To be Argued by:
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(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

REPLY BRIEF FOR DEFENDANT-APPELLANT

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In Reply to Respondent Adar Bays LLC's ("AB") Brief in opposition, Appellant GeneSYS ID, Inc. ("GeneSYS") submits the following:

PRELIMINARY STATEMENT

The Arguments Set Forth Herein and in GeneSYS Principal Brief Have Not Been Made to, and Rejected by, Any District Court.

Throughout its arguments, AB repeatedly makes claims to the effect that the arguments presented in this appeal "have been made to and rejected by over a dozen district courts and at least once in the Supreme Court of New York." Br. at 6; *see* Br. at 10, 11,14,

This is entirely false. The arguments set forth herein and in the principal brief have never been presented in the lower courts, and are substantially different from the usury arguments presented at the district court in this case—or *any case*. (The Court can see for itself: the memorandum of law from the district court is found in the appendix at A-191). The critical deficiency in the district court briefs on this subject is that they lack adequate explanation of convertible notes and how they work. GeneSYS has attempted to remedy this deficiency with the more complete explanations set forth herein and in its principal brief.

ARGUMENT

CERTIFIED QUESTION ONE

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 conversion option should be treated as interest.

(The Certified Question Pertains to the Conversion Option, Not to Convertible Notes)

Throughout its brief, AB repeatedly construes the argument as pertaining to the value of convertible Notes instead of the conversion option, arguing (for example) that GeneSYS "goes to great lengths to liken the instrument to a stock option . . . . [h]owever, the convertible note herein is neither a warrant nor an option." Br. at 2. Accordingly, the analysis AB advocates is irrelevant, and is simply introduced in order to derail focus on the real issue, which is the value of the conversion option.

GeneSYS does not argue that the convertible note is a warrant or an option. GeneSYS states that the *conversion option* which is embedded in the Promissory Note, is an option, largely because it (1) fits the definition of an option, and (2) nearly every authority with an opinion on the question on the question regards it as one. McMillan, Lawrence G., OPTIONS AS A STRATEGIC INVESTMENT (NYIF Corp., 1986)

at 4 (defining a stock option as "the right to buy or sell a particular stock at a certain price for a particular period of time."); 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.").

I. RESPONDENT'S PRIMARY OBJECTIONS FAIL AS A MATTER OF LAW.

AB's primary objections to treating the conversion options as interest are as follows: Because (1) the lender might decide not to exercise the option; (2) even if the lender wanted to exercise the option, numerous intervening circumstances might prevent the lender's ability to exercise; (3) the stock value might decline after transfer; and (4) even if the option were exercised, the value of the stock to AB is not the same as the value to GeneSYS; therefore the value of the stock cannot be considered "charged interest" to AB. For the reasons discussed below, these arguments fail.

A. That AB "Might Not Exercise the Option" Is Irrelevant and Contravenes Well-established Holdings of the New York Courts.

As noted in GeneSYS' principal brief, New York courts definitively reject this proposition, holding that when 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.). *Blue Wolf* is consistent with New York caselaw holding that a valuable right given as consideration for a loan will render the loan usurious if the interest rate is already pegged at the maximum rate.

1. <u>Where the Lender Has Sole Discretion to Exercise the Option, Choosing Not to Exercise the Option to Convert Does Not Change its Value</u>

AB contends that the value of the conversion option should not be included as interest because of the possibility "that a noteholder may not exercise the conversion right, as is often the case." Br. at 15.

This argument fails. The option to convert has value on the day it is granted. The lender has sole discretion to exercise the option, and the fact that a lender might choose not to exercise it does not change its value.

2. <u>Lenders Not Converting are Outlier Cases; AB Admits that the Option to Convert Was a Material Term of the Agreements.</u>

Even if it were relevant, it is not credible to state that it is "often the case" that a Lender foregoes its right to convert. That AB can find two outlier cases where the lender did not convert is of little consequence; the two cases cited as examples are default judgments (the defendant never showed up) and provide no information as to why the lender failed to exercise the option in those cases.

On the other hand, AB's Complaint before the district court demonstrates a very different attitude toward the conversion option than what AB seems to imply with this argument. In its Complaint, AB is adamant that the option to convert was an essential part of the contract, stating

> AB's ability to obtain stock at a discount to the market price then resell it on the open market afforded AB the opportunity to obtain a return on its investment from third parties and at a significantly higher rate of return. Any failure by [GeneSYS] to honor Conversion Notices, therefore, would deprive AB of the essential benefit for which it negotiated, and for which it purchased, the Note.

Complaint at ¶11 (A-11); *see also* Decl. of A. Goldstein at ¶22 (A-351) (stating that "The conversion feature is a material term of the Note. Any failure by [GeneSYS] to honor a notice of conversion, therefore, would deprive [AB] of a benefit for which it negotiated, and for which it purchased, the Note.").

Further, an examination of the Agreements themselves reveals a similar centrality of importance of the conversion option: well over half of the provisions set forth in the Note and SPA are dedicated to protecting the value of, and the Lender's ability to exercise the conversion option. *See* Note (A-33); SPA (A-20). *See also* Decl. of A. Goldstein ¶¶ 16-52 (A-347-360) (describing various provisions in the Note that "provide protection to [AB's] conversion right."). Accordingly, AB's contention that it might not exercise the option cannot be taken seriously.

B. AB's "Intervening Circumstances" that Might Prevent Conversion are All Incidents of DEFAULT.

Next, AB contends that the conversion option cannot be valued because "intervening circumstances which could, and one of which did in this case, lead to an inability of a noteholder to convert." Br. at 35. As examples of such intervening circumstances that could prevent conversion, AB states:

> Appellant could be delisted from the exchange, as it ultimately was. Appellant could intentionally go delinquent in its public filings. Appellant could fire its transfer agent in order to prevent conversion, as it did herein. Appellant could run out of shares. Ultimately, if a noteholder opts not to convert, or if the market price for issuer's stock is $0.00, or there is no stock available, or there is no demand for its stock, the discount amounts to $0.00 charged, earned, discounted, gained, or taxed, regardless of Appellant's valuation theories.

Br. at 35-36 (citations omitted).

What AB fails to mention is that each of these potential "events" that may devalue the conversion right are *"Events of Default" under the Note*. Upon default, AB, in its sole discretion may consider the Note "immediately due and payable, and may immediately, and without expiration of any period of grace, enforce any and all of the Holder's rights and remedies provided herein or any other rights or remedies afforded by law." Note at ¶ 8.

1. The Fact that a Borrower May Default on a Contract Does Not Affect the Value of the Conversion Option (Nor Does it Permit a Usurious Interest Rate).

Accordingly, AB is essentially arguing that the value of the conversion right is uncertain because *GeneSYS might breach the contract*. The possibility that a debtor may default on a contract does has no bearing on the how the interest rate is calculated.

The events shown in the chart below set forth most (but not all) incidents of default under the Note or SPA, as well as the consequences for those occurrences under the contract.

2. Chart of Incidents Affecting AB's Ability to Exercise the Conversion Option

OCCURRENCE	CONSEQUENCE
Borrower Prepays Note	PREPAYMENT INTEREST: between 5483% and 78%.
Refusal to honor conversion/failure to deliver shares	DEFAULT-8(k) • 24% interest rate going forward • $250 per day, $500 per day after day 10 • Make whole cash payment ¶8
Bankruptcy /Insolvency	DEFAULT 8(d) 24% interest
No bidders (I.e., "no demand for the stock")	DEFAULT 8(n) 24% interest + 20% increase in principal
Failure to pay interest or principal on THIS OR ANY OTHER NOTE ISSUED TO AB BY GENESYS.	DEFAULT Note 8(a) • 24% interest rate going forward • 10% increase in principal

Delisting of Stock	DEFAULT 8(i) • 24% interest going forward • and 50% increase in principal
Failure to keep current in SEC filings	DEFAULT 8(m) • 24% interest going forward, • Holder entitled to use lowest closing bid price during delinquency period.
Breach of any Covenant, Warranty, or Representation provided in ¶¶ 3 and 4 of SPA	• DEFAULT- 24% interest rate going forward
Failure to Maintain Share Reserve ("no stock available")	DEFAULT 8(l) 24% interest rate
Failure to Remove Restriction on Stock	DEFAULT- SPA at ¶ g.
Default or breach of any term on any similar debt instrument	DEFAULT
DTC Chill	Conversion strike price lowered to 55% of FMV while chill is in effect (Note at 4(a))

It is clear that AB vigorously protected its conversion right by taking every possible event that might adversely affect the value of the option and calling it an event of default. *See* Decl. A. Goldstein (A-347-360). Under this scheme, AB cannot seriously contend that any of these incidents of default actually impair the value of the option. Upon default, AB can sue the borrower for the full value of the conversion option, as it did in this case.

C. AB is Not Guaranteed that It Would "See Any Value From A Conversion"

AB essentially argues that it is not guaranteed to make a profit on every conversion. As discussed in GeneSYS' principal brief, whether or not AB makes a profit on sales of the stock it receives from conversion cannot be a factor in valuing the option. The stock price may decline, increase, or stay the same. As AB so constantly repeats, once AB takes the stock in repayment of the loan, gains or losses thereafter are AB's responsibility as an investor.[1]

1. AB's Example of Volatility During the 3-Day Settlement Period Disproves its Own Theory.

As an example of the stock price volatility jeopardizing its profits from conversion, AB points to the historic stock prices around the time that AB submitted

[1] The Second Circuit voiced similar concerns in its Order certifying questions to this Court. Adar Bays, LLC v. GeneSYS ID, Inc., 962 F.3d 86 (2d Cir. 2020). In addition to the inability to convert, the Second Circuit noted concerns over the value of the stock subsequent to AB's receipt, observing that "the possibility that the shares transferred could become worthless due to bankruptcy or other events remains as an obstacle to the neat calculus which GeneSYS puts forth," and that "unlike a payment of cash, the lender, even in loans like the one at issue here, takes on additional risk by choosing to convert principal to equity." 2d Cir. Order at n.3, n.7. Essentially, the second circuit raises the same *profits* issue addressed in *Union Capital, LLC v. Vape Holdings, Inc.,*2017 U.S. Dist. LEXIS 60455 (S.D.N.Y. 2017).

While it is possible that the stock price might go down thereafter, or the company bankrupt, it must be recalled that it is also possible that the stock price might go up- even tenfold. This is the reason that the valuation based on guessing the "future profits" or losses a stock has been repeatedly rejected.

The Second Circuit order also cites to an SEC press release from 2003 as potentially addressing concerns presented by convertible notes. The press release addresses a case where the holders of convertible securities engaged in short-selling to manipulate the stock price downward in order to obtain more shares upon conversion, but there is no mention of a steep conversion

its notice of conversion. AB contends that the 54% gain is not guaranteed because the stock price may decline during the three day period between the lender's submission of the conversion notice and the lender's actual receipt of the stock. AB states:

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

Br. at 17.

Notwithstanding the fact that this scenario did not occur (the trading prices are correct, but the price swing took place over four days, not three[2]) AB's contention is remarkable because of how many facts it conveniently ignores. First, AB omits that the 35% discount is not simply applied to the trading price on the date of exercise; the discount is applied to the *lowest trading price in the previous 20 days*. In this case, the 20-day low was $ 0.0175, and with the discount applied, AB

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discount. For SEC enforcement actions addressing precisely the lending model used in this case, recent see https://www.sec.gov/litigation/complaints/2020/comp24886.pdf.

[2] Which means that the "make whole" provision (Note ¶8) would have compensated for the price difference.

paid $0.011375 per share. Hence, even with the unusual four-day price collapse[2] to .021, AB would still be getting the stock for 54% less than the trading price.

2. Implication of Potential Loss During the Three-Day Settlement Period is Specious Because AB Shares Were to be Electronically Delivered.

Second, AB fails to mention that the 3-day settlement period is an SEC rule that applies to all stock transfers. Third, AB neglects to mention that, in reality, the conversion stocks were to be transferred electronically through the Depositary Trust and Clearing Corporation (referred to as "DTC") and usually arrive in a trader's account the next day, if not sooner. In fact, under Note ¶4(a), AB is entitled to an even lower share price (55% of fmv instead of 65%) if DTC restricts electronic clearing of the stock (i.e, a "DTC chill") Id. (For a description of a DTC chill, see https://www.sec.gov/fast-answers/answersdtc-chillshtm.html (last visited October 22, 2020.).

D. AB's Market Price Valuation Theories Are Inaccurate and Irrelevant

AB next contends that fair market value is not the proper valuation for the stock in this case, because a publicly traded corporation (like GeneSYS) cannot legally sell its common stock on the open market, but AB can. Hence, GeneSYS

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[2] AB is comparing the highest intraday trading price on 11-29-2016 to the lowest intraday price on 12-5-2016. The average trading prices for those days was .040 and .026, respectively.

cannot rely "on the premise that the value of the shares to Respondent – the market value – is the same as the value to Appellant." Br. at 16.

1. <u>The Theory is Inaccurate.</u>

AB misstates the basis for fair market value. Fair market value is the price that is produced by willing buyers and sellers in a competitive market, which economics teaches is the most reliable evidence of value. *See United States v. Cartwright*, 411 U.S. 546, 551 (1973). The fact that GeneSYS is legally precluded from selling its own shares into the market has nothing to do with the value of those shares.

Further, issuance of shares is not free. Each issuance of shares dilutes the value held by the current shareholders, who, in a practical sense, cannot be viewed as separate from the Company itself. Each dilution means that those shareholders own less of the company and less of all the company's future earnings.

2. <u>The Theory is Irrelevant--Because the Usury Statutes Measure Interest by the Value of What the Lender "Charges, Takes, or Receives."</u>

Ultimately, AB's valuation theory is irrelevant because usury is focused on the conduct of the lender, not the borrower; it is measured by what the *lender* "charges takes or receives" for the loan. Under section 190.40, a person is guilty of criminal usury when he "charges takes or receives any money or other property as interest on the loan . . . at a rate exceeding twenty-five per centum per annum . . .".

N.Y. Penal Law § 190.40. *See also* NY. G.O.L. § 5-501[2] (providing that "[n]o person or corporation shall directly or indirectly, charge, take or receive any money, goods or other things in action as interest on the loan . . .).

As observed by the court in *Schermerhorn v. Am. Life Ins. & Trust Co*, the usury statute is focused on the conduct of the Lender, not the borrower. The court observed:

> In order to make the borrower's losses material to the question of usury, it must appear that they in some way contributed to the lender's gain, either for himself or some other person. He is the one upon whom the statute operates, and who is thereby forbidden to receive more than the legal rate. This is not only the language of the statute, but the proposition is in accordance with its policy.

Schermerhorn v. Am. Life Ins. & Trust Co., 14 Barb. 131, 145 (1852) 1852 N.Y. App. Div. LEXIS 147.

E. **Under the Usury Statutes, any Property Used to Repay the Loan is Interest, Regardless of When it is Conveyed.**

AB next makes the bizarre claim that the "Legislature's Use of the Word "Property" is Not Relevant to the Questions Before the Court, Because No Stock is Transferred at the Time of Contracting." AB Br. at 18. This contention is obviously baseless, and AB provides no legal support for it whatsoever. Nowhere in the statute (either current or historical) or in caselaw (current or historical) is there

a requirement that property be transferred at the time of contracting to be considered interest.

In fact, interest payments are almost by definition ***not*** made at the time of the loan contract– they are paid when the loan or loan payments are due. At the time of the contract, the obligation to pay interest, as well as principal, is simply a contractual obligation, (or the Lender's contractual right). Although the courts generally consider up-front payments (in property or cash) as part of the interest rate, (or a reduction in the amount loaned, which has the same effect on the interest rate) such payments are the exception, not the rule.

Further, under AB's interpretation, even the 8% stated interest rate on the Note would not be considered interest, because it is not paid at the time of contracting. Ironically, the contract also specifies that the 8% interest payments be made in stock. Note at 1, and ¶ 4(b). AB does not explain why its right to receive the future payments in stock under paragraph 4(b) constitutes interest, but its right to receive future payments an of an additional 54% under 4(a) (conversion) is not.

Finally, AB ignores the fact that stock options are property. Stock options are valuable assets, and in this case the option to convert has a readily ascertainable intrinsic value.

F. <u>AB's "In Addition to" vs "In lieu of" Distinction Makes No Sense for Valuation Purposes</u>

AB repeatedly brings up the argument that the shares of stock delivered "in lieu of repayment" as opposed to "*in addition to* repayment" should be treated differently for purposes of valuation. Br. at 22. Unfortunately, AB never explains why they should be valued differently, or what exactly that value would be.

Stock is not delivered as a substitute for repayment, *it is the repayment*. Shares of stock are delivered *in lieu of* repayment in *cash*. But the important part is that repayment by exercise of the conversion option delivers, by value, an additional 54% more shares than the amount owed. That is, for every $100 of debt used to exercise the option, AB receives $154 worth of stock. Hence, delivery of shares "in lieu of" repayment in cash also delivers *additional stock value.*

1. <u>The Fixed Discount Conversion Option is More Accurately Valued than the "Up-front" Delivery of Restricted Stocks in *Hillair Capital Investments, L.P. v. Integrated Freight Corp.*, 963 F. Supp. 2d 336 (S.D.N.Y. 2009).</u>

While there was no stock issued "up front" in this case, the conversion options issued "up front" were exercisable in 180 days, hardly different from the *Hillair* stock, which was restricted for the first 180 days (due to the same SEC Rule 144). In *Hillair*, the lender could sell the stock in 180 days, at whatever price the stock was then trading.

However, unlike the lender in this case, the recipient of restricted stock would not be insulated from price declines during the six-month restriction period—this is the reason restricted stock is given a lower valuation. Further, the *Hillair* lender would not be protected from price declines that may occur when the lender quickly sells the stock into the market.

In this case, AB is insulated from price declines during the 180-day restriction period because it is contractually guaranteed an extra 54% in stock value at conversion, regardless of the trading price. Moreover, AB's ability to convert an infinite number of times, in whatever quantity it thought the market could bear, further insulated it from subsequent price declines, even those caused by its own selling activity.

What is the difference between delivery of 180-day restricted stock as up front consideration and delivery of an option to buy unrestricted stock that vests in 180 days? In one case the lender has possession of an equity, in the other case the lender has a contractual right to purchase the equity at a price guaranteed to be 35% lower than the market price. Both are assets with value.

G. Contrary to AB's Assertions, Cleveland v. Loder Was Not Overruled by *Hartley*.

AB next contends that *Cleveland v. Loder*, 7 Paige Ch. 557 (N.Y. 1839) is no longer good law[3]. AB asserts that the quoted proposition from *Cleveland*, that "[w]henever the lender stipulates even for a chance of an advantage beyond the legal interest, the contract is usurious . . ." is cherry picked and "no longer a part of contemporary usury jurisprudence." Br. at 22.

According to AB, the quoted proposition was essentially overruled by *Hartley v. Eagle Inc. Co. of London, Eng.*, 222 N.Y. 178, 184 (1918), which held that "an agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not ipso facto usurious, because of the possibility that more than the legal interest will be paid." AB contends that, as a result of the *Hartley* case:

> the numerous New York District Courts addressing Appellant's arguments and applying New York law cite to the proposition from *Lehman v. Roseanne Investors Corp.*, 106 A.D.2d 617, 618 (2d Dep't

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[3] AB also implies that all pre-1965 caselaw on usury is "questionable" because the language of the usury statute has changed over the years and because Penal Law §190.40 did not even exist in its current form until 1975. Br. at 18. This argument is meritless. Notwithstanding that the usury defense was not available to corporations between the late 1800's and 1965, the language of the usury statutes has been remarkably consistent since 1828, when it stated

> No person or corporation shall, directly or indirectly, take or receive in money, goods, or things in action, or in any other way, any greater sum or greater value, for the loan or forbearance of any money goods or things in action, than is above prescribed.

Rev. Stat. 1828.

> 1984) which states "there is a strong presumption against the finding of usurious intent and . . . a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest." As made clear above, each aspect of the conversion right, from the exercise itself, to the availability of shares, to the price of the shares following exercise, is uncertain, making it no more than a mere possibility that Respondent would receive more than a legal rate.

Br. at 22.

Contrary to AB's assertion, *Hartley v. Eagle* did not overrule *Cleveland v. Loder*, nor did it vitiate the proposition that "[w]henever the lender stipulates even for a chance of an advantage beyond the legal interest, the contract is usurious." *Cleveland, Id*. In fact, *Cleveland v. Loder* and this very same passage is quoted approvingly in *Cusick v. Ifshin*, 70 Misc. 2d 564 (Civ. Ct. 1972) one of the two cases that *Lehman v. Rosanne Investors* relies upon for its holding.

The difference between *Hartley* and *Cleveland* has to do with intent, and specifically turns on whether the how much control the lender has over the potentially excessive interest charged. In *Hartley*, timeframe for repayment of the loan could not be known or controlled by either party, because the loan was due upon the death of the borrower's grandmother, which had yet to occur.

Accordingly, the annualized interest rate would not be known in advance, and was based upon a reasonable contingency over which neither party had control. If the grandmother died within a short period of time, the interest rate would be above

the legal rate, but if she lived a long time, the interest rate could be far below the legal rate. With this in mind, the *Hartley* court held that:

> [A]n agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not ipso facto usurious, because of the possibility that more than the legal interest will be paid. Otherwise no valid transfer or assignment of an interest dependent upon a life estate could be made for less than the full value.

Hartley v. Eagle Ins. Co., 222 N.Y. 178, 184-85 (1918). Notably, although the *Hartley* court reversed the lower court's holding that the loan was usurious as a matter of law, it did not preclude that a factfinder might determine usury based upon the intent of the lender. The Hartley court then ordered a trial on that question of intent. *Id*. at 188-9.

The *Hartley* situation is obviously different from the one in *Cleveland v. Loder*, where, at the time repayment was due, the lender was given sole discretion decide between taking repayment in cash at the legal rate, or 200 shares of stock at a potentially illegal rate. Because the lender would only take the stock if it was worth more than the repayment plus maximum legal interest, it was clear from the terms of the contract that the lender could exact more than the legal rate.

In *Blue Wolf* the appellate division made a logical addition to these holdings, stating that where a loan instrument "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*, 961 N.Y.S.2d 86, **89 (citing *Diehl v Becker*, 227 NY 318, 326 (1919) and *Browne v Vredenburgh*, 43 NY 195, 198 (1870)).

In this case, the lender is given sole discretion to exercise the conversion option, which by contract mandates that a minimum of 54% excess value will be conveyed upon exercise. The "contingencies" AB complains of—that it might not exercise the option, that the borrower might default, and that it might not make the right amount of profit when it ultimately sells the shares—are not the "reasonable contingency" described in *Hartley*.

H. ***Seidel*** **Never Held that "the Nature of a Transaction Can Transform a Lender Into an Investor"**

AB contends that "two relevant principles clearly emerged from *Seidel[v. 18 E. 17th St. Owners, Inc.,* 79 N.Y.2d 735 (N.Y. 1992)]: (i) if the transaction is not a loan, there can be no usury, and (ii) the nature of a transaction can transform a lender into an investor." Br. at 39.

While statement (i) is obviously true, statement (ii) is simply a fantasy. Nowhere does *Seidel* state, or anywhere imply, that "the nature of a transaction can transform a lender into an investor." If anything, *Seidel* holds the *exact opposite* of what AB advocates: The transaction is a loan or it is not a loan; it does not start as

one thing and become another based on the lender's option (or exercise of that option) to take a share of the business in lieu of repayment in cash.

The task of the *Seidel* court was to determine whether the transaction was a loan (and subject to usury laws), or whether the lender's option to exchange some of the debt for shares of the co-op meant that the entire transaction was actually a joint venture, *or any type of investment not covered by the usury laws*.

The *Seidel* court found the agreement to be a loan because it contained the standard indicia of a loan: the language of the agreement and the types of instruments involved indicated a loan. The fact that the lender had a unilateral option (which the lender exercised) to take shares of the co-op in lieu of $75,000 of the debt did not transform the loan into a joint venture; as in the present case, it is simply how part of the loan was repaid.

Contrary to AB's assertion, the district courts do not cite *Seidel* for the proposition that the "'form and substance' of the arrangement could transform a loan to an investment." Br. at 39. (Compare *Franklin Realty Co. v. PAAMCO Founders Co., LLC*, 2010 LEXIS 148395, at *14-15 (S.D.N.Y. Aug. 27, 2010) (observing that *Seidel* "stands for the proposition that a lender's conversion right does not preclude a finding of usury.")).

For the proposition AB is advocating, district courts cite only to *Beaufort Capital Partners LLC v. Oxysure Sys., Inc.,* 2017 US Dist LEXIS 32335 (S.D.N.Y.

Mar. 7, 2017) which speculates, in dictum, that "[t]hough 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." *Beaufort*, 2017 US Dist. LEXIS 32335, at *7-8. As discussed in GeneSYS' principal brief, *Beaufort* fails to consider that the exercise of the option doesn't *transform* the loan contract, it *ends* the loan contract **because the loan is repaid with stock (including the 54% gain)**.

The loans in this case don't have the character of an equity investment**.** The loans can be repaid with equity. Upon conversion, the loan contract is at an end and the debt is repaid. The lender now owns stock.

At no point has AB argued that the transaction was not a loan at its inception; it just argues that repayment of the loan transformed it into something other than a repaid loan. AB does not explain (nor do the courts in *Beaufort* or *Seidel*) how a loan that is repaid with stock is not simply a "repaid loan," but is instead somehow retroactively becomes an equity investment. Or how a lender, who obtained stock as repayment for a loan, somehow was never a lender to begin with.

Ultimately, if the Court strips away the complexities that AB has overlaid on these transactions, they are revealed simply as a loan of money that enables the lender to extract a usurious interest rate – all under the guise of just being a good investor.

As the New York Court of Appeals has long held:

> The transaction must be judged by its real character, rather than by the form and color which the parties have seen fit to give it. The shifts and devices of usurers to evade the statutes against usury, have taken every shape and form that the wit of man could devise, but none have been allowed to prevail. Courts have been astute in getting at the true intent of the parties, and giving effect to the statute.

Quackenbos v. Sayer, 62 N.Y. 344 (1875).

II. SECOND CERTIFIED 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, the contract is void ab initio.

As argued in GeneSYS' principal brief, the 25% criminal usury rate from Penal Law § 190.40 becomes relevant in civil litigation because two provisions of the civil usury statutes which designate that for 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).

I. **The Historical Reading Favors Voiding**

The proper reading of the statute is not that corporations must sue under the criminal law, but that the interest rate from the criminal statute is incorporated by reference into the civil statute. In years past, New York civil courts shared this interpretation, and it was apparently a view held by legal commentators at the time, who observed that the new civil statute "the defense of usury is restored to corporate borrowers charged over 25 per cent interest." *Syndicate Loan-Shark Activities and New York's Usury Statute*, 66 COLUM. L. REV. 167, 174 (1966).

J. **"Affirmative Defense" Has Meaning**

As inferred by the trial court in *Blue Wolf Capital Fund*, even if loans are not voided under 190.40, the civil usury statute clearly provides an "affirmative defense" of usury, which must mean something. The court took it to mean that although the loan was not void, it was not enforceable either. *Blue Wolf Capital Fund II, L.P., v. Am. Stevedoring Inc.*, 2011 N.Y. Misc. LEXIS 6932 (2011) at *18.

K. **Equitable Remedies Should Not Apply to Illegal Contracts**

AB Contends that, contrary to GeneSYS' arguments about 190.40, corporate borrowers do actually have a remedy against criminally usurious loans because certain district courts have fashioned the equitable remedy of reducing the criminally usurious interest rates to a non-criminal level. Br. at 46.

However, refusal to enforce the contract altogether is actually the suitable remedy, because loan contracts charging in excess of 25% interest *violate the criminal law*. Refusal to enforce contract has nothing to do with equitable principles. As the New York Court of Appeals has observed, a court's refusal to enforce an illegal contract:

> is not based on a search for the equitable outcome of a particular case, or on a calculation of which result will most contribute, in an immediate and practical way, to the enforcement of a particular statute or public policy. Rather, they are based on the sound premise that courts show insufficient respect for themselves and for the law when they help a party to benefit from illegal activity. As Justice Brandeis explained:
>
> The court's aid is denied . . . when he who seeks it has violated the law in connection with the very transaction as to which he seeks legal redress. . . . It is denied in order to maintain respect for law; in order to promote confidence in the administration of justice; in order to preserve the judicial process from contamination.

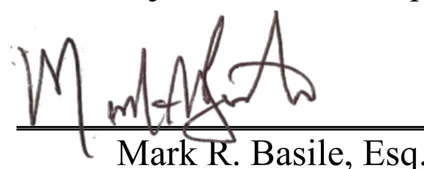
Balbuena v. IDR Realty LLC, 6 N.Y.3d 338, 364-5 (2006) (dissenting opinion) (quoting *Olmstead v. United States*, 277 U.S. 438, 484, (1928) (dissenting opinion; citations omitted)).

CONCLUSION

For the reasons set forth herein and in its principal brief, Appellant GeneSYS respectfully submits that the correct answer to the certified questions is that (1) Yes, the value of the conversion option must be included as interest; and (2) Yes, a loan found to be criminally usurious is void, ab initio pursuant to N.Y.G.O.L. §5-511.

Respectfully Submitted,

Marjorie Santelli, Esq.



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Certification of Compliance

This Reply 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 less than 7,000 words, exclusive of the Table of Contents, Table of Authorities, signature block, Certification of Compliance, and Certificate of Service.

CERTIFICATE OF SERVICE

I hereby certify that on October 23, 2020, a copy of the foregoing Reply 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.