To be Argued by:
MARJORIE M. SANTELLI
(Time Requested 20 Minutes)

CTQ 2020-00005

Court of Appeals
of the
State of New York

GENESYS-ID, INC.,

Defendant-Appellant,

– v. –

ADAR BAYS, LLC,

Respondent.

ON QUESTIONS CERTIFIED BY THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR DEFENDANT-APPELLANT

On the Brief

MARK R. BASILE, ESQ.
MARJORIE M. SANTELLI, ESQ.
THE BASILE LAW FIRM P.C.
400 Jericho Turnpike, Suite 104
Jericho, New York 11753
(516) 455-2134

As Co-Counsel

JONATHAN URETSKY, ESQ.
PHILLIPSON & URETSKY, LLP
111 Broadway, 8th Floor
New York, New York 10006
(212) 571-1255

Attorneys for Defendant-Appellant

Dated Completed: August 20, 2020

U.S. District Court, Southern District of New York Docket No. 1:17-cv-01175-ALC
U.S. Court of Appeals for the Second Circuit Docket No. 18-3023-cv

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Relevant Portions of the NY Statutory Scheme on Usury

NY Gen. Oblig. § 5-501. Rate of interest; usury forbidden

1. The rate of interest, as computed pursuant to this title, upon the loan or forbearance of any money, goods, or things inaction, except as provided in subdivisions five and six of this section or as otherwise provided by law, shall be six percentum per annum unless a different rate is prescribed in section fourteen-a of the banking law.

2. No person or corporation shall, directly or indirectly, charge, take or receive any money, goods or things in action as interest on the loan or forbearance of any money, goods or things in action at a rate exceeding the rate above prescribed. The amount charged, taken or received as interest shall include any and all amounts paid or payable, directly or indirectly, by any person, to or for the account of the lender in consideration for making the loan or forbearance as defined by the superintendent of financial services pursuant to subdivision three of section fourteen-a of the banking law except such fee as may be fixed by the commissioner of taxation and finance as the cost of servicing loans made by the property and liability insurance security fund.

*   *   *   *

4. Except as otherwise provided by law, interest shall not be charged, taken or received on any loan or forbearance at a rate exceeding such rate of interest as may be authorized by law at the time the loan or forbearance is made, whether or not the loan or forbearance is made pursuant to a prior contract or commitment providing for a greater rate of interest, provided, however, that no change in the rate of interest prescribed in section fourteen-a of the banking law shall affect (a) the validity of a loan or forbearance made before the date such rate becomes effective, or (b) the enforceability of such loan or forbearance in accordance with its terms, except that if any loan or forbearance provides for an increase in the rate of interest during the term of such loan or forbearance, the increased rate shall not exceed such rate of interest as may have been authorized by law at the time such loan or forbearance was made.

4-a. Notwithstanding the provisions of subdivision four of this section, a loan or forbearance repayable on demand may provide for changes, reflecting variations in lending rates, from time to time in the rate of interest payable on such loan or forbearance up to the rate of interest authorized by law at the time of such change and in such case the rate of interest maybe so changed in accordance with the terms

of the contract or loan commitment relating thereto; provided, however, that the rate of interest charged, taken or received on such a loan or forbearance shall not exceed the rate of interest authorized by law as it may subsequently be reduced from time to time; and further provided, however, that in no event shall such a loan or forbearance by subject to an authorized rate of interest less than that applicable at the time such loan or forbearance was made. The provisions of this subdivision shall apply only to a loan or forbearance repayable on demand which has an initial principal of more than five thousand dollars and which the borrower has the right to repay at any time in whole or in part, together with accrued interest on the principal so repaid, without any penalty. With respect to a loan or forbearance covered by this subdivision, the lender shall disclose to the borrower in writing not less often than annually the amount of interest accrued or payable as of the date of such disclosure and the manner by which such amount was computed.

* * * *

§ 5-501 (cont'd.)

6.

a. No law regulating the maximum rate of interest which may be charged, taken or received, except section 190.40 and section 190.42 of the penal law, shall apply to any loan or forbearance in the amount of two hundred fifty thousand dollars or more, other than a loan or a forbearance secured primarily by an interest in real property improved by a one or two family residence. A loan of two hundred fifty thousand dollars or more which is to be advanced in installments pursuant to a written agreement by a lender shall be deemed to be a single loan for the total amount which the lender has agreed to advance pursuant to such agreement on the terms and conditions provided therein.

b. No law regulating the maximum rate of interest which may be charged, taken or received, including section 190.40 and section 190.42 of the penal law, shall apply to any loan or forbearance in the amount of two million five hundred thousand dollars or more. Loans or forbearances aggregating two million five hundred thousand dollars or more which are to be made or advanced to any one borrower in one or more installments pursuant to a written agreement by one or more lenders shall be deemed to be a single loan or forbearance for the total amount which the lender or lenders have agreed to advance or make pursuant to such agreement on the terms and conditions provided therein.

7. Except as otherwise expressly provided by law, in the event of prepayment in full of a loan, any refund of unearned interest to which the borrower may be entitled may not be computed by a sum of the balances or similar method but must be determined according to a generally accepted actuarial method.

(Sections 5-501(3), (5) omitted).

NY Gen. Oblig. § 5-511. Usurious contracts void.
1. All bonds, bills, notes, assurances, conveyances, all other contracts or securities whatsoever, except bottomry and respondentia bonds and contracts, and all deposits of goods or other things whatsoever, whereupon or whereby there shall be reserved or taken, or secured or agreed to be reserved or taken, any greater sum, or greater value, for the loan or forbearance of any money, goods or other things in action, than is prescribed in section 5-501, shall be void, except that the knowingly taking, receiving, reserving or charging such a greater sum or greater value by a savings bank, a savings and loan association or a federal savings and loan association shall only be held and adjudged a forfeiture of the entire interest which the loan or obligation carries with it or which has been agreed to be paid thereon. If a greater sum or greater value has been paid, the person paying the same or his legal representative may recover from the savings bank, the savings and loan association or the federal savings and loan association twice the entire amount of the interest thus paid.

2. Except as provided in subdivision one, whenever it shall satisfactorily appear by the admissions of the defendant, or by proof, that any bond, bill, note, assurance, pledge, conveyance, contract, security or any evidence of debt, has been take nor received in violation of the foregoing provisions, the court shall declare the same to be void, and enjoin any prosecution thereon, and order the same to be surrendered and cancelled.

NY Gen. Oblig. § 5-521. Corporations prohibited from interposing defense of usury
1. No corporation shall hereafter interpose the defense of usury in any action. The term corporation, as used in this section, shall be construed to include all associations, and joint-stock companies having any of the powers and privileges of corporations not possessed by individuals or partnerships.

2. The provisions of subdivision one of this section shall not apply to a corporation, the principal asset of which shall be the ownership of a one or two family dwelling,

where it appears either that the said corporation was organized and created, or that the controlling interest therein was acquired, within a period of six months prior to the execution, by said corporation of a bond or note evidencing indebtedness, and a mortgage creating a lien for said indebtedness on the said one or two family dwelling; provided, that as to any such bond, note or mortgage executed by such a corporation and effective prior to April sixth, nineteen hundred fifty-six, the defense of usury may be interposed only in an action or proceeding instituted for the collection, enforcement or foreclosure of such note, bond or mortgage. Any provision of any contract, or any separate written instrument executed prior to, simultaneously with or within sixty days after the delivery of any moneys to any borrower in connection with such indebtedness, whereby the defense of usury is waived or any such corporation is estopped from asserting it, is hereby declared to be contrary to public policy and absolutely void.

3.The provisions of subdivision one of this section shall not apply to any action in which a corporation interposes a defense of criminal usury as described in section 190.40 of the penal law.

NY Penal § 190.40. Criminal usury in the second degree

A person is guilty of criminal usury in the second degree when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding twenty-five per centum per annum or the equivalent rate for a longer or shorter period.

Criminal usury in the second degree is a class E felony.

I. CERTIFIED 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. GLOSSARY OF RELEVANT TERMS

Stock Option or "Option" - is the right to buy or sell a particular stock at a certain price for a limited period of time. *McMillan, Lawrence G*., OPTIONS AS A STRATEGIC INVESTMENT (NYIF Corp., 1986) at 4.

Liquidity – ability to buy or sell an asset quickly and in large volume without substantially affecting the asset's price. DICTIONARY OF FINANCE AND INVESTMENT TERMS, 4th Ed. at 416. (Barron's Educational Series 2018).

Realized Profit (or Loss)- profit or loss resulting from the sale or other disposal of a security. *Id*. at 608.

Strike (Exercise) Price- the price that must be paid for a common stock when the option is exercised. *Id*. at 790.

Warrant- an option issued by a company or a financial institution. Hull, John C., *Options, Futures, and Other Derivatives*, 714 (5th Ed. 2002) (PDF of entire textbook available online at https://fac.ksu.edu.sa/sites/default/files/options_futures_and_other_derivatives_5th_ed.pdf

III. STATEMENT OF THE CASE

Prohibitions upon usury have been part of New York State law for more than 170 years. As one court observed, the statute is fairly simple, and very few attempt a direct violation of it; "and yet there is hardly a term of the court, in which questions involving an indirect violation of the usury laws-- rendered intricate and difficult by the ever-waking ingenuity of human avarice--are not presented for consideration." *Schermerhorn v. Am. Life Ins. & Trust Co*., 14 Barb. 131, 142 (1850), 1852 N.Y. App. Div. LEXIS 147 at *23.

In recent years, usury cases are somewhat rare, and the courts have become less adept at identifying "indirect" violations of the statute. Yet the ever-waking ingenuity of human avarice presses on, and in this matter, has brought forth the "intricate and difficult" version of the loan instrument known as a "convertible promissory note."

A "convertible promissory note" is constituted by a Promissory Note and a Share Purchase Agreement: simply put, they are loans that allow the lender to take repayment in securities instead of cash, or more precisely, to exchange the debt for company stock. This repayment, or "conversion" feature is the defining characteristic of the convertible note. By the textbook definition, convertible notes

"are similar to bonds with warrants in that the investor is purchasing the equivalent of a bond with an option."[1]

What makes the convertible notes in these cases unique is that, instead of having the option to "convert" the debt into stock at a *fixed price*, the conversion option specifies that when the debt is exchanged for stock, the debt 'purchases' the stock at a *fixed 35% discount* to the market price. Unlike typical fixed-price options, whose value increases or decreases along with stock price, the fixed discount *guarantees the same value regardless of the stock price*. A 35% discount guarantees a 54% rate of return (the same as a 50% discount guarantees a 100% rate of return).

The U.S. Securities and Exchange Commission actually warns companies about the grave risks that accompany fixed-discount convertible notes, stating:

> A market-price based conversion formula [(like the fixed-discount rate)] protects the holders of the convertibles against price declines, while subjecting both the company and the holders of its common stock to certain risks. Because a market-price based conversion formula can lead to dramatic stock price reductions and corresponding negative effects on both the company and its shareholders [these convertibles] have colloquially been called "floorless," "toxic," "death spiral," and "ratchet" convertibles.

https://www.investor.gov/introduction-investing/investing-basics/glossary/convertible-securities

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[1] Brigham & Houston, *supra* at 892. See also Sharpe, William F., Alexander, Gordon J., Bailey, Jeffery V., *Investments*, 5th Ed. at 716-17 (1995) ("[a] convertible bond is, for practical purposes, a bond [(debt instrument)] with a nondetachable warrant plus the restriction that only the bond is usable [] to pay the exercise price.").

(last visited August 11, 2020) (hereinafter "SEC Warning").

The first question is whether the value of the conversion option should be included in the note's interest calculation for purposes of New York's usury laws. (Yes, it should be.) However, in spite of the unambiguous value conferred by the option (and standard methods for valuation), the federal courts applying New York usury law have ruled that its value is speculative and therefore cannot be included as interest. Yet, an analysis of those rulings reveals either that the courts have been fundamentally misled as to the nature of the conversion option itself, or have deviated from settled methods of valuation generally, and departed radically from standard methods of options valuation.

In the second certified question, the Court is called to interpret the statutory scheme on usury—to determine the *civil* remedy for loans charging in excess of the *criminally usurious* interest rate. It is undisputed that N.Y. Gen. Oblig. Law § 5-511 provides that *civilly* usurious loans (charging in excess of 16% interest) shall be void. But for loans that violate the criminal usury statute (charging in excess of 25% interest), some courts have posited that the statutes ***could be interpreted*** to say that voiding of the loan is not available. That is, the New York Legislature *might have meant* that bad lenders should be severely penalized, but *very* bad lenders should have no penalty at all.

It is the hope of the Appellant that this Court will finally undertake the plenary analysis necessary to correct these complex but obvious errors.

IV. BACKGROUND

GeneSYS, ID, Inc. ("GeneSYS") (formerly known as "RX Safes, Inc."), is a microcap medical-supply company with shares traded publicly in the over the counter market. Adar Bays, LLC ("AB") is a lender that specializes financing for cash-flow-restricted microcap companies trading on the over-the-counter markets.

On May 24, 2016, AB made a loan of $33,000 to GeneSYS in exchange for a $35,000 Convertible Promissory Note ("Note") with a stated interest rate of 8% a.p.r. and a one-year maturity date. ($2,000 was subtracted for AB's costs). Note at 1(A 33-34). The Note also contained a conversion option, which gave AB the right to "convert" or exchange the debt for shares of GeneSYS common stock at a 35% discount to the market price at the time of exercise. The conversion option vested (became exercisable) 180 days after issuance, in this case, on November 20, 2016.

On November 28, 2016, AB sought to convert $5,000.00 of the debt into 439,560 shares of common stock, and submitted to GeneSYS a Notice of Conversion for that amount. GeneSYS defaulted on the Note by terminating its transfer agent and refusing to honor the Notice of Conversion. GeneSYS sought to renegotiate the Note but AB had no interest in doing so.

A. **Proceedings at the Southern District of New York**

AB ultimately filed suit in the Southern District of New York in February of 2017, alleging, inter alia, breach of contract, default, and anticipatory breach, and seeking damages in the amount of $150,000.00 plus attorney fees. Amd. Compl. at 11 (A-8).

GeneSYS moved for dismissal of AB's complaint on the ground that, with the 35% conversion discount and other charges included in the calculation, the actual interest rate AB was charging on the Note was in excess of the 25% interest-rate cap set forth in New York's criminal usury law §190.40, which rendered the loan agreement void and unenforceable.

The district court rejected GeneSYS' usury defense, holding that the value gained by exercise of the conversion option was too uncertain to be included as part of the interest rate. Order, 341 F.Supp.3d at 356. The court then granted summary judgment in favor of AB, awarding $92,304.76 in expectation damages, based on the value of the stock AB would have received if it had converted the entire debt on November 28, 2016.

V. 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.

SHORT ANSWER: Yes, the value of the option must be treated as interest.

VI. SUMMARY OF THE ARGUMENT

The district court cases analyzing convertible notes for usury follow a familiar pattern. A Lender exercises a conversion option, the borrower refuses to honor the exercise and fails to deliver the stock. The Lender brings suit for breach of contract and default on the Note. The Borrower then asserts a usury defense based on the value that the Lender is guaranteed upon exercise of the option (which typically give the lender a discount between 35 and 45% on the trading price). In response, the court, relying on *Union Capital, Adar Bays*, and the like,[2] rejects the usury claim on the ground that the value of the 35% discount is "too uncertain" to include as part of the interest calculation. According to the district courts, this is so, because, *inter alia*, the stock the Lender receives at conversion may become illiquid, experience sudden price decreases, etc., and the Lender's profits therefore cannot be known until after the converted stock is sold.

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[2] *Union Capital*, *LLC v Vape Holdings Inc*., 2017 WL 1406278 (SDNY Mar. 31, 2017); *Adar Bays, LLC v. Aim Exploration, Inc*., 285 F. Supp. 3d 698 (SDNY 2018).

Then, in complete contradiction, the same court, typically in the same Opinion, awards expectation damages to the Lender, based on the fair market value of the stock on the date of the breach, which the court is able to calculate down to the last cent. Although expectation damages compensate for the value of the stock the Lender would have received from exercise of the conversion option, the court is no longer concerned with the liquidity, sudden price decreases, or any other of the issues that prevented it from assigning value to the stock when making their usury analysis.

In this case, the court's rejection of the conversion discount as interest is set forth on pages 20-22 of the Slip Opinion (Second Circuit record) (published Opinion at 341 F. Supp. 3d. 339, 354-56). The errors in the court's analysis are noted below and discussed more fully herein, in the sections noted.

Error 1: The court states,

> [a]s AB notes, however, cases relied on by GeneSYS address Notes that required loan repayment *and* deliveries of shared stock, as opposed to delivery of stock *in lieu of* loan repayment. Under such circumstances the stock value was plainly relevant to calculating the interest rate.[(**ERROR 1])**

Slip Op. at 20. The court does not explain why stock given *in addition to* repayment of the loan should be valued any differently than stock given *as* repayment of the loan; where a lender is taking nearly double the value of what it is owed, it should make no difference *when* the extra payment is taken. "If it appears that at the end

of all the payments, the lender will have received more than his principal with lawful interest, the contract is usurious." *Schermerhorn v. Talman*, 14 N.Y. 93, 121 (1856).

Errors 2, 3, and **4**: The district court relied on the passage from *Union Capital* quoted below. As indicated, each of the three sentences in that passage contains a serious error. The passage states:

> [Lender] simply held an option to convert shares, and it could have elected to obtain repayment in cash, which would clearly not have been usurious. [**(ERROR 2)]**Moreover, even if Union chose to convert the loan principal into shares, any potential profit Union 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 . . . **[(ERROR 3)]**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. **[(ERROR 4)]**.

Slip Op. at 21 (entire quote is from *Union Capital,* 2017 WL 1406278 at *5).

Error 2: The notion that a loan is not usurious because the Lender only had an "option" to receive the excessive interest rate is contrary to well established caselaw, and contrary to well established methods of options valuation. This is discussed in **Section G.3**.

Error 3: Here, the *Union Capital* court is attempting to value the conversion discount based on lender's "*lost profits*"—that is, the profits a lender might reap if and when it sold the stock it received as repayment of the loan. This method of valuation is contrary to New York law. The stock itself was the payment (measured by fair market value at the time of transfer) and any *profits* or losses the lender might

realize from selling the stock at a higher or lower price than the market price on the date it received the shares is immaterial, and never part of valuation analysis. This is discussed in **Section G.**

Error 4: This last holding is attributed to *Beaufort Capital Partners LLC v. Oxysure Sys., Inc.,* 2017 WL 913791, (S.D.N.Y. Mar. 7, 2017). *Beaufort* appears to say that if a loan is repaid with stock, the entire loan is retroactively transformed into an equity investment, and that the usury laws would no longer apply. This statement has no basis in reason or in law, and is discussed in **Section H.**

Errors 5, 6 and 7: Finally, the district court's analysis itself contains further error, stating:

> The conversion right was simply too uncertain at the time of contracting. As courts have noted, a myriad of circumstances could decrease the price of the stock, **(ERROR 5)** including 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." **[(ERROR 6)]***Adar Bays*, 285 F. Supp. 3d at 702-03; *accord Phlo,* 2001 U.S. Dist. LEXIS 17490, 2001 WL 1313387, at *5 ("[I]t 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.").**[(ERROR 7)].**

Slip Op. at 22.

Error 5: If the court understood how the fixed discount worked, it would not be concerned with the stock price. As explained above, the trading price of the stock has no effect on the value gained when the option is exercised. Regardless of

the stock price on the date of exercise, the Lender is guaranteed by the contract to receive, by value**, 54% more stock than it pays for**.[3]

Error 6: This statement is problematic because each of the alleged impairments of the conversion option is an incident that puts the borrower *in default*. The risk that the borrower may default on a loan does not impact the calculation of the interest rate the Lender is charging. The claim that an *interest rate* is "uncertain" because the borrower might default on the loan is contrary to law. *Schermerhorn v. Talman,* 14 N.Y. at 118 (holding that a lender cannot defend charging a usurious interest rate "by showing that the responsibility of the borrower is doubtful").

Error 7: The citation to *Phlo Corp*. as analogous to this case is fundamentally erroneous, because *Phlo Corp*. dealt with typical fixed-price options, which are radically different from those at issue here. This error is discussed in **Section E.2.**

[3] Contrary to most of the pleadings submitted to the district court and court of appeals, a 35% discount does not yield a 35% gain, it yields a 54% gain (the same as a 54% a,p.r. if the gain occurs at the one-year mark.). This is calculated as $\frac{100}{65}$ =1.5385 or the principal plus 53.85% interest, rounded to 54%. **The discount rate and the interest rate are not the same**. For example: At a 50% discount, buyer gets two for the price of one: a 100% gain. Further, if a lender receives two dollars for every one dollar it loaned, borrower must give two dollars for every one dollar it borrowed; this is a 100% rate of interest (or gain for the lender).

VII. ARGUMENT

A. The Promissory Note

The agreement in this case is made up of a Promissory Note ("Note") and Securities Purchase Agreement ("SPA"). (Only the most relevant portions are excerpted here.) The Note provides the following:

1. Stated Rate and Maturity Date.

> FOR VALUE RECEIVED, [GeneSYS] (the "Company") promises to pay to the order of ADAR BAYS, LLC and its authorized successors and permitted assigns ("Holder"), the aggregate principal face amount of Thirty Five Thousand dollars exactly (U.S. $35,000.00) on May 24, 2017 ("Maturity Date") and to pay interest on the principal amount outstanding hereunder at the rate of 8% per annum commencing on May 24, 2016.

Note 1 at 1. (Appendix ("A")-33). As noted in the excerpt above, the amount due under the Note is $35,000.00, with a stated interest rate of 8% per annum, with repayment due on May 24, 2017.

2. Prepayment.

Paragraph 4(c) of the Note provides that the borrower may repay the loan early (up to 180 days after closing) but with substantial penalties. For prepayment between days 1 - 60, the borrower must pay 115% of principal plus accrued interest; for repayment between day 60 -121, borrower must pay 125% of the principal plus accrued interest; for prepayment between days 120 -180, borrower must repay 135% of principal plus accrued interest. Note at 4(c) (A-32)

When annualized, the interest rates for prepayment range from **5483%** (prepayment on day 1) to **78%** (prepayment on day 180).[4] "Prepayment" after day 180 *is not permitted*, which means that the lender has free reign to convert the debt into stock**.** *Id*. Notably, the conversion shares become freely trading six months (182.5 days) after the closing date. *See* Rule 144, 17 C.F.R. § 230.144(d)(3)(ii).

3. Conversion. (An Option to Use Debt to Purchase Stock at a 35% Discount)

As explained above, "conversion" simply refers to the process by which AB exercises the option to exchange GeneSYS' debt (principal + stated interest) for company stock. AB uses the debt (or any portion thereof) to pay the strike price of the option instead of paying in cash. Each conversion extinguishes the debt as to the amount converted (because that portion of the debt is repaid with stock) until the loan is fully repaid. Notes at 4(a). (A-35).

As set forth in paragraph 4 of the Note:

> **4. (a)** The Holder of this Note is entitled, at its option, at any time . . . after 180 days from the date of the note, to convert all or any amount of the principal face amount of this Note then outstanding into shares of the Company's common stock (the "<u>Common Stock</u>") at a price ("<u>Conversion Price</u>") for each share of Common Stock equal to 65% of the <u>lowest trading price</u> of the Common Stock as reported on the National Quotations Bureau OTCQB exchange . . . ("<u>Exchange</u>"), for the *twenty* prior trading days including the day on which the Notice of Conversion is received . . . .

Note at ¶ 4(a) (A-34).

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[4] 35% x 365/180 + 8% stated = 78%.

a. Rolling Conversions.

It must be understood that it is the business model of AB (and all fixed-discount convertible note lenders) to sell the conversion stock as fast as it possibly can. Hence, the right to "convert all or any amount" of the debt (principal + interest) at any given time is one of the most important provisions in the Note. The ability to convert the debt in tranches allows the lender to convert (and sell the stock acquired) as small or as large of a portion of the loan that the market can bear. This insulates the lender from illiquidity issues and price depressions that might result if it had to convert the entire debt all at once and sell a large quantity of stock into the market.

For example,[5] if AB converted $5,000 of debt when stock was trading at $1.00 per share, AB would receive 7,700 shares of stock (worth $7,700)—because it was getting the stock at the discounted price of $0.65 per share. If AB immediately sold all of the shares into the market and (hypothetically) drove down the price to $0.80 per share, it would be of little concern to AB, because the next tranche of stock it converted would have a strike price set at 65% of the lower $0.80 price (*i.e.,* 0.52 per share). Hence, for the next $5,000 of debt converted, AB would receive 9,625 shares (but *still worth* $7,700). This would proceed in the same manner for every subsequent tranche of debt AB converted. The share price and number of shares

[5] Again, for purposes of simplicity, numbers are rounded.

issued fluctuates, *but the value does not*. The lower the stock price goes, the more shares they receive for the same dollar amount converted in the next tranche, always at a 35% discount to the new market price, no matter how low the share price goes. *See* SEC Warning, *supra*.

b. 20-day low baseline.

Upon exercise of the option, the holder exchanges debt for stock at a price equal to 65% of the lowest trading price from the previous 20 trading days—not 65% of fair market value. The "20-day-low" is obviously more favorable for the lender than the standard "fair market value," which is defined as "the mean between the highest and lowest quoted selling prices on the valuation date." *See* 26 C.F.R. § 20.2031-2; *Boyce v. Soundview Tech. Grp., Inc.*, 464 F.3d 376, 385 (2d Cir. 2006).

Hence, if there is a substantial difference between "20-day-low" value and the actual trading price on the date of exercise, the holder will reap *additional* gains on top of those already accrued from the 35% discount. However, because those gains are dependent upon the stock price at the time of exercise, they are harder to predict; therefore, Appellant does not suggest that they be included in the interest calculation here.[6]

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[6] Because the debt is almost always converted in tranches, the 20–day low price can easily be manipulated. For a single tranche, the lender could take the majority of converted shares and dribble them into the market to avoid depressing the share price. However, with its final stock sale before the next conversion, the lender could dump enough shares into the market to drive the price down for that single day, thereby ensuring that the 20-day low is as far below the market price as possible.

c. Total Gains from Conversion.

The total amount that AB receives in repayment of the Note that can be ascertained from the face of the agreement includes: the value of the conversion option (which guarantees a 54% percent gain),[7] as well as the stated 8% interest. When annualized, these payments constitute interest rates ranging between **62%** (54% plus 8% equals 62%) for conversions on day 365) and **125%** (for conversions on day 181).[8]

4. Default.

The events of default and consequences thereof are set forth in paragraph 8 of the Notes, which outlines fourteen separate events of default (not including the "breaches of covenant" set forth in the SPA). Note at 8(a)-(n); SPA at 4(a)-(f) (A-26). The occurrence of a default event increases the stated interest to 24% and incurs various penalties, but does not prevent AB from continuing to convert the total debt (including default payments) into stock at the fixed 35% discount.

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[7] This is calculated as $\frac{100}{65}$ =1.5385 or 1.54. As previously noted, t**he discount rate and the interest rate are not the same**, and may be explained thusly: At a 50% discount, buyer gets two for the price of one. But the buyer also receives two dollars for every one dollar it loaned must give two dollars for every one dollar it borrowed, which translates to a 100% interest rate.

[8] 62% x $\frac{365}{181}$ = 125% interest when annualized.

B. <u>The Conversion Option Guarantees that the Value of Stock Received at Exercise is Always 54% Greater than the Amount of Debt Converted</u>

Because the Note provides for conversion at a fixed 35% discount to the baseline "market price" of the stock (instead of a fixed share price), the minimum value the lender gains by taking repayment in stock (conversion) *never varies* and can be calculated easily from the face of the Note. As discussed above, the prices and number of shares fluctuate, but the added 54% gain in value does not.

As it happens, AB's November 28, 2016 Notice of Conversion demonstrates precisely how the 54% gain is added in pracice:

Notice of Conversion

Date of Conversion		**November 28, 2016**
Conversion Amount		**$5,000**
Applicable Conversion Price:	**$0.011375**	**= 439,560 shares.**
Lowest Trading Price 11/22/16=		**$0 .0175**

(Share price on Nov. 28, 2016 — $.03)

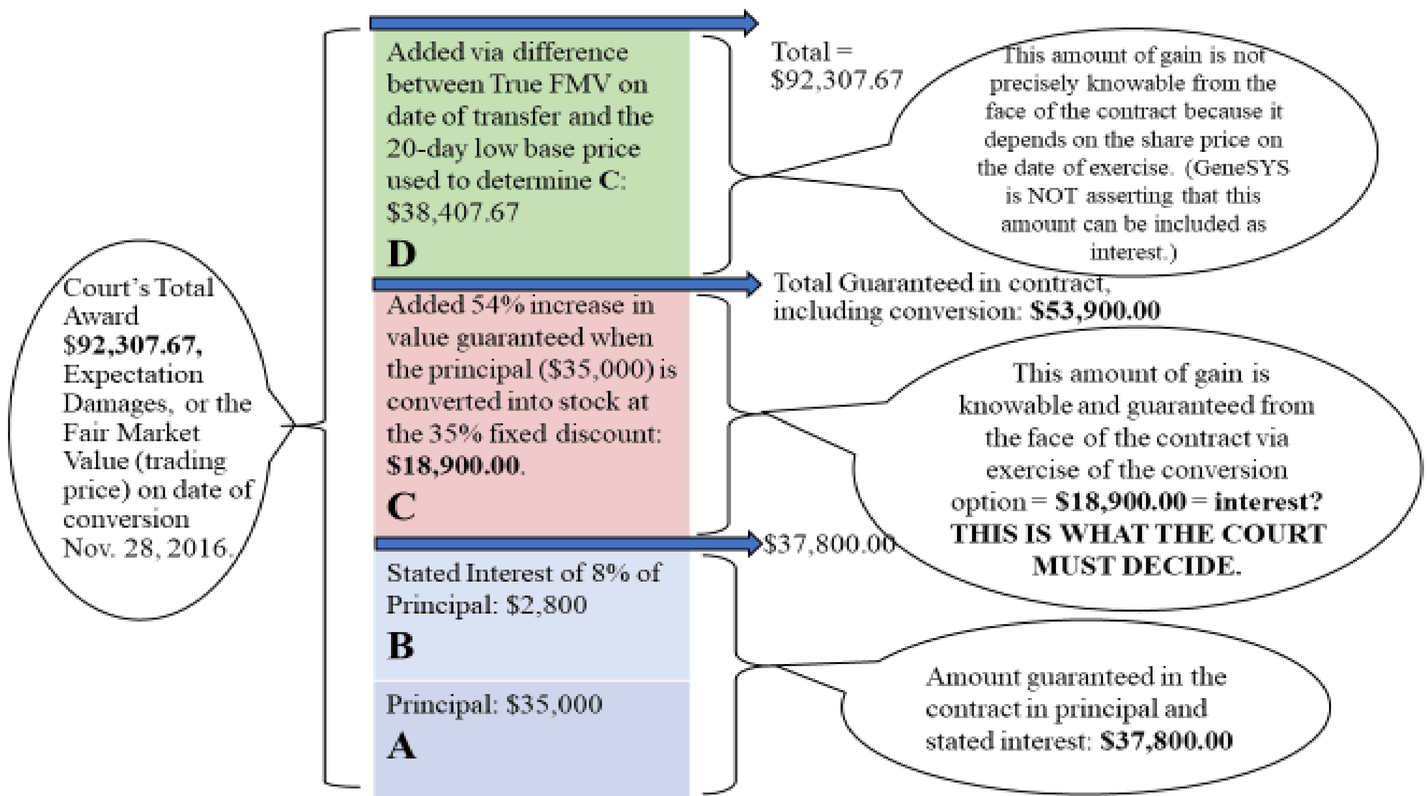
Notice of Conv., (A-42). As shown above, the "Applicable Conversion Price" is stated as .011375 per share, calculated by taking 65% of the 20-day low price (shown as .0175 on 11/22/16) which yields (.65 x $0.0175) = $0.011375 per share.

Applying that discounted strike price, the $5,000 worth of debt purchases 439,560 shares of stock—with a *minimum* (that is, using the 20-day low trading price) fair market value of $7,700. That is, every dollar of debt purchases $1.54 worth of stock ($5,000 x 1.54 = $7,700) for a **54%** gain at every conversion. Hence,

the 35% conversion discount guarantees AB an ***extra*** **$2,700** worth of stock. Applied to the entire $35,000 debt, the approximate equation would be thus: $35,000 x 1.54 = $53,900.00 (Shown as **C** in Diagram 1 below.)

Of course, the market price on the date of conversion, at .03 per share, was well above the .0175 baseline value used to calculate AB's discounted strike price. Hence, based on the average trading price on November 28, 2016, the 439,560 shares had an actual fair market value of $13,186.80, putting AB's gains at **163.736%.** If the entire debt were converted at that price (which is how the district court calculated damages) AB would receive 3,076,922 shares multiplied by the .03 per share market price, for a total of $92,307.67 (shown as **C** in Diagram 1, below). ($35,000 x 163.736% =92,307.60).

The district court calculated AB's expectation damages by applying the values in the Notice of Conversion to the entire $35,000 Note. Hence, the district court determined that for the entire loan amount of $35,000, the total value of the shares AB would have received if GeneSYS had delivered the shares was **$92,307.67**.



1. Diagram 1: DAMAGES CALCULATION (Based on 11/28/2016 Conversion Notice)

Per the express terms of the Note, exercise of the option to take repayment in stock guarantees to the lender repayment of the principal **(A)** and stated 8% interest (**B**)[9] plus a 54% gain from the fixed discount rate (**C**), which together (at 62% a.p.r.) far exceed the criminally usurious interest rate of 25%. Although the additional gains from the "spread" between the 20-day low price (.0175) and the actual trading

[9] For unexplained reasons, the 8% a.p.r. interest charge (which would have amounted to approximately $1,400 on Nov. 28, 2016) was not included in the plaintiff's complaint or the district court's award. Nonetheless, that amount was agreed to in the Note and must obviously be included here.

price on date of conversion ($.03) may be enormous, ***that number*** (**D** in the diagram above) depends on the trading price at the time of exercise and cannot be ascertained from the face of the Note. Because that precise gain cannot be predicted from the face of the Note, GeneSYS is **NOT** arguing for this number to be included in the interest calculation in this case.

Accordingly, the total minimum interest rate is easily calculated from the face of the loan agreement, which is the stated 8% interest in **(B)** plus the added 54% ($18,846) shown in **(C)**.

LEGAL ANALYSIS

C. <u>The Usury Statutes Contemplate that Property May be Taken as Interest on a Loan</u>

The Criminal Usury Statute provides:

> **§ 190.40. Criminal usury in the second degree**
>
> A person is guilty of criminal usury in the second degree when, not being authorized or permitted by law to do so, he knowingly charges, takes or receives any money or other property as interest on the loan or forbearance of any money or other property, at a rate exceeding twenty-five per centum per annum or the equivalent rate for a longer or shorter period.

New York Penal Law § 190.40. Further, as defined in the civil usury statute, **interest** "shall include any and all amounts paid or payable, directly or indirectly, by any person, to or for the account of the lender in consideration for making the loan or forbearance." NY G.O.L. § 5-501(2).

It cannot be overemphasized that section 190.40 expressly provides that interest may be taken not just in the form of money, but also in the form of ***property***. The plain language of the statute conveys that property transferred in payment of usurious interest constitutes usury, just the same as payment in money, if the lender thereby obtains more than twenty-five percent interest per annum as consideration for the loan.

It therefore follows that, when property is conveyed under a loan, "directly or indirectly, by any person, to or for the account of the lender in consideration for making the loan," the value of that property must be included in the interest rate. This notion is not only a logical reading of the statute, it is supported by long-settled New York caselaw, which holds that when a lender is given something of value beyond the legal rate of interest —including a contingent right to profits or property— the loan would be considered usurious. *See Diehl v. Becker*, 227 N.Y. 318, 326 (1919) (holding that a contingent right to profits was valuable, was compensation for the loan, and raised the interest rate to a usurious level); *Cleveland v. Lode*r, 7 Paige Ch. 557, 559 (N.Y. 1839) (holding that "[w]henever the lender stipulates even for the chance of an advantage beyond the legal interest, the contract is usurious, if he is entitled by the contract to have the money lent with the interest thereon repaid to him at all events."); *Moore v. Plaza Commercial Corp*., 9 A.D.2d 223 (App. Div. 1st Dept. 1959) (finding usury when lender's contingent right to

profits accompanied charge of maximum interest rate); *Cusick v. Ifshin*, 70 Misc. 2d 564, 567, (Civ. Ct. 1972).

In some cases, a valuation of the property is necessary to determine the interest rate charged. *See, e.g., Quackenbos v. Sayer*, 62 N.Y. 344, 347 (1878); *Schermerhorn v. Am. Life Ins. & Trust Co*., 14 Barb. 131, 147 (holding that "[i]n these cases it is evident that the things substituted for, and loaned as money, must be truly estimated and valued at their money value.)." However, where the loan contract expressly designates the property to be taken by its monetary value, no such finding would be necessary. *See, e.g.*, *Funding Group v. Water Chef*, 852 N.Y.S. 2d 736 (Sp. Ct. N.Y. County, 2008); *Am. E. Grp., LLC v. Livewire Ergrogenics, Inc*., 2018 LEXIS 184683 (S.D.N.Y. Oct. 27, 2018) *modified* 2020 LEXIS 14235 (S.D.N.Y., Jan. 28, 2020).

1. New York Case Law Holds that the Value of Securities Received as Consideration for a Loan Must Be Included in the Interest Calculation

Under New York caselaw, the value of securities given as consideration for a loan are included in the interest rate. In *Funding Group,* 852 N.Y.S. 2d 736, the loan agreement charged a 10% monthly interest rate (120% a.p.r.) and required a large up-front incentive payment— all of which were to be paid in corporate stock. The court found the note's 120% a.p.r. to be usurious on its face and did not question that interest rate simply because the interest payments were in stock instead of cash. *Funding Group*, 852 N.Y.S.2d at 740-41.

Likewise in *Alpha Capital Anstalt v. bioMETRX, Inc.*, 2010 Misc. LEXIS 1265 (Sp. Ct. Suffolk County, 2010), the loan agreements required that, in addition to the stated interest rate, the company-borrower was to provide additional up-front consideration in the form of 200,000 warrant options that were deep "in the money" at the time of issuance (but carried a six-month restriction). The court denied the lender's summary judgment motion, holding that, with the value of the warrant options included in the calculation, the effective interest rate was quite possibly usurious. The court ordered factfinding on the value of the warrants and effective interest rate.

In *Cleveland v. Loder*, 7 Paige Ch. 557, the New York Court of Appeals addressed a situation similar to this case. *Cleveland* involved a six-month loan of $5,000. However, the lender was given an option to take either repayment in cash (at the maximum legal interest rate on the due date) or, at any point during the six-month period, to take 200 shares of company stock in lieu of repayment in cash—regardless of the stock price at the time of the exchange. The 200 shares of stock were worth $5,000 ($25/share) at the outset, but the price was expected to rise.

As the *Cleveland* court observed, because the lender was given (in addition to the maximum legal interest rate) a six-month option to use the debt to purchase the 200 shares of stock at $25 a share (a right with clear economic value) the loan was usurious *per se*. As the court explained, "[w]henever the lender stipulates even for

the chance of an advantage beyond the legal interest the contract is usurious, if he is entitled by the contract to have the money lent with the interest thereon repaid to him at all events." *Cleveland*, 7 Paige Ch. at 559 (citations omitted).

A similar option was discussed in *Leavitt v. DeLauny,* 4 NY 364 (1850), where the New York Court of Appeals reiterated that "a party may lawfully lend stock, *as stock*, to be replaced, or he may lend the produce of it, as money, or he may give *the borrower* the option to repay either in the one way or the other. But he cannot legally reserve to himself a right to determine in future, which it shall be" without potentially running afoul of the usury statute. D*eLauny*, 4 NY 364 at 370.

Federal *District Courts* have reached similar conclusions when lenders take securities as consideration for a loan. *See e.g., Sabella v. Scantek Med. Inc*., 2009 LEXIS 88170 (S.D.N.Y. Sept. 25, 2009) (holding that lender's entitlement to common stock for making a loan will render the loan usurious if the value of the shares "cause the return on the loan to exceed 25%."); *Hillair Capital Invs., L.P., v. Integrated Freight Corp*., 963 F. Supp. 2d 336 (S.D.N.Y. 2013)(value of restricted stock given as up front consideration for loan must be added to interest rate); *Livewire,* 2018 LEXIS 184683 (holding that where consideration for the loan included restricted stock designated by monetary value, its value was "unambiguous" and therefore the effective (usurious) interest rate could be determined from the face of the Note.).

D. **Valuation of Property is Settled Law: Fair Market Value at the Time of Transfer**

"Fair market value" is the standard for property valuation. Fair market value is defined as "the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *United States v. Cartwright*, 411 U.S. 546, 551 (1973).

This standard of valuation is uncontroversial and used in virtually every area of law. Income received "in a form other than cash" is taxed at its fair market value. *Collins v. Commissioner*, 3 F.3d 625, 633 (2d Cir. 1993). The IRS maintains that "[i]f a creditor receives property in exchange for discharging a debt then the debt is considered paid to the extent of the fair market value of the property acquired." *Commissioner v. Spreckels,* 120 F.2d 517 (9th Cir. 1941); *Kohn v. Commissioner,* 16 T.C.960 (1951), *affd*. 197 F.2d. 480 (2d Cir.1952). New York law applies the same concepts, dictating that a mortgage debt is satisfied to the extent of the fair market value of the property taken in foreclosure. *See, e.g.*, *Onondaga Sav. Bank v. Cale Devel. Co*., 63 A.D.2d 415 (App. Div. 4th Dept. 1978) (mortgage debt); NY CLS RPAPL § 371(2); *see also Halsey v. Winant*, 233 A.D. 103, 112-13, 251 N.Y.S. 81, 91-92 (App. Div. 1st Dept. 1931) (computing value of privately-held stock and holding that when "a creditor takes property in satisfaction of an

antecedent debt, the property must be no more than a 'fair equivalent'" of what is owed).

1. Valuation at Time of Transfer.

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 . . ." *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); *In re Coated Sales, Inc*., 144 B.R. 663, 668 (Bankr. S.D.N.Y., 1992) ("[A] company's assets must be valued at the time of the alleged transfer and not at what they turned out to be worth at some time after the bankruptcy intervened.").

E. Valuation of Securities is Settled Law—Fair Market Value at Date of Transfer.

When the property to be valued "consists of securities traded on a stock exchange, 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." *Cartwright*, 411 U.S. at 551; *Richardson v. Commissioner*, 151 F.2d 102, 103 (2d Cir. 1945).

1. Valuation of Options is Settled Law: Ascertainable Value on the Date of Transfer

The right to purchase stock at a discount has obvious value. The "opportunity to purchase securities at a discounted price" is deemed compensation under securities regulations, tax laws, and criminal laws, and nearly any other instance where property might be conveyed. *See, e.g.*, *United States v. Ostrander*, 999 F.2d 27, 30 (2d Cir. 1993) (stock option in the money is a "thing of value" under 18 U.S.C. § 1954); 17 C.F.R. § 229.402(c); 26 USC § 83; 26 C.F.R. 1.83-3. 18 U.S.C. 1956;18 U.S.C. § 1954.

In certain industries, stock options are used as compensation almost as frequently as cash, and a substantial number of cases address their valuation. *See, e.g., Resnik v. Schwartz*, 303 F3d 147, 154 (2d Cir. 2002). "A stock option . . . has a readily discernible value: namely, the difference between the option price and the market price when the [holder] exercises the option . . . . no one disputes that this is the value of the option when exercised." *Wis. Cent. Ltd. v. United States*, 138 S. Ct. 2067, 2079-80 (2018) (debating whether stock options should be considered a type of money under IRS definitions). Tax laws, securities laws and generally accepted accounting standards all require companies to report compensation with stock options, and to provide estimates of the "grant date present value" of options so conferred. 17 C.F.R. § 229.402(c); *see also* 26 U.S.C. §83; 26 C.F.R. § 1.83-3; 18 U.S.C. § 1956.

a. Options with Intrinsic Value.

The controlling factor in any option valuation is the amount by which the market price of the stock price exceeds the exercise price. This is referred to as the "intrinsic value" of an option. Charles J. Woelfel, *Encyclopedia of Banking & Finance* 874 (10th ed. 1994). Thus, if a stock is trading at $50 a share, and the exercise price of the option is $ 40 a share, the intrinsic value of the option is $10; the option is said to be "in the money" by $10. *Id*.

No complex valuation formula[10] is necessary to determine the value of options where the strike price is not a fixed dollar amount, but simply pegged at 35% below whatever the market price happens to be at the time of exercise. In such a case, the strike price floats but the intrinsic value of the option is fixed at a 54% gain. (As explained above, 54% is the measure of value gained from a 35% discount).

For the recipient of an option (who must pay taxes in the year received) the value of the option can be measured at several points in time. It can be measured (1) when the option is granted (or "vested");[11] (2) when (or if) the option itself is

[10] Such as the Black-Scholes model. *See* Hull, (p.2 *supra*) at 234.

[11] For taxation purposes, a stock option must be declared as income at the time it is granted if it is (1) transferable, (2) not subject to forfeiture, and (3) has an ascertainable market value. 26 USC §83(a). However, the controlling factor is whether the option has a determinable market value when received. *Commissioner v. Estate of Ogsbury*, 258 F.2d 294, 295-96 (2d Cir. 1958).

In this case, the option to convert was transferable (*see* Note ¶3) and had a readily ascertainable (intrinsic) market value on the date the Note was issued. The Lender's only risk of forfeiture was that the borrower might pre-pay the loan prior to day 180 when the option vested. However, in that case, the Lender would be simply trading one usurious interest rate for another;

sold to someone else; (3) when the option is exercised; and (4) when the stock obtained via exercise of the option is sold. *Comm'r v. LoBue*, 351 U.S. 243 (1956); *Comm'r v. Smith*, 324 U.S. 177 (1945); *Resnik*, 303 F3d at 154.

As Justice Harlan observed:

> When the respondent received an unconditional option to buy stock at less than the market price, he received an *asset of substantial and immediately realizable value, at least equal to the then-existing spread between the option price and the market price*. It was at that time that the corporation conferred a benefit upon him. At the exercise of the option, the corporation "gave" the respondent nothing; it simply satisfied a previously-created legal obligation. That transaction, by which the respondent merely converted his asset from an option into stock, should be of no consequence for tax purposes. The option should be taxable as income when given, and any subsequent gain through appreciation of the stock, whether realized by sale of the option, if transferable, or by sale of the stock acquired by its exercise, is attributable to the sale of a capital asset . . . .

Comm'r v. LoBue, 351 U.S. 243, 250-51 (Harlan, JJ. dissenting) (emphasis added).

The New York Court of Appeals has also weighed in on the different accretions of income that occur when stock options are conveyed:

> Although the gain on qualified stock options . . . is *realized* at the time the options are exercised, the gain is not *recognized* until the stocks are disposed of. Thus, although under Federal law both the gain on the appreciation of the stock after it is purchased and the compensation derived from the exercise of the option are actually *recognized* when

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as noted in part A above, the interest rate for prepayment of the Note ranged between **5,483%** (prepayment on day 1) to **78%** (prepayment on day 180).

> the stock is sold, there are two realization events reflecting the taxation of two distinct accretions to income.

Michaelsen v. New York State Tax Commn., 67 N.Y.2d. 579, 583-84 (1986). The *Michaelsen* court's observation—that the gains from exercise of the option and gains from disposing of the option stock after it is purchased constitute "two distinct accretions to income"—is key to understanding the errors in the district court's (and others) valuation of the conversion option.

2. The Options in *Phlo Corp. v. Stevens* Were Found to Have Little or No the Value, and Therefore Did Not Affect the Interest Rate Calculation

The case *Phlo Corp. v. Stevens,* 2001 U.S. Dist. LEXIS 17490 (S.D.N.Y. 2001) is routinely cited by the district courts as support for holding that the value of stock options—*any* options, apparently as a matter of law—are too speculative to be included in the calculation of interest for purposes of a usury analysis.

However, a closer reading of *Phlo Corp.* reveals that this is not the holding of that case. *Phlo Corp*. involved a situation nearly identical to that presented in *Alpha Capital Anstalt v. bioMETRX*, *supra*. Like *Alpha Capital*, the lender in *Phlo Corp*. was given warrant options as a type of "up-front" consideration for the loan (in *Phlo* the warrants were given as consideration for an extension on the loan payment.) As with *Alpha Capital*, the borrower in *Phlo* argued that the loan was usurious because if the value of the options were added to the stated interest, the total rate would be above the 25% rate set forth in the criminal usury statute. *Phlo*, at *11.

The *Phlo* court rejected the borrower's argument—not because the value of the warrants had no bearing on the interest calculation, but because the warrants in that case had a demonstrably low value. Unlike the warrants in *Alpha Capital* (and unlike the conversion options in this case) the *Phlo* warrants were substantially "out of the money" when issued to the lender (the exercise price was higher than the stock price), and the stock performance thereafter was mediocre at best. Accordingly, the *Phlo* court concluded that because the warrants *in that case* had no intrinsic value at all at issuance, and it could not be known whether the warrants would ever have value (whether the stock price would ever rise above the exercise price), "it was not clear that any effective interest rate in excess of 25% would ever have to be paid." *Phlo Corp.,* at *13.

Unlike *Phlo*, the options in this case carry an exercise price that is guaranteed to be 35% lower than the market price at the time of exercise; the options here are "in the money" from inception to death. Further, their precise value is not speculative: they are worth (a minimum) of 54% more than the amount converted.

F. <u>Contrary to Holding of the District Court, the Value Conveyed by the Conversion Option is Not Uncertain and Not Dependent Upon the Market Price</u>

In the decision on appeal, the district court held that the value imparted by the discount rate should not be included as interest because the "conversion right was

simply too uncertain at the time of contracting." (Slip op. at 22) 341 F. Supp.3d at 356 (citing *Phlo Corp. v. Stevens*).

This holding simply cannot be squared with the reality of what is conveyed by the fixed discount conversion options in this case. As described above, the conversion options have no set strike price; unlike the fixed-price warrants at issue in *Phlo* (which were "out of the money" at issuance and might never have value) the conversion options in this case are *always* in the money.

The conversion option in this case necessarily has the same value at grant as it does at the time of exercise because the terms of the contract dictate the precise minimum value that the holder will receive *upon exercise*. The number of shares acquired by the conversion fluctuates, but the dollar value of the stock the lender receives from the fixed discount does not fluctuate either higher or lower. (The 20-day low is a separate and additional benefit that confers even more value to the option, never less).

The value of the conversion option, and ultimately the total interest rate, is easily discerned by examining the 'four corners' of the loan agreements, with no need to resort to extrinsic evidence. *Freitas v Geddes Sav. & Loan Assn.*, 63 N.Y.2d 254, 265 (1984) (holding that usury is established on the face of the loan instrument when resort to extrinsic evidence is unnecessary to determine the rate of interest).

G. In Assessing the Value of the Conversion Option, *Union Capital* Rejects Fair Market Value in Favor of Predicting "Lost Profits," Which it Deems Unworkable.

In support of its holding, the district court relies primarily on the case *Union Capital v. Vape Holdings, Inc*., 2017 US Dist. LEXIS 60445 (S.D.N.Y. Mar. 31 2017), which is quoted at length in the opinion. *Union Capital,* which involved a conversion option nearly identical to the one in this case, appears to be the progenitor of a line of cases holding that conversion options cannot be valued for purposes of an interest rate calculation-- because the potential profits that the Lender might realize from selling the stock it received upon exercising the option cannot be known in advance. As explained below, valuing stock options on a "lost profits" theory is contrary to clearly established law.

In *Union Capital*, the borrower-defendant might be blamed for starting the "lost profits" analysis by arguing (wrongly) that the interest rate should include the "immense profits" that the lender would ultimately reap from selling the stock it gained via exercise of the option (instead of the value of what the lender actually received).

In responding to the lost profits argument, the court stated:

> [Borrower] argues that, in considering the effective interest rate, the Court should also include the potential profit [Lender] might reap by converting shares at a 42% discount. The Court disagrees. [The Lender] 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 [Lender] chose to convert the loan principal into

> shares, any potential profit [Lender] 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.

Union Capital, at *12-13. The *Union Capital* court's above observation– that the exact profits from the sale of the securities conveyed in repayment of a loan could never be known in advance (or from the face of the agreement)– is obvious; the same could be said for *any property conveyed in repayment of a loan*. At the time the property is conveyed, no one could possibly know the price it will ultimately be sold for, or if it will be sold at all.

If this "future lost profits" inquiry was used in every usury case, the courts would effectively read payment in property out of the usury statutes. Further, Penal Law § 190.40 provides that criminal usury is measured by what a lender "knowingly charges, takes or receives" as interest on a loan. **The statute makes no reference whatsoever to the *profits*** that the lender could or would be able to reap by selling the property taken or received, or whether the lender needed to sell the property at all. Focus on ultimate profits is not only unknowable, it would lead to absurd results. A lender who specified a *de minimis* discount rate for the conversion of shares could be found liable for usury if the share price spiked after conversion; alternatively, if the property received as payment is never sold, then the lender could never be accused of usury no matter how valuable.

It must also be recognized that the valuation method used in *Union Capital* violates the fundamental principle that property is valued at the time of transfer, and that subsequent events such as sale of the property, cannot and "do not alter the value that the consideration had at the time of the transfer." *See, e.g*. 20 NYCRR 590.26;. *Cheltoncort Co. v. Tax Appeals Tribunal*, 185 A.D.2d 49 (App. Div. 1992). The fair market value of the property is "immutably fixed" on the date of transfer, and "that value is in no way contingent on indeterminate future events." *Forty Second St. Co. v. Tax Appeals Tribunal*, 219 A.D.2d 98, 100 (Sup. Ct. App. Div. 3rd Dept. 1996). That is, the lender must be "charged with the value of property at the time he receives it regardless of what is later received from the sale of it." (*Calimpco, Inc.* v. *Warden*, 100 Cal.App.2d 429, 448 [224 P.2d 421]) (interpreting usury statute similar to New York).

In fact, New York courts "reject[ ] the contention that in order to calculate damages it would [be] necessary to speculate when and if a plaintiff would sell its stock." *LG Capital Funding, LLC v. Vape Holdings, Inc*., 2016 U.S. Dist. LEXIS 72149, at *10-11 (E.D.N.Y. June 1, 2016). Instead, New York courts maintain that the "damage award resulting from a breach of an agreement to purchase securities is the difference between the contract price and the fair market value of the asset at the time of breach." *Sharma v. Skaarup Ship Mgmt. Corp*., 916 F.2d 820, 825 (2d. Cir. 1990). *See also Kovens v Paul*, 2009 US Dist LEXIS 19378, *11 (S.D.N.Y.

March 4, 2009) (applying New York law); *Simon v. Electrospace Corp*., 28 NY2d 136, 145 (1971); *Aroneck v Atkin*, 90 AD2d 966, 966 (4th Dept 1982).

1. Union Capital's Use of "Lost Profits" to Value Stock Options is a Fundamental Error

The *Union Capital* court seems to have overlooked that the gains realized from exercise of an option and the gains from selling the stock acquired thereby are "*two separate accretions of income*." *Michaelsen*, 67 N.Y. 2d. at 584.

As explained above, the value of a stock option can be measured (1) when the option is granted; (2) when the option is exercised; and (3) when the stock gained via exercise is sold. *LoBue*, 351 U.S. 243. However, in attempting to value the conversion option in that case, *Union Capital* focused on the inability to know what profits that the lender might ultimately reap from selling the stock it acquired (point (3)), overlooking the fact that the lender gained a valuable consideration (stock) upon exercise of the option (point (2)), or that the minimum value of the conversion option was apparent from the four corners of the Agreement on the date it was granted (point (1)).

2. In Calculating Damages Union Capital Suddenly Rejects "Lost Profits" Valuation in Favor of Fair Market Value at the Time of Transfer!

Frustratingly, not more than four paragraphs after using a "lost profits" valuation to conclude that the value of the conversion option was "too uncertain to incorporate into an interest calculation," the *Union Capital* court arrives at the **exact**

opposite conclusion when valuing the option for the purpose of a damages award. To wit, the court held:

> [T]he measure of expectation damages was readily ascertainable from the face of the Contracts. As already discussed, "[t]he damage award resulting from a breach of an agreement to purchase securities is the difference between the contract price and the fair market value of the asset at the time of the breach, not the difference between the contract price and the value of the shares sometime subsequent to the breach." *Sharma, 916 F.2d at 825*. Thus, determining damages in the event of a failure to deliver converted shares was no more complicated or ephemeral than the method of calculating the conversion in the first place.

Union Capital, 2017 US Dist. LEXIS 60445, at *20-21.

It is unclear how the *Union Capital* court could conclude that "determining damages . . . was no more complicated or ephemeral than the method of calculating the conversion in the first place," when two pages prior it had concluded that the value of the conversion option was "too uncertain" to include as interest!

Ironically, *Union Capital* used standard options valuation for damages (*Sharma*) but not to value the options in the first place. The district court in this case, in following *Union Capital*, did precisely the same thing: it determined that the minimum 54% gain imparted by the option was "too uncertain" to be calculated as interest, but when calculating damages, the court was able to determine the amount owing down to the last cent.

3. *Union Capital's* Holding that the Value of the Conversion Option Should Not be Considered Interest Because it Was Only an "Option" is Erroneous and Contrary to Well-Established Law.

The district court also approvingly cited *Union Capital's* observation that the lender "simply held an option to convert shares, and it could have elected to obtain repayment in cash, which would clearly not have been usurious." 341 F.Supp.3d at 355.

By almost any reading, this statement is contrary to law and must be rejected. First, it ignores that most any option or warrant has value on the date it is granted (particularly when the option has intrinsic value) and is therefore valuable consideration on the date received. As noted previously, this concept is well-recognized by the New York Court of Appeals, *see, e.g., Diehl*, 227 N.Y. at 326.

Second, New York caselaw makes it crystal clear that a lender cannot escape the usury laws by making the usurious interest rate an "option" that it may or may not choose to exploit. Where a loan agreement "provides that the creditor will receive additional payment in the event of a contingency beyond the borrower's control, the contingent payment constitutes interest within the meaning of the usury statutes." *Blue Wolf Capital Fund II, L.P., v. Am. Stevedoring Inc.*, 105 A.D.3d 178, 183 (NY App.Div. 1st Dept.); *Diehl,* 227 N.Y. 318; *Cusick v. Ifshin*, 334 N.Y.S.2d 106 (N.Y. County, June 8, 1972); *Browne v. Vredenburgh*, 43 N.Y. 195, 197 (1870) (holding that where a lender stipulates for a contingent benefit beyond the legal rate

of interest, and borrower has no power to relieve himself of usurious contingency, the contract is usurious).

The rationale for this rule should be obvious. Without it, a lender could charge any rate it wanted so long as the usurious rate was deemed "only optional" in the contract. A promissory note payable at 5% annual interest rate but reserving to the lender 'the option to charge 55% if it so chooses' would be deemed perfectly legal. Promises of this nature have never been accepted by New York courts. *See Cleveland*, 7 Paige Ch. 557; *DeLauny,* 4 NY at 370 (holding that "a party may lawfully lend stock, *as stock*, to be replaced, or he may lend the produce of it, as money, or he may give *the borrower* the option to repay either in the one way or the other . . . [b]ut he cannot legally reserve to himself a right to determine in future, which it shall be").

In this case, the right of the lender to its return of principal plus 8% interest was absolute, as was its option to take repayment in stock (with a 54% gain) if it chose to exercise that option. Neither the principal, nor the interest, nor the monetary value of the stock to be received upon exercise of the option were subject to the profitability of the business.

H. A Lender That Exercises an Option to Take Repayment in Stock is Not an Investor, it is a Repaid Lender.

In support of its decision that the conversion option should not be included as interest, the district court also cited the case of *Beaufort Capital Partners, LLC, v.*

Oxysure Sys., Inc., 2017 US Dist. LEXIS 32335 (S.D.N.Y. Mar. 7, 2017). *Beaufort* involved a fixed discount rate convertible promissory note very similar to the one in this case. The *Beaufort* court, (in dictum) observed:

> the usury defense would likely nonetheless fail because it relies on the debt-to-equity conversion feature of the notes . . . [] 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. *See Seidel v. 18 E. 17th St. Owners, Inc.,* 79 N.Y.2d 735, 744 (N.Y. 1992).

Beaufort, 2017 US Dist. LEXIS 32335, at *7-8 (some citations omitted).

Although unattributed, the *Beaufort* analysis appears to have originated with the New York trial-level case *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 N.Y. Misc. LEXIS 4294, (N.Y. Sup. Ct. Nov. 23, 2015), one of the few state-court decisions addressing the fixed discount conversion option in the context of a usury defense. Like *Beaufort*, the *Sanomedics* court rejected a usury claim, holding:

> It is further noted that "[u]sury laws apply only to loans or forbearances, not investments" (*Seidel, 79 NY2d at 744*). Although the initial transactions were loans, which were clearly not usurious, as [Lender] notes, the Securities Purchase Agreement provided that, upon conversion, [Borrower] was selling securities under Note 1 to it as an "investor." The conversion to stock would convert [Lender] from a lender to an investor with the right to share in the profits and losses of [Borrower].
>
> . . .
>
> While a loan may not be disguised as an investment as a cover for usury, the Notes refer to [Defendant] as the borrower, and only upon conversion at plaintiff's election would [Defendant's] debt to plaintiff become an investment, upon which plaintiff took the risk that the stock could be completely worthless.

Sanomedics, 2015 N.Y. Misc. LEXIS 4294 at *29-30.

Contrary to the apparent holding in *Sanomedics,* the lender's option to take repayment in stock instead of cash does not mysteriously transform the entire transaction into something other than a loan of money.

"Conversion from debt to equity" just means that the *debt was repaid with stock*. Payment of a debt discharges a borrower's obligations and ends the contract. *See* U.C.C. §§ 3-601 *et. seq*.; *In re Oneida Ltd.*, 400 B.R. 384, 391 (Bankr. S.D.N.Y. 2009). When both sides have fully performed, the contract is at an end. *Restatement (Second) of Contracts* § 235(1) (1981) ("full performance of a duty under a contract discharges the duty"). Even when a debt is repaid in installments, the obligations under the contract are extinguished as to the amount paid. Where "a creditor receives property in exchange for discharging a debt then the debt is considered paid to the extent of the fair market value of the property acquired." *Litzenberg v. Comm'r*, 1988 T.Ct. LEXIS 555, at *9 (T.C. Oct. 4, 1988); *see LoBue*, 351 U.S. at 247, ("It makes no difference that the compensation is paid in stock rather than in money."). Although upon repayment the lender holds stock (property that is an investment), which is subject to increase or decrease in value thereafter, those subsequent gains or losses are an entirely separate accretion of income that have nothing to do with what the lender was paid. *See Michaelsen, supra*. In the present matter, AB had an "absolute and unconditional right" to be paid with stock worth $92,307.67; whatever

gains or losses it might have incurred after receipt of that stock payment is irrelevant to the value it received.

The *Sanomedics* court's statement that the borrower's debt to plaintiff would "become" an investment is no different than stating that one's paycheck can "become" groceries. As one court observed,

> "[t]hat a bond is convertible at the sole option of its holder into stock should no more affect its essential quality of being a bond than should the fact that cash is convertible into stock affect the nature of cash. Any bond, or any property, for that matter, is convertible into stock through the intermediate step of converting it to cash."

In re Will of Miguel, 336 N.Y.S.2d 376, 379 (1972).

1. Under New York Caselaw, A Lender's Option to Take Repayment in Securities Does Not Change its Fundamental Character as a Loan.

New York courts settled this question long ago in a series of cases involving loans that gave the lender an option to take payment in stock. The fact that a lender may elect to take payment in securities as opposed to cash, does not change the fundamental character of a loan.

As explained by the Court of Appeals in *Hodges v. Shuler*, 22 N. Y. Rep. 114 (1860) a promissory note "was an absolute and unconditional engagement to pay money on a day fixed; and although the election was given . . . to exchange it for stock, this did not alter its character . . ." 22 N.Y. 114, 118 (1860). In a similar case it was held that a promissory note:

> is for the unconditional payment of money, at a specified time, to the payee's order . . . although an election was given to the promisees upon a surrender of the instrument to exchange it for stock, this did not alter its character as a promissory note.

Hostatter v. Wilson, 1862 N.Y. App. Div. LEXIS 25 (1862). Moreover, New York courts have, through their findings of usury in cases such as *Cleveland v. Loder*, thoroughly conveyed the opinion that where repayment of a loan is accompanied by an option to take repayment of the debt in stock, the agreement in no way escapes the usury laws. As the Court observed in *Leavitt v. DeLauny*, a lender charging the maximum rate who is also given an option to take a quantity of stock instead of a cash payment, is guilty of usury because of the added value of the option. "His principal never was in any hazard, as he was, at all events, sure of having that, with legal interest, and had a chance of an advantage if stock rose." *DeLauny*, 4 N.Y. at 370.

2. *Beaufort* and *Sanomedics* Contravene this Court's Holding in *Seidel v. 18 E. 17th St. Owners, Inc.*, 79 N.Y.2d 735 (1992).

Although *Beaufort* and *Sanomedics* both cite *Seidel v. 18 E. 17th St. Owners* as supporting authority, *Seidel* explicitly rejects the notion that the lender's option to take repayment of the loan with company shares transformed the loan into some sort of investment no longer subject to the usury statutes. *Seidel* involved a corporate borrower that took out a loan to finance the purchase of a building, which it intended to turn it into a co-op. In addition to the high interest rate on the loan, the lender was given an option to exchange the remaining $75,000 of debt for ownership shares in the co-op building (which the lender exercised). *Seidel*, 79 N.Y.2d at 738.

Because the lender had an option to take repayment in what was essentially an ownership interest in the borrower-corporation, the Appellate Division raised the question (which it certified to the Court of Appeals) of whether the transaction was actually a joint venture instead of a loan, and "thus unregulated by usury laws." *Id*. at 739. The Court of Appeals answered the certified question in the negative, stating:

> The mere presence of a unilateral option in favor of [the lender] . . . did not transform the lender into a joint venturer. If the court can see that the real transaction was the loan or forbearance of money at usurious interest, its plain and imperative duty is to so declare, and to hold the security void."

Seidel, 79 N.Y.2d at 744.

Likewise, in this case, the mere presence of a unilateral option permitting the lender to exchange the debt for a publicly traded stock does not transform a lender into an investor any more than payment in grain would make it a farmer. It is simply a way for the loan to be *repaid*.

In addition to *Hodges*, *Seidel*, *Hosstatter*, and *DeLauney*, other controlling New York cases definitively reject the *Beaufort/Sanomedics* proposition. *See Kornfeld v. NRX Techs., Inc.*, 93 A.D.2d 772 (App. Div. 1983) *aff'd*, 465 N.E.2d 30 (N.Y. 1984) (holding that "[t]he conversion option contained in the note does not alter the fact that the note is 'an instrument for the payment of money only' and a proper subject of a motion pursuant to CPLR 3213."); *Simon v. Indus. City Distillery, Inc.*, 159 A.D.3d 505 at 505 (N.Y. App. Div. 2018) (same); *see also Vis Vires Grp., Inc. v. Endonovo Therapeutics, Inc.*, 2016 U.S. Dist. LEXIS 147658 (E.D.N.Y. October 24, 2016) at *19-20 (holding that "[i]t would be a bridge too far" to support "the broad proposition that a payment instrument can never be considered a promissory note if it allows for the principal amount owed to be repaid in securities rather than traditional currency.").

Given that the usury statutes expressly contemplate loan repayment with property (*e.g.*, §5-501(2), §190.40) the notion—that inclusion of an option to convert repayment with certain forms of property (stock) would take transaction out of the usury statutes altogether—is quite a dramatic revelation. The judicial creation of such a loophole would hardly seem to be in keeping with the intentions of the New York Legislature, which regards criminal usury as an important public policy.

In addressing usury, New York authorities observe that there is a distinct difference between a loan and an investment, explaining:

> There can be no usury unless the principal sum advanced is repayable absolutely. If it is payable upon some contingency that may not happen, and that really exposes the lender to a hazard of losing the sum advanced, then the reservation of more than legal interest will not render the transaction usurious, in the absence of a showing that the risk assumed was so unsubstantial as to bear no reasonable relation to the amount charged. This risk of loss is to be distinguished from the risk of nonpayment that is inherent in every loan and that may only be compensated for by statutory interest; the risk of loss by the death or insolvency of the borrower is the ordinary risk that every person runs who lends money on personal security only.

72 N.Y. Jur. 2d. *Interest and Usury*, § 87. *See also Transmedia Rest. Co. v. 33 E. 61st St. Rest. Corp.*, 710 N.Y.S.2d 756, 760 (Sup. Ct. 2000); *Merch. Funding Svcs. v. Volunteer Pharmacy Inc.,* 44 N.Y.S.3d 876 (Sup. Ct. 2016). In this case, the principal sum advanced to GeneSYS under the Note is repayable absolutely, never at risk, and not simply "payable upon some contingency that may not happen."

Paragraph 5 of the Note expressly states: "No provision of this Note shall alter or impair the obligation of the Company, which is absolute and unconditional, to pay the principal of, and interest on, this Note at the time, place, and rate, and in the form, herein prescribed." Note p.5 (A-35).

As AB's suit to recover the value due under the contract illustrates, the Borrower's "absolute and unconditional" obligation to pay "at the time, [] and rate, and form, herein prescribed" includes payment in stock (at the discounted rate) once the option is exercised. By the terms of the Note, the value to be received by AB does not represent a mere "possibility" that conversion will yield more than the legal rate of interest, it represents a guarantee— or else the borrower finds itself in default, and in a lawsuit.

VIII. SECOND QUESTION:

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.

SHORT ANSWER: Yes, a criminally usurious contract is void *ab initio*.

A. The Voiding Statute and Penal Law 190.40

To begin the analysis, we observe that section 5-511 of New York's *civil* usury law provides:

§ 5-511 Usurious Contracts Void

> **1.** All bonds, bills, notes, assurances, conveyances, all other contracts or securities whatsoever...whereupon or whereby there shall be reserved or taken . . . any greater sum, or greater value, for the loan or forbearance of any money, goods or other things in action, **than is prescribed in section 5-501,** shall be void...

NY GOL §5-511 (emphasis added). The interest rate cap for civil usury "prescribed in section 5-501" is 16% (N.Y. Banking Law § 14-a).

1. Penal Law §190.40 -Relevance to Civil Usury Lawsuits

The 25% criminal usury rate from Penal Law § 190.40 becomes relevant in civil litigation because two provisions of the civil usury statutes designate that for a loans that are (1) in excess of $250,000 or (2) made to corporations, a higher bar for usury is set: For such cases, *civil* usury will be found only if the interest rate charged

is in excess of the criminally usurious interest rate 25% that is set forth in §190.40. *See* N.Y.G.O.L. §§ 5-501(6)(a) and 5-521(3).

In years past, New York civil courts have relied on section 5-511 to void loans that violated the civil usury interest rate in **section 5-501** *or* loans that violated the criminally usurious interest rate in Penal Law § 190.40. Given that a loan charging in excess of 25% interest would violate both the civil and criminal provisions, this should be no surprise.

In spite of the clear directive of section 5-511, (and several decades of application) most of the federal courts in this circuit applying New York usury law have concluded that the voiding mechanism in section 5-511 does **not** authorize the voiding of criminally usurious loans to corporations. These rulings are directly attributed to the dicta set forth in *In re: Venture Mortgage Fund LP*, 282 F. 3d 185 (2d Cir. 2002).

B. *In Re Venture Mortgage Fund:* The Second Circuit Questions Whether §5-511 Voiding Applies to Loans Greater than 250K (§5-501(6)) and Loans to Corporations (§5-521(3)

In the *Venture* case, the Second Circuit examined the statutory language of §5-501(6), and, *sua sponte* questioned the correctness of the then-prevailing interpretation, *i.e.,* whether it was correct to hold that the §5-511 voiding mechanism operated to void criminally usurious loans in excess of $250,000.00. The court's doubts about voiding stemmed from somewhat sparse language of section 5-501(6)(a) which provides, in relevant part:

> **6. a.** No law regulating the maximum rate of interest which may be charged, taken or received, **except section 190.40 and section 190.42** of the penal law, shall apply to any loan or forbearance in the amount of two hundred fifty thousand dollars or more . . . .

N.Y.G.O.L. § 5-501(6) (a) (emphasis added). In reading the above-quoted provision, the *Venture* court speculated that, if *only* section 190.40 and 190.42 of the penal law regulated loans of $250,000.00 or more, the rest of the civil usury provisions–*including the §5-511 voiding mechanism*– would not apply. Further, because section 190.40 itself contained no voiding mechanism, voiding might not be available as a remedy for civil litigants at all. *In re Venture*, 282 F.3d at 190.

Importantly for the purposes of this case, the *Venture* court also observed (in a footnote) that the same problem arose in the *other* civil usury provision referencing Penal Law § 190.40: section 5-521(3), which addresses loans to corporations. Section 5-521(3) is the civil usury exception that allows corporations to interpose a

defense of usury- but *only* if the loan charges a criminally usurious interest rate. (Otherwise corporations are not protected by the usury statute, see N.Y.G.O.L.§5-521(1)). Section 5-521(3) provides:

> **3.** The provisions of subdivision one of this section shall not apply to any action in which a corporation interposes a defense of criminal usury ***as described in section 190.40 of the penal law*.**

N.Y.G.O.L.§ 5-521(3) (emphasis added). The *Venture* court drew no definitive conclusions on the interpretation of either provision, and left the matter "an open question," with the caution that its analysis was framed "at some length in dictum because . . . this opinion might otherwise be misread to settle or foreclose the issue in the federal courts of this Circuit." *In re Venture* at 190 and n. 3.

In spite of the cautious language used by the *Venture* court, nearly every federal court in this circuit now uses that case to reject the remedy of voiding for criminally usurious loans to corporate borrowers. *See, e.g*., *LG Capital Funding, LLC, v Vapor Group, Inc.*, 2018 US Dist. LEXIS 108385 (E.D.N.Y. June 27, 2018).

However, as demonstrated below, the *In re Venture* analysis is (1) contrary to the clear guidance of New York Court of Appeals, and (2) is premised upon an erroneous interpretation of the statutory scheme, and therefore must be rejected.

1. The Interpretations in *In re Venture* are Contrary to Authoritative New York State Court Rulings

Controlling state court decisions on the issue almost universally hold that section 5-511 operates to void criminally usurious loans made to corporations. *See Hammelburger v. Foursome Inn, Corp.*, 54 N.Y.2d 580 (1981); *Band Realty Co. v. N. Brewster, Inc.*, 37 N.Y.2d 460 (1975); *Blue Wolf*, 105 A.D.3d 178; *Fareri v. Rain's Int'l, Ltd.*, 589 N.Y.S.2d 579 (2d Dep't 1992); *see also In re McCorhill Pub., Inc.*, 86 B.R. 783 (Bankr. S.D.N.Y. 1988).

In *Hammelburger v. Foursome Inn, Corp.* (which involved a corporate borrower), the New York Court of Appeals took note of the Legislature's statement that "it would be most inappropriate to permit a usurer to recover on a loan for which he could be prosecuted," and observed:

> Noteworthy is the fact that though the Legislature authorized the pleading of criminal usury as a defense by a corporation (General Obligations Law, § 5-521, subd. 3), **it made no change in the provisions of section 5-511 declaring "void," as to individuals and other entities as well as corporations, any instrument reserving** interest in excess of the legal rate . . . .

Hammelburger, 54 N.Y.2d 580, 591 (emphasis added). Also noteworthy is that although the *Hammelburger* court remanded the case for further proceedings, it did not question the Appellate Division's holding that voiding of a criminally usurious loan was the proper remedy, even for a corporation. *See Hammelburger,* 76 A.D.2d 646, 651 (2d Dep't 1980).

2. *In re Venture* Erroneously seeks to Find a Civil Remedy in the Penal Statute That Does Not Provide A Private Right of Action

After concluding that loans in excess of $250,000 were governed only by the criminal usury law(§190.40) the *Ventures* court then posited that the loans in question (to corporations, or in excess of $250,000) could not be voided under the criminal statute either.

The court observed:

> It appears from a close reading of the complex and cross referencing statutes that compose New York's usury law that the voiding provision only operates to void loans that violate the *civil* usury statute--a statute that by its terms applies only to loans of less than $ 250,000 (with interest in excess of 16%)--and might not operate to void a loan of $ 250,000 or greater even if such loan's annual interest rate exceeds 25% and is therefore criminally usurious . . . . Nothing we see in the criminal usury statute, NY Penal Law 190.40, provides for voiding . . . .

In re Venture, 282 F.3d. at 189. In sum, the *In re Venture* court speculated that, if the loan is for $250,000 or more (5-501(6)(a)), or if the borrower is a corporation (§5-521(3)) the only defense against usury is found in NY Penal Law§190.40; and, because section 190.40 does not provide for voiding, the remedy of voiding is not available for those loans. According to the *Ventures* court interpretation, a loan with interest rate so egregious that it actually constitutes a crime cannot be voided; only less-egregious, non-criminal loans may be voided.

The *Venture* court's conclusion is not correct because the analysis is flawed. The critical error of *In re Venture* is evident from that court's observation that

"[n]othing we see in the criminal usury statute NY Penal Law 190.40 provides for voiding." This is true statement: The punishment for violation of that provision (noted as a "class E felony") is set forth in Penal Law § 70.00 (Sentences of Imprisonment for a Felony).

Unfortunately, the 'remedies' listed under Penal Law § 70.00 for violations of §190.40 are (obviously) not available to private litigants in a civil lawsuit, *because section 190.40 is a penal law*. That is, section 190.40, as a penal law, *does not provide civil litigants any remedy at all*. A private individual plaintiff "has no private right of action to enforce state criminal statutes and lacks the authority to institute a criminal investigation." *Berger v. N.Y. State Office for People with Developmental Disabilities*, 2016 U.S. Dist. LEXIS 155585, at *16-17 (N.D.N.Y. Nov. 8, 2016).

The violation of a statute only gives rise to a private cause of action **where the statute itself expressly provides for one**. *Cort v. Ash*, 422 U.S. 66 (1975). Private rights of action are provided in many New York statutes, and in a number of provisions, the Legislature put a criminal penalty and a private right to sue in the same general provision. *See, e.g.*, N.Y. Gen. Oblig. Law § 11-105; N.Y. Agric. & Mkts. Law §378; N.Y. Bus. Corp. Law § 1613; N.Y. Civ. Rights Law § 50-b. The Legislature did not do so with respect to §190.40.

3. Penal Law § 190.40 Does Not Provide for a Private Right of Action

Section 190.40 *provides no private right of action*. For individuals seeking a civil remedy for usurious loans, the New York legislature *only provided a private right of action (or defense) in NY GOL §§ 5-501-5-521 et. seq*. Accordingly, viewing section 190.40 in isolation—as if it encompassed a private right of action in itself—and attempting to discern the civil remedies to be imposed thereby, is erroneous.

C. <u>The Mention of 190.40 in the Civil Statute is ONLY an Incorporation by Reference</u>

While it is true that sections 190.40 and 190.42 are *referenced* in three separate places in the civil usury statutes, it would be absurd to interpret those references as directing litigants to find a remedy under a statute that does not even provide for a cause of action, let alone a remedy. Instead, those references, (particularly in §5-521(3)) are best interpreted (and can only be interpreted) as *incorporating*, for certain situations (corporations, larger loans, etc.), the higher interest-rate-cap found in section 190.40. This would appear to be the view of the New York Court of Appeals, which stated:

> Section 190.40 of the Penal Law provides that interest on a loan or forbearance 'at a rate exceeding twenty-five per centum per annum or the equivalent rate for a longer or shorter period' constitutes criminal usury. Correspondingly, § 5-521(3) of the General Obligations Law **incorporates and makes applicable by express reference** the 25% criterion contained in the Penal Law as the predicate for the defense of usury in a civil action.

Band Realty Co. v. N. Brewster, Inc., 37 N.Y.2d 460 (1975).

That section 190.40 is referenced only for the purpose of incorporating the higher interest rate in that provision-- is also in much better harmony with the statutory language of section 5-521(3) itself, which provides that "the provisions of subdivision one of this section shall not apply to any action in which a corporation interposes a defense of criminal usury ***as described in*** *section 190.40 of the penal law*." N.Y.G.O.L. 5-521(3) (emphasis added). "As described in" does not mean "sue under." Except for the interest rate, the criminal usury *described* in section 190.40 appears to be identical to that described in section 5-501.

Although the specific reference to section 190.40 set forth in §5-501(6)(a) (loans in excess of $250,000) does not use the "as described in" phrase, it is relevant that section 5-501(6)(a) *only* mentions section 190.40 in the context of the applicable interest rate, stating: "No law regulating the maximum rate of interest charged, taken or received, *except section190.40 and 190.42 of the penal law* shall apply . . . ." N.Y. G.O.L. § 5-501(6).

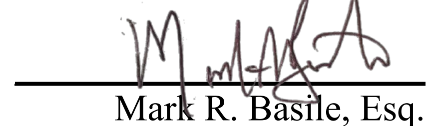
IX. CONCLUSION

For the foregoing reasons, this Court should (a) conclude that the value of the conversion option should be included in the interest calculation; and (b) in accordance with its previous observations in *Band Realty* and *Hammelburger*, hold definitively that N.Y. G.O.L. § 5-511 operates to void criminally usurious loans *as described in* NY Penal Law § 190.40, *i.e.*, charging interest in excess of 25%.

Dated: August 20, 2020

Respectfully Submitted,

Marjorie Santelli, Esq.



Mark R. Basile, Esq.

THE BASILE LAW FIRM P.C.
400 Jericho Turnpike, Ste, 104
Jericho, New York 11753
Tel. 516.455.1500
Fax. 631.498.0478
marjorie@thebasilelawfirm.com
mark@thebasilelawfirm.com

Certification of Compliance

This Principal Brief by GeneSYS ID, Inc., 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 13,967, exclusive of the Table of Contents, Table of Authorities and relevant statutory excerpts, Questions presented, signature block, Certification of Compliance, and Certificate of Service.

CERTIFICATE OF SERVICE

I hereby certify that on August 20, 2020, a copy of the foregoing Principal Brief of Appellant GeneSYS ID, Inc., was electronically filed with the Clerk of Court using the New York Court of Appeals' electronic filing system. Notice of this filing will be sent by operation of the Court's electronic filing system to all parties indicated on the electronic filing receipt.