y. Slip Op. 30045(U). It cannot be understated that *BioMetrix, Inc.* involved a motion for summary judgment in lieu of complaint, and was ultimately discontinued, presumably due to settlement. Thus, the decision in the case only states that various questions of fact remained, precluding summary judgment in lieu of complaint. It is of no value to this Court.

The remainder of Appellant's arguments relating to *Phlo* are equally unavailing. The *Phlo* court analyzed whether certain warrants should be considered interest for the purposes of a usury determination. The Court found that they should

[2] It should be noted that Appellant miscited this case throughout its Brief. It should also be noted that Mr. Mark Basile, counsel for Appellant, was a named defendant in the matter.

not, as the "loan to [Plaintiff] was not structured in a way that [Defendant] would necessarily receive more than the legal rate of interest." *Id.*, at 5. Appellant attempts to contort this holding by stating that the Court reached its determination because the warrants at issue "were substantially 'out of the money' when issued to the lender . . . , and the stock performance thereafter was mediocre, at best." App. Brief at 32. This is untrue. The *Phlo* court stated that "[a]n agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not ipso facto usurious, because of the possibility that more than legal interest must be paid" and "[t]here is a strong presumption against the finding of usurious intent and a loan is not usurious merely because there is a mere possibility that the lender will receive more than the legal rate of interest." *Phlo*., at 4. Applying those principles, the Court found that "it was not clear that any effective interest rate in excess of 25% would ever have to be paid, as the value of the warrants was uncertain." *Id.*

The Court then referred to fluctuating stock prices, the market impact of liquidating such volumes of shares, and the potential inability to liquidate the shares. In other words, the Court determined that despite providing the warrants at the time of contracting, the uncertainty surrounding the value of those warrants place them outside the scope of a usury determination. *Id.*, at 14.

Appellant then continues its battering home of the false premise that the value of the conversion right herein is guaranteed, despite the presence of the same uncertainty of exercise, liquidity, and marketability that lead the *Phlo* court to determine that the warrants were not subject to a usury defense.

Appellant argues that these factors are not applicable here because the discount to the market price "guarantees" that Respondent would be "in the money." This wholly disregards the court's analysis regarding marketability and liquidation of the stock. The *Phlo* court acknowledged that if "the stock is not being actively traded," the plaintiff might not be able to liquidate the stock and the price would "undoubtedly drop." 2001 WL 1313387 *5 (S.D.N.Y. Oct. 25, 2001). The Court concluded "it is far from clear, in light of the numbers and the circumstances, that the effective interest would exceed 25% in any event." *Id.*

It is even less clear herein – not only could the price or demand drop to a point of illiquidity, but a number of circumstances could prevent conversion. Respondent could opt not to convert. Appellant could be delisted from the exchange, as it ultimately was. Appellant could intentionally go delinquent in its public filings. Appellant could fire its transfer agent in order to prevent conversion, as it did herein. See e.g., *Adar Bays, LLC v. GeneSYS ID, Inc.*, 341 F. Supp. 3d 339, 346 (S.D.N.Y.) ("[Defendant's] 10-Q for the period ending September 30, 2016 stated that the company 'terminated its transfer agent on September 6, 2016, preventing further

toxic conversions and bringing all parties to the table to discuss a satisfactory settlement"). Appellant could run out of shares. See, e.g, *LG Capital Funding, LLC v. PositiveID Corp.*, 2019 WL 3437973 *5 (E.D.N.Y. July 29, 2019) ("[Defendant's transfer agent] was unable to process [plaintiff's conversion] request because [defendant] 'did not have any shares available in treasury'").

Ultimately, if a noteholder opts not to convert, or if the market price for issuer's stock is $0.00, or there is no stock available, or there is no demand for its stock, the discount amounts to $0.00 charged, earned, discounted, gained, or taxed, regardless of Appellant's valuation theories.

Appellant's next argument attacks the Hon. Richard J. Sullivan's findings in *Union Capital, LLC v. Vape Holdings Inc.*, 2017 WL 1406278 (S.D.N.Y. Mar. 31, 2017) on two grounds. First, Appellant repeats, again, that the value of the conversion right is known at the time of contracting and the value is the difference between conversion price and the market price of the stock. This is incorrect for the reasons stated repeatedly herein: the conversion right itself is not guaranteed to be exercised, exercisable, or profitable, and presuming the market price of the stock is the value of the stock to Appellant is inappropriate.

Second, Appellant claims that Judge Sullivan should have treated the valuation of the conversion right exactly the same way as His Honor calculated damages. App. Brief at 36. This represents such a fundamental misunderstanding of

damages and interest that it warrants little analysis. Put simply, for Respondent's damages, the market price for the stock is appropriate because had Respondent received the stock, it could have sold it on the open market to third parties at that price. In contrast, Appellant could not have sold it on the open market, so it is inappropriate to assume the same market price for Appellant. Damages are not interchangeable with interest, despite Appellant's best efforts to use statutes, definitions, and legal theories interchangeably.

vi. A Stockholder is, by Definition, an Investor and Therefore the Nature of the Transaction Changes from a Loan to an Investment Upon Conversion.

The dozens of courts that have rejected Appellant's arguments have relied, in part, on the fact that upon conversion – the only point at which the speculation around the conversion right is eliminated – the nature of the transaction changes from a loan to an equity investment, and is thus no longer subject to a usury defense. This consistent holding comes from *Seidel v. 18 E. 17th St. Owners, Inc.,* 79 N.Y.2d 735, 744 (N.Y. 1992), in which this Court analyzed a transaction for usury and found that the surrounding circumstances could in fact transform a loan to an equity investment.

In *Seidel*, a partnership borrowed from plaintiffs' decedent to help finance the purchase of a building. *Seidel*, 79 N.Y.2d at 738. In exchange for the loan, the partnership executed "a $225,000.00 bond bearing 8% interest, secured by a second

mortgage on the building." *Id.* Pursuant to the parties' agreement, $150,000.00 was to be prepaid to plaintiffs' decedent and plaintiffs' decedent was given an option to exchange the remaining $75,000.00 due on the bond for a floor of the building. *Id.* Defendants made the principal payment of $75,000.00 plus interest due. *Id.* Plaintiffs' decedent exercised her option for the floor of the building. Plaintiffs' decedent then commenced an action to foreclose on the mortgage for the $75,000.00 due on the bond plus accrued interest. *Id.* Defendants moved to dismiss asserting that the transaction was usurious. *Id.* The Supreme Court of New York determined that the initial outlay was $150,000.00 and the realization from the transaction was $312,000.00, making the actual interest rate of the loan to be 28.6%. *Id.* The Appellate Division affirmed, opining, inter alia, that the transaction could be viewed as a joint venture, thus unregulated by usury laws. *Id.*

The Court of Appeals disagreed. First, the Court of Appeals laid out the principles which are applicable here, then applied them to the specific facts of *Seidel* to determine that the agreement was not transformed from a loan to equity upon the exercise of the right to the floor of the building.

Relevant to the present matter, the Court of Appeals stated that "[u]sury laws apply only to loans or forbearances, not investments. If the transaction is not a loan, 'there can be no usury, however unconscionable the contract may be.'" *Seidel*, 79 N.Y.2d at 744 citing *Orvis v Curtiss*, 157 NY 657, 661 (1899). In applying this

standard to the facts of *Seidel*, the Court disagreed that plaintiffs' decedent could be a joint venturer of Defendants' cooperative, because the parties' agreements refer to plaintiffs' decedent as "Lender" and a "loan" of $150,000.00. *Id.* The Court of Appeals referred to the bond and mortgage as traditional loan documents. Moreover, the option without more "did not transform the lender into a joint venturer." *Id.*

Nonetheless, two relevant principles clearly emerged from *Seidel*: (i) if the transaction is not a loan, there can be no usury, and (ii) the nature of a transaction can transform a lender into an investor. It is in this context that courts have frequently cited *Seidel*, not because the transaction in *Seidel* was transformed from a loan to an investment, but because *Seidel* held that the "form and substance" of the arrangement could transform a loan to an investment.

For this reason, the New York Supreme Court, the Southern District Court of New York, and the Eastern District Court of New York have all cited *Seidel* while finding that the form and substance of these transactions change them from a loan to an investment arrangement upon conversion.

The New York Supreme Court first faced a near-identical usury defense as the defense here in *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 WL 7429581 (N.Y. Sup. Ct. Nov. 23, 2015). Applying the *Seidel* principle, the Supreme Court of Kings County stated that "[a]lthough the initial transactions were loans, which were clearly not usurious, . . .[t]he conversion to stock would convert

plaintiff from a lender to an investor with the right to share in the profits and losses of [defendant].” Tellingly, as *Seidel* looked to the substance and language of the transaction to find that both indicated that a joint-venture was not formed, the *Sanomedics* court looked to the substance and language of the transaction to find that both indicated that an investment relationship was formed and defendant’s usury defense was rejected. *Beaufort, Union et al.* followed the same logic.

The remainder of Appellant’s arguments on this point consist of irrelevant cases, and misplaced analogies; and must be given no weight in the Court’s analysis. The Uniform Commercial Code, Bankruptcy proceedings involving executive compensation, findings in relation to 19th century railroad bonds, grounds for denying motions for summary judgment in lieu of complaint, or matters from the Queens County Surrogates Court do not change the facts of this matter or the glut of persuasive analysis provided by dozens of judges in this state.

Accordingly, it is respectfully requested that this Court answer the first question presented in the negative and put an end to Appellant and its counsel’s assault on the Respondent and similarly situated investor’s industry.

IV. SECOND QUESTION

If the interest charged on a loan is determined to be criminally usurious under N.Y. Penal Law §1 90.40, whether the contract is void ab initio pursuant to N.Y. Gen. Oblig. Law § 5-511.

1. Short Answer

Because the legislature clearly contemplated different treatment of individuals and corporations within § 5-501 et seq., and specifically excluded corporations from relying on the same as an affirmative defense, it must be presumed that corporations are equally excluded from the remedy provided within the same statutory framework from which it is excluded.

2. Argument

i. Principals of Statutory Interpretation Dictate that the Legislature Intentionally Excluded Corporations from the Remedy Provided in § 5-511.

Using principles of statutory interpretation, it is clear that the legislature intended for corporations to be precluded from the entire civil usury defense outlined in N.Y. Gen. Oblig. Law § 5-501 et seq. and thus, respectfully, it is not within the Court's power to write into a statute what was intentionally excluded.

There are two types of usury defenses. Civil usury is governed by § 5-501 et. seq. of the N.Y. Gen. Oblig. Law § 5-501 and provides that "no person . . . shall . . . charge, take or receive any money . . . as interest on the loan of any money . . . at a rate exceeding [16% per annum]." § 5-511 of the N.Y. Gen. Oblig. Law provides

that contracts "prescribed in § 5-501, shall be void," and § 5-521(a) provides that "[n]o corporation shall hereafter interpose the defense of usury in any action." § 5-521(c) of the N.Y. Gen. Oblig. Law provides that a corporation may "interpose[] a defense of criminal usury as described in section 190.40 of the penal law."

§ 190.40 of the New York Penal Law is the criminal usury statute, which sets the impermissible rate at 25% and makes no mention of voiding the agreement. There has been confusion in some New York courts due to the interplay between the civil and criminal usury statutes. However, both state and federal courts have acknowledged that "there is no specific statutory authority for voiding a loan that violates the criminal usury statute." *Adar Bays, LLC v. GeneSYS ID, Inc.*, 341 F. Supp. 3d 339 (S.D.N.Y. 2018); *Funding Grp., Inc. v. Water Chef, Inc.*, 19 Misc. 3d 483 (Sup. Ct., N.Y. County 2008).

Although seemingly clear, applying principals of statutory interpretation lead to the same conclusion – that there is no statutory authority for voiding a loan that violates the criminal usury statute.

First, Gen. Oblig. Law § 5-511 states that loans found to violate "section 5-501, shall be void." This specific reference to § 5-501 cannot be ignored. § 5-501 prescribes loans in excess of 16% and §5-521 prohibits corporations from asserting the defense pursuant to § 5-501. The principle of *espressio unius est exsclusio alterius* dictates that the specific inclusion of one implies the specific exclusion of

another. Thus, by including §5-501 but not §190.40, it must be assumed that the legislature did not intend for § 5-511 to apply to § 190.40. The legislature could have included a reference to § 190.40, or excluded the specific reference to § 5-501 and voided usurious loans generally. It did not, and the Court of Appeals is required to interpret the statute as such.

Second, the principle of *in pari materia* dictates that in the event of an ambiguity, the Court should look to the surrounding statutes, countering any suggestion that this omission was unintentional. § 5-521(1) prohibits corporations from asserting "the defense of usury in any action." § 5-521(3) states that this limitation does not apply to a "defense of criminal usury as described § 190.40 of the penal law." Thus, the legislature clearly contemplated the interplay between the defenses of civil and criminal usury, and intended for them to be different, not only in name and interest rate, but also in rights and remedies throughout the statutory framework.

Thus, while Appellant disagrees with the way the statutes were drafted, it is not this Court's role to legislate, and the Court is bound to interpret the statutes as written.

ii. Appellant's Case Law is Incorrect.

Appellant devotes several pages of its argument to disputing a decision from the Second Circuit Court– *In re Venture Fund* – that provided a detailed analysis and

found against Appellant's position. Respondent's position is that *In re Venture's* observations and findings, while accurate, are of no import in this Court, as they are not controlling. Thus, Respondent will only address those cases in Appellant's argument that Appellant calls "controlling state court decisions."

First, Appellant states that state courts "almost universally hold that § 5-511 operates to void criminally usurious loans made to corporations" and cites to four cases. Despite taking pages of issue with other courts relying on *In re Venture,* Appellant relies wholly on dicta from *Hammelburger v. Foursome Inn, Corp*, 54 N.Y.2d 580 (1981) to support its proposition that "it would be most inappropriate to permit a usurer to recover on a loan for which he could be prosecuted." *Hammelburger*, however, was analyzing the question of whether to "make an innocent assignee pay for the crime of the usurer." Id at 591. Of note, yet also dicta, is the Court's discussion as to why the legislature allowed for corporations to interpose the defense of criminal usury after 115 years of not allowing corporations to do so. Namely, it was not that publicly traded corporations with legal representation and sophisticated boards deserved protection; rather, it was because loan-sharks had begun requiring loanees to incorporate just to avoid the defense.

If the spirit of protection found in the dicta of *Hammelburger* is to be considered by this Court, it should favor the good faith investor, rather than the sophisticated entity using the usury defense as a means for a windfall.

Band Realty Co. v. North Brewster, Inc., 37 N.Y.2d 460 (1975) makes no reference to whether the loan would be void or not, and only speaks to the method of calculating interest. It would seem that Appellant included the case to make it appear as though there was more support for its proposition.

Blue Wolf Capital Fund II, L.P. v. American Stevedoring, Inc. and *Fareri v. Rain's Intern. Ltd.*, 187 A.D.2d 481, do void loans found to be criminally usurious but do so improperly, relying on § 5-511 and *Szerdahelyi v. Harris*, 67 N.Y.2d 42 (1986). *Szerdehelyi*, however, only involved civil usury. It was an action between two individuals and the interest rate found by the Court was 21%. Thus, the bases for voiding the loans were improper.

iii. Appellant's Argument Regarding § 190.40 not Providing a Right of Action is Circular and Contrary to the Plain Reading of the Statutes.

Appellant's next argument tracks as follows. Because § 5-521 directs corporations to Penal Law § 190.40, and because Penal Law § 190.40 does not provide a remedy, it must be the case that § 5-511 voids loans in violation of Penal Law § 190.40 because Penal Law § 190.40 does not provide a private cause of action.

This defies logic. First, it disregards the specific references to and exclusions of Penal Law § 190.40 and corporations in § 5-501 et seq., which must be considered in conjunction with the decision by the legislature to not reference § 190.40 and corporations in § 5-511.

Second, it forecloses the idea of differing tiers of protection, despite a clear legislative intent to create them. Section 5-501 et seq. is drafted such that the more sophisticated the party, the less protection is needed. For instance, an individual accepting a loan under $250,000.00 is provided the protection of a 16% interest rate and the remedy of voiding the loan. On the other hand, if the loan is greater than $250,000.00, the 16% civil usury cap does not apply, and the 25% criminal usury cap is in effect. Further, because a corporation is presumed to be more sophisticated than an individual, the entirety of § 5-501 et seq is unavailable, and the interest cap is 25%. Even more telling, for an individual accepting a loan in excess of 2.5 million dollars, even the 25% civil usury cap is unavailable.

Finally, with no justification, it proceeds through its analysis as if § 5-511 does not serve to void a loan, the corporate loanee would have no remedy whatsoever, despite a trend, at least among District Courts, of adjusting the interest rate to a permissible one to avoid disproportionately harsh consequences when not warranted. See e.g., *LG Capital Funding, LLC v. Vapor Grp, Inc.*, WL 3193209 (E.D.N.Y. June 28, 2018); *Carlone v. Lion & The Bull Films, Inc.*, 861 F. Supp. 2d 312, 323 (S.D.N.Y. 2012). See also, *Prof'l Merch. Advance Capital, LLC v. C Care Servs., LLC*, 2015 WL 4392081 (S.D.N.Y. July 15, 2015). A circumstance such as this, where the Note was issued under the supervision of the very same individual now arguing it to be usurious, does not warrant such a harsh result.

Accordingly, it is respectfully requested that this Court answer the second question presented in the negative and not write into the statutes what the Legislature clearly intended to exclude.

V. **CONCLUSION**

For the foregoing reasons, it is respectfully requested that the Court answer both questions presented in the negative.

Dated: New York, New York
October 7, 2020

Respectfully Submitted,

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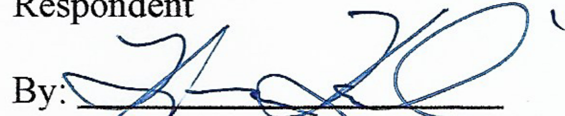

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Certification of Compliance

This Principal Brief by Adar Bays, LLC has been prepared in accordance with New York Court of Appeals Rules 500.1 and 500.13(a) using: Microsoft Word, Times New Roman, 14 Point Type, with a total word count of fewer than 14,000 words, exclusive of the Table of Contents and Table of Authorities.