18-3023

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

ADAR BAYS, LLC

Plaintiff-Appellee,

—against—

GENESYSID, INC FKA RX SALES, INC

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFF-APPELLEE

KEVIN KEHRLI
GARSON, SEGAL, STEINMETZ,
FLADGATE LLP
164 West 25th Street, Suite 11R
New York, New York 10001
(212) 380-3623

Attorneys for Plaintiff-Appellee

RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, Plaintiff-Appellee Adar Bays, LLC discloses that it is not a publicly held corporation, has no parent corporation, and no publicly held corporation owns 10% or more of its stock.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases **Page(s)**

Statutes

PRELIMINARY STATEMENT

Appellant is a sophisticated, publicly traded entity that issued a convertible redeemable note (the "Note") to Appellee under the supervision of counsel. Appellant shirked its obligations under the Note at the first opportunity, and is now attempting to void the entire transaction as usurious. After accepting Appellee's money and reaping all the benefits of the bargain, Appellant is simply seeking a windfall.

SUMMARY OF THE ARGUMENT

Appellant's argument is backward, first arguing the remedy to which it believes it is entitled, then arguing one of the two elements of its defense. Appellee will present its argument in the same order for the convenience of the Court, but notes that Appellant would first need to prove that the convertible note at issue charges an impermissible interest rate and then that Appellee intended to charge a usurious rate before the issue of a remedy would require addressing.

Appellant, as a corporation, is statutorily precluded from asserting the defense of civil usury as outlined in N.Y. Gen Oblig. L. §§5-501 et seq. Instead, Appellant may assert the defense of criminal usury pursuant to N.Y. Pen. L. §190.40. N.Y. Gen. Oblig. L. §5-521 makes that undeniably clear. Nonetheless, Appellant argues that §§5-501 et seq. must be read "*in para* [sic] *materia*" with §190.40 because "the civil usury statutes and the criminal usury statutes are similar." (DKT 42, pp. 15-16). However, the opposite is true. Applying principles of statutory interpretation

show that the legislature contemplated the both defenses and intended for them to be separate and distinct in application, availability, interest rate, and remedies. This Court has acknowledged that there is "no statutory authority for voiding a loan that violates the criminal usury statute," *Brodie v. Schmutz (In re Venture Mort. Fund, L.P.)*, 282 F.3d 185, 190 FN 4 (2nd Cir., 2002), but Appellant will not do the same. Importantly, because Appellant did not meet its "heavy burden" of proving each element of its usury defense, the District Court below did not need to address this argument.

Seemingly perturbed by the District Court's reliance on the analysis provided in the abundance of District Court matters that addressed the same arguments, Appellant asks this Court to not "simply mimic what . . . courts in this Circuit on these issues" and provides numerous flawed arguments. (DKT 42, p. 15). Specifically, Appellant argues that five terms of the Note constitute "hidden interest" and should be considered in a usury determination: (i) attorneys' fees withheld from the funding amount and paid directly to transactional counsel; (ii) the 35% discount at which Appellee was entitled to convert principal of the note into shares; (iii) the amounts charged should Appellant elect to prepay the note; (iv) the reserve of shares placed in the control of Appellant's agent in order to effectuate stock conversions under the Note; and (v) default interest that would be charge in the event that Appellant defaults under the Note. None should be considered interest.

There is no question that a borrower can pay reasonable fees attendant to a loan without rendering the transaction usurious, and that attorneys' fees fall into said said category. *Coastal Inv. Partners, LLC v. DSG Global, Inc.*, 2018 U.S. Dist. LEXIS 96078 *17 (S.D.N.Y. 2018). Appellant mistakenly shifts the burden of proof with regard to whether the attorneys' fees paid constitute hidden interest, arguing that Appellee failed to present evidence of the services the the attorneys provided. (DKT 42, p. 16). This argument can be dismissed outright, as it is well-established that criminal usury is an affirmative defense, and the defendant must prove each of the defense's elements by clear and convincing evidence.

Next, Appellant argues that the 35% discount at which Appellee was entitled to shares should be considered interest for the purposes of a usury determination. Various principles in usury law make clear that this is wrong. Applying these principles, as over a dozen district and state courts have done, leads to the conclusion that at the time of contracting, the point at which the usury determination is made, it would be entirely speculative whether Appellee would opt to or be able to exercise the conversion right. Once the speculation is removed and the right is exercised, the nature of the transaction becomes one of equity, which is no longer subject to the criminal usury statute. In other words, there is no point in the life of the transaction where the 35% discount could be considered interest. This is the result of an established line of case law in the Eastern and Southern Districts, as well as the

Supreme Court of New York. See e.g., *Union Capital, LLC v. Vape Holdings Inc.*, 2017 U.S. Dist. LEXIS 60445 (S.D.N.Y. 2017); *LG Capital Funding v. PositiveID Corp.*, 2019 U.S. Dist. LEXIS 126991 (E.D.N.Y. 2019); *EMA Fin., LLC v. AIM Exploration, Inc.*, 2019 U.S. Dist. LEXIS 26141 (S.D.N.Y 2019); *EMA Fin. LLC v. Joey New York, Inc.*, 2019 U.S. Dist. LEXIS 161454 (S.D.N.Y. 2019); *Beaufort Capital Partners, LLC v. Oxysure Sys. Inc.*, 2017 U.S. Dist. LEXIS 32335 (S.D.N.Y. 2017); *LG Capital Funding, LLC v. Aim Exploration, Inc.*, 2018 U.S. Dist. LEXIS 147411 (S.D.N.Y. 2018); *LG Capital Funding, LLC v. One World Holdings, LLC*, 2018 U.S. Dist. LEXIS 107369 (E.D.N.Y. June 22, 2018); *LG Capital Funding v. Vapor Grp, Inc.*, 2018 U.S. Dist. LEXIS 108385 (E.D.N.Y. 2018); *LG Capital Funding, LLC v. 5Barz International, Inc.*, 307 F. Supp. 3d 84 (E.D.N.Y. 2018); *LG Capital Funding, LLC v. Windstream Technologies*, 2018 U.S. Dist. LEXIS 147409 (S.D.N.Y. 2018); *Adar Bays, LLC v. 5Barz Int'l, Inc.*, 2018 U.S. Dist. LEXIS 139843 (S.D.N.Y. 2018); *Adar Bays, LLC v. Aim Exploration, Inc.*, 285 F. Supp. 3d 698 (S.D.N.Y. 2018); *Coastal Inv. Partners, LLC v. DSG Global, Inc.*, 2018 U.S. Dist. LEXIS 96078 (S.D.N.Y. 2018); *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 Misc. LEXIS 4294 (N.Y. Sup., Kings Co.). (Hereinafter, this line of case law shall be referred to as "*Union et al.*")

Third, Appellant points to prepayment "penalties" contained in the Note, claiming those amounts should be considered interest. This is misplaced. In order

for a payment contingency to be considered interest for a usury determination, the contingency must be in the exclusive control of the lender. *Salamone, P.C. v. Russo*, 129 A.D.3d 879, 881 (2d Dep't 2015). Again, this can be dismissed summarily. In order for Appellant to avoid the imposition of prepayment charges, Appellant could simply elect not to prepay. Thus, the contingency is within the exclusive control of Appellant and cannot be considered interest.

Fourth, Appellant argues that "the 35% discount when coupled with the rate of 24% upon GeneSYS' default constitutes criminal usury." (DKT 42, pp. 17). Leaving aside that the 35% discount should not be considered interest, any amounts charged following a default should also not be considered interest. Such was clear law for decades until a single, outlying decision in the Southern District, *Madden v. Midland Funding, LLC*, 237 F. Supp. 3d 130 (S.D.N.Y. 2017), went to great lengths to distinguish dozens of state and federal cases in order to ultimately state that "the New York Court of Appeals, were it to face this situation, would hold that the criminal usury cap limits interest charged od debts to 25% annually, even for defaulted debts. *Id.*, at 144. *Madden* is not relevant for several reasons. First, application of the common-place usury principle that the contingency must be in the exclusive control of the lender shows that the court reached the wrong conclusion. Like the prepayment above, a default is in the exclusive control of the borrower. If the borrower complies with the terms terms of the note, no default interest or

penalties would be charged, so amounts charged following a default should not be included in a usury determination. Second, it was simply incorrect. In the words of the Hon. Sterling Johnson, there is "overwhelming authority" stating that amounts charged following a default should not be included in a usury determination. *LG Capital Funding, LLC v. One World Holdings, LLC*, 2018 U.S. Dist. LEXIS 107369 *34 (E.D.N.Y. June 22, 2018). Finally, *Madden's* holding was applied for the purposes of the 25% usury limitation serving as a predicate for Plaintiff's Fair Debt Collection Practices Act claims brought by an individual against a credit card company. *Madden v. Midland Funding, LLC*, 237 F. Supp. 3d 130, 147 (S.D.N.Y. 2017). Here, where a sophisticated, publicly traded entity is simply seeking to skirt its obligations under a contract negotiated by counsel, the holding should not apply.

Finally, Appellant argues that a share reserve, established with Appellant's own designated agent, constitutes interest. This fails for the same reasons its argument regarding the conversion discount fails, and others. First, the share reserve, established as a mechanism to effectuate performance of the conversion right in the note, is placed in the custody and control of Appellant's own designated agent. Upon conversion, the agent would deliver the shares to Appellee, and the respective amounts converted would no longer be due to Appellee. Upon full performance of the Note, whether through prepayment, conversions, or payment upon maturity, the share reserve would be cancelled, and the shares would be

returned to Appellant. Accordingly, there is only one point at which the share reserve, or portions thereof, could be considered "charged" to Appellant for the purposes of a usury determination – when shares are actually delivered. To find otherwise would undermine the most basic principle of agency. As stated countless times by lower courts, at the point of conversion, the transaction is no longer susceptible to a usury defense because it becomes an equity investment, rather than a loan. See, *Union et al.*

Last, while not specifically addressed by Appellant, it is important to note that in order for it to meet its "heavy burden" of proving its affirmative defense, Appellant would also be required to prove that Appellee intended for the transaction to charge a usurious interest rate. To do so would raise serious questions of due process, as by May 2016, when the transaction was undertaken, *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 Misc. LEXIS 4294 (N.Y. Sup., Kings Co.), in the New York State Court had already found that a near identical note was not usurious when attacked with these same arguments. To be clear, Appellant is seeking to overturn a developed line of case law, not resolve a split or conflict. Appellee's reliance on judicial opinions should be considered in determining its intent, and to impugn intent in the face of such case law and void the transaction would not serve justice. Thus, even if successful in all its other arguments, Appellant's burden with regard to intent is insurmountable.

This brief will present the differing usury statutory framework, as well as a concise overview of the basic principles of New York's usury law, then each of Appellant's points are addressed in turn, highlighting the multitude of district and state court decisions that addressed the arguments made by Appellant herein.

ARGUMENT

I. NEW YORK'S USURY LAWS

There are two types of usury defenses–civil usury and criminal usury. Appellant intentionally blurs the line between them to suit its arguments.

§5-501 of the New York General Obligations Law, the civil usury statute, provides that "no person . . . shall . . . charge, take or receive any money . . . as interest on the loan of any money . . . at a rate exceeding [16% per annum]."

§190.40 of the New York Penal Law, the criminal usury statute, provides that "[a] person is guilty of criminal usury in the second degree when . . . he knowingly charges, takes or receives any money . . . as interest on the loan . . . of any money . . . , at a rate exceeding [25% per annum]."

§5-511 of the New York General Obligations Law provides that contracts "prescribed in §5-501," the *civil* usury statute, shall be void, but there is "no specific statutory authority for voiding a loan that violates the criminal usury statute." *Brodie v. Schmutz (In re Venture Mort. Fund, L.P.)*, 282 F.3d 185, 190 FN 4 (2nd Cir., 2002).

Finally, and importantly, §5-521 of the New York General Obligations Law provides that a corporation may not assert the defense of civil usury as defined in §5-501 *et seq.*, but that it may assert a defense of criminal usury, as defined in §190.40 of the New York Penal Law. Thus, it is essential to emphasize which defense Defendant, a corporation, can avail itself of—criminal usury pursuant to N.Y. Pen. L. §190.40 vis-à-vis N.Y. G.O.L. §5-521, and not civil usury pursuant to N.Y. G.O.L. §§5-511 and 5-501.

II. BASIC PRINCIPLES OF NEW YORK USURY LAW

It is well-established that "[u]sury is an affirmative defense, and a heavy burden rests upon the party seeking to impeach a transaction based upon usury." *Union Capital LLC v. Vape Holdings, Inc.*, 2017 U.S. Dist. LEXIS 60445 *10-11 (S.D.N.Y. 2017). There is a strong presumption against the finding of usurious intent when the loan is not usurious on its face. See, *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 77 (2d Cir. 1980); *Roswell Capital Partners LLC v. Alternative Constr. Techs.*, 2009 U.S. Dist. LEXIS 7690 (S.D.N.Y. 2009); *LG Capital Funding, LLC v. Sanomedics Int'l Holdings, Inc.*, 2015 Misc. LEXIS 4294 (N.Y. Sup., Kings Co.). "Defendant [must] establish usury by clear and convincing evidence." *Sabella v. Scantek Med., Inc.*, 2009 U.S. Dist. LEXIS 88170 *45 (S.D.N.Y. 2009). "Criminal usury requires proof that the lender (1) knowingly charged, took or received (2) annual interest exceeding 25% (3) on a loan or forbearance." *Id*. "For a loan to be

criminally usurious under that section, the alleged usurer must 'knowingly' charge interest in excess of the legal rate." *Mallis v. Bankers Trust Co.*, 615 F.2d 68, 77 (2d Cir. 1980).

To determine whether a charge or contingency constitutes effective, or "hidden" interest, a court should "look not to its form but to its substance or true character" *Blue Wolf Capital Fund II, L.P. v. Am. Stevedoring, Inc.*, 105 A.D. 178, 183 (1st Dep't 2013). "[A] borrower may pay reasonable expenses attendant on a loan without rendering the loan usurious," and "[a]ttorneys' fees associated with the loan can constitute reasonable expenses." *Coastal Inv. Partners, LLC v. DSG Global, Inc.*, 2018 U.S. Dist. LEXIS 96078 *17 (S.D.N.Y. 2018). "However, when fee payments do not actually reimburse lenders for expenses associated with the loan . . . then such fee expenses can be considered in determining the interest rate." *Id*. Finally, if a charge is "based upon a contingency within the control of the debtor . . . and the debtor could [avoid] the imposition of such charges" it is not to be considered interest. *Salamone, P.C. v. Russo*, 129 A.D.3d 879 (2d Dep't 2015)

III. APPELLANT'S POINTS ADDRESSED

A. APPELLANT, A CORPORATION, IS SPECIFICALLY AND STATUTORILY PRECLUDED FROM AVAILING ITSELF OF GEN. OBLIG. LAW §5-501 et seq., AND THEREFORE, THE INTEREST RATE OF THE NOTE, IF FOUND TO BE USURIOUS, SHOULD BE ADJUSTED, RATHER THAN THE NOTE VOIDED.

Before presenting its arguments that the Note charges a usurious interest rate, Appellant starts at the end, arguing that "two statutory provisions dealing with the same subject matter should be construed *in pari materia*," such that the transaction should be voided entirely. (DKT 42, p. 19). Put simply, application of statutory interpretational principles shows that the opposite is true. When the legislature makes a clear delineation between the two defenses by creating separate statutes, one of which specifically references the other, and restricting the application of one but not the other, the two must be construed separately.

As stated, there are two types of usury defenses. Civil usury is governed by §5-501 et. seq. of the N.Y. Gen. Obl. L. §5-501 of the N.Y. Gen. Obl. L. provides that "no person . . . shall . . . charge, take or receive any money . . . as interest on the loan of any money . . . at a rate exceeding [16% per annum]." §5-511 provides that contracts "prescribed in §5-501, shall be void," and §5-521(a) provides that "[n]o corporation shall hereafter interpose the defense of usury in any action," but §5-521(c) of the N.Y. Gen. Obl. L. provides that a corporation may "interpose[] a defense of criminal usury as described in section 190.40 of the penal law." §190.40

of the New York Penal Law is the criminal usury statute, which sets the impermissible rate at 25% and makes no mention of voiding the agreement.

Despite some confusion in some New York courts due to the interplay between the civil and criminal usury statutes, this court, as well as state and district courts have acknowledged that "there is no specific statutory authority for voiding a loan that violates the criminal usury statute." *Brodie v. Schmutz (In re Venture Mort. Fund, L.P.)*, 282 F.3d 185, FN4 (2nd Cir., 2002); *Am. Equities Grp., Inc. v. Avaha Dairy Prods. Corp.*, 2007 U.S. Dist. LEXIS 93511 (S.D.N.Y. 2007); *Funding Grp., Inc. v. Water Chef, Inc.*, 19 Misc. 3d 483 (Sup. Ct., N.Y. County 2008).

Indeed, this Court listed several factors leading to the confusion in *Brodie v. Schmutz (In re Venture Mort. Fund, L.P.)*, 282 F.3d 185 (2d Cir. 2002). First, the Court acknowledged a fatal flaw in *Szerdahelyi v. Harris*, 67 N.Y.2d 42 (1986), the case upon which most courts have based their decisions to void a criminally usurious loan. Namely, that the loan in *Szerdahelyi* violated only the civil usury statute, and thus reliance on §5-511 to void it was appropriate. *In re Venture*, 282 F.3d at 190. Second, it acknowledged that "New York's usury laws are harsh, and courts have been reluctant to extend them beyond cases that fall squarely under the statutes." *Id.* at 189. Third, it recognized various carve-outs created by the legislature to avoid the harsh consequences of voiding a loan when such a drastic remedy is unwarranted. *Id.* at 189. Finally, it acknowledged that there is "no specific statutory authority for

voiding a loan that violates the criminal usury statute without violating the civil usury statute." *Id.*, at FN 4.

The same conclusion can be reached independently through the application of two basic principles of statutory interpretation.

First, Gen. Obl. L. §5-511 states that loans found to violate "section 5-501, shall be void." This specific reference to §5-501 cannot be ignored. §5-501 prescribes loans in excess of 16% and §5-521 prohibits corporations from asserting the defense pursuant to §5-501. The principle of *espressio unius est exsclusio alterius* dictates that the specific inclusion of one implies the specific exclusion of another. Thus, by including the reference to §5-501 but not §190.40, it should be assumed that the legislature did not intend for §5-511 to apply to §190.40. The legislature could have included a reference to §190.40, or excluded the specific reference to §5-501 and voided usurious loans generally. It did not, and the Circuit should interpret the statute as such.

Second, the Circuit could apply the principle of *in pari materia*, which, despite Appellant's incorrect application, dictates that in the event of an ambiguity, the Court should look to the surrounding statutes. Proper application of the doctrine counters any suggestion that the omission of a reference to the criminal usury statute in §5-511 was unintentional. §5-521(1) prohibits corporations from asserting "the defense of usury in any action." §5-521(3) states that this limitation does not apply

to a "defense of criminal usury as described §190.40 of the penal law." Comparing these two provisions, as well as the sequence of statutes from §5-501 to §5-521, with their specific references and carve-outs related to the civil and criminal statutes, shows that when the legislature referred to usury, generally, it was referring to usury within §5-501, because each allusion to the criminal usury statute contained a reference to §190.40. Thus, the legislature clearly contemplated the interplay between the defenses of civil and criminal usury, and intended for them to be different, not only in name and interest rate, but also in rights and remedies throughout the statutory framework.

Despite the significant authority stating that there is no statutory ground for voiding a criminally usurious loan, and the clear legislative intent for the statutes to be distinct, Appellant argues that the holding in *Fred Schutzman Co. v. Park Slope Advanced Medical, PLLC*, 128 A.D.3d 1007 (2d Dep't 2015) should apply to void the Note. The *Schutzman* holding, however, is based on a circular finding that is unsupported by case law and contrary to the basic aforementioned principles. Citing no authority and failing even to acknowledge the numerous matters which stated that §5-511 does not provide grounds to void a criminally usurious loan, the *Schutzman* Court puzzlingly stated that "even though the defendants in this case would have been precluded from interposing the defense of [civil] usury . . . the note imposed an annual interest rate in excess of 16%, and since that rate was more than the rate

prescribed in Gen Ob. L. §5-501, the note was void pursuant to Gen. Ob. L. §5-511." *Id.* at 1008. In other words, the Court found that even though the defendant was precluded from relying on the defense, the defense applies. It is logically irreconcilable, and thus, the Circuit should follow the contrary authority supported by law and with reason.

Finally, a number of lower courts have recognized that the consequences of voiding an agreement, prohibiting equitable remedies, and allowing the borrower to simply "walk away from the agreement" are disproportionally harsh. In response, rather than voiding the transactions in their entirety, the courts have adopted a "better approach . . . [of] void[ing] only the usurious interest rate." *Carlone v. Lion & The Bull Films, Inc.*, 861 F. Supp. 2d 312, 323 (S.D.N.Y. 2012). See also, *Prof'l Merch. Advance Capital, LLC v. C Care Servs., LLC*, 2015 U.S. Dist. LEXIS 92035 FN 4 (S.D.N.Y. 2015) ("If the Court were to find that the Agreement contravened New York's criminal usury law, the Court would nevertheless not void the agreement *ab initio*, but would rather revise the interest obligation to require a non-usurious rate.")

Most relevant, in *LG Capital Funding, LLC v. Vapor Grp, Inc.*, 2018 U.S. Dist. LEXIS 108385 (S.D.N.Y. 2018), the Hon. Nina Gershon of the Eastern District Court of New York ruled on partial summary judgment that the Court would not void the transaction if it were deemed to violate the criminal usury law. The Court first "noted the 'harsh' consequences to a lender of voiding a usurious loan

transaction: 'the borrower is relieved of all further payment—not only interest but also outstanding principal ... [i]n effect, the borrower can simply keep the borrowed funds and walk away from the agreement.'" *Id.*, at 10. Further, it acknowledged that recently, "courts have declined to void usurious loans, preferring the alternatives offered by the Second Circuit." *Id*. Based on the trends of law in the Circuit, Judge Gershon "[found] no reason not to abide by the terms of an agreement entered into by two sophisticated parties, especially when the alternative—to void [the Note]—would cause precisely the kind of 'harsh' circumstances against which the *In re Ventures* Court cautioned" and held that "[s]hould the interest rate be found usurious, the rate [would] be revised to a non-usurious rate." *Id*, at 11.

Identical circumstances exist here. Appellant is a sophisticated, publicly traded entity that issued the Note with full knowledge of its terms. It is not a victim of predatory lending, but is merely seeking a windfall. On the other hand, Appellee complied with all of the terms of the Note and has been told by numerous courts that the terms are not usurious. Clearly here, a balance of the equities shows that if any party has unclean hands, it is Appellant.

Therefore, whether agreeing with the majority of the lower courts' rationale regarding the plain meaning of the statute, or applying canons of statutory interpretation, §5-511 does not apply to a corporation asserting the defense of criminal usury and does not provide grounds for voiding a loan in violation thereof.

B. A BORROWER MAY PAY REASONABLE EXPENSES ATTENDANT WITH THE LOAN WITHOUT RENDERING THE LOAN USURIOUS.

Appellant's next argument is that Appellee failed to present sufficient evidence showing that the attorneys' fees paid by Appellant in conjunction with the issuance of the Note were "legitimate and reasonable," and as such, should be considered hidden interest that, when paired with prepayment amounts and the 35% discount in the conversion right, brings the effective interest rate above 25%. (DKT 42, p. 26). There are three fatal flaws in this argument. First, it well settled that reasonable fees paid by the borrower in conjunction with the issuance of a loan are not included in a usury determination. Second, it is equally well settled that in proving the affirmative defense of criminal usury, it is the defendant's burden to prove each element. Third, even if Appellant is correct, without being paired with Appellant's kitchen-sink of "hidden interest" terms, the attorneys' fees would not bring the effective interest to an impermissible rate.

Once again, "[u]sury is an affirmative defense, and a heavy burden rests upon the party seeking to impeach a transaction based upon usury." *Union Capital LLC v. Vape Holdings, Inc.*, 2017 U.S. Dist. LEXIS 60445 *10-11 (S.D.N.Y. 2017). "[U]sury must be proved by clear evidence as to all of its elements and will not be presumed." *Freitas v. Geddes S&L Ass'n*, 63 N.Y.2d 254, 261 (1984) (emphasis added); See also, *Concord Fin. Corp. v. Wing Fook*, 1997 U.S. Dist. LEXIS 9643

(S.D.N.Y. 1997); *Oliveto Holdings, Inc. v. Rattenni*, 110 A.D. 3d 969, 972 (2d Dep't 2013)("A borrower bears the burden of proving each element of usury by clear and convincing evidence"). "[A] borrower may pay reasonable expenses attendant on a loan without rendering the loan usurious," and "[a]ttorneys' fees associated with the loan can constitute reasonable expenses." *Coastal Inv. Partners, LLC v. DSG Global, Inc.*, 2018 U.S. Dist. LEXIS 96078 *17 (S.D.N.Y. 2018). "However, when fee payments do not actually reimburse lenders for expenses associated with the loan . . . then such fee expenses can be considered in determining the interest rate." *Id.* The burden of showing that expenses paid were either unreasonable or did not actually reimburse the lender falls to the party asserting the affirmative defense. See eg., *Lloyd Capital Corp. v. Pat Henchar, Inc.* 80 N.Y.2d 124 (1992)("defendants made no showing that the fees charged in this case were a pretext for higher interest.") Whether the charge constitutes "hidden" interest is undoubtedly an element of a usury defense; and thus, it is Appellant's burden to prove it.

In the face of the aforementioned and the District Court's proper finding that "[Appellant] adduce[d] no evidence that the $2,000 fee did not legitimately reimburse [Appellee's] attorney's fees" [SPA 19], Appellant seeks to shift the burden of proof of Appellant's affirmative defense to Appellee, stating "[Appellee] did not present any evidence showing that the $2,000.00 payable to its attorneys was

legitimate and reasonable." (DKT 42, p. 26). Put simply, that is not the law, and the argument fails.

Looking to the evidence on the record makes Appellant's burden even more difficult, if not impossible, to meet. In a Disbursement Authorization issued by Appellant in conjunction with the issuance of the Note, Appellant directed Appellee to wire $2,000.00 to New Venture Attorneys, P.C. (JA-401). The evidence on the record shows that the $2,000.00 was wired directly to New Venture Attorneys in accordance with the Disbursement Authorization. (JA-404). Accordingly, Appellant cannot argue that "the fee payment did not actually reimburse" Appellee or that the fees "were a pretext for higher interest," as it went directly to the attorneys and was not paid to Appellee as interest.

Last, if the Circuit were to determine that the other terms that Appellant argues constitute interest are not interest, the question of whether the $2,000.00 in fees constitutes interest is moot. As Appellant states, the $2,000.00 in attorneys' fees equals 6% of the Note's value. If it were to be considered interest, an increase by 6% to the Note's stated interest rate of 8% is well below the 25% prescribed rate.

C. THE CONVERSION DISCOUNT CANNOT BE CONSIDERED INTEREST BECAUSE AT THE TIME OF CONTRACTING, IT IS TOO UNCERTAIN AND AT THE TIME OF EXERCISE, THE TRANSACTION IS NO LONGER SUBJECT TO A USURY DEFENSE.

Appellant's next argument is one that has been made to over a dozen courts below, and is now being made in several matters in this circuit – that the 35% discount at which Appellee was entitled to receive stock upon election constitutes hidden interest. It is difficult at this point to provide any analysis that has not already been provided by numerous courts below, but a summary of the development of the line of case law is provided instead.

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

First, the New York Supreme Court, in *LG Capital Funding, LLC v. Sanomedics Int'l. Holdings, Inc.*, 2015 N.Y. Misc. 4294 (Sup. Ct. 2015), analyzed a usury defense when plaintiff brought an action against a corporation based upon similar convertible notes. The *Sanomedics* notes provided for a conversion price equal to 55% of the average of the lowest three trading prices for the ten prior trading days, only marginally different terms from the Note's terms herein. Defendant

argued that the notes were usurious and unenforceable based on this conversion provision. The court first found that the notes were not usurious on their faces because they provided for 8% and 10% per annum interest rates. *Id*. at 29.

Next, the court stated:

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

Reaching a similar conclusion, the Hon. Richard J. Sullivan, then of the Southern District Court of New York, applied the same established usury principals to a similar scenario as here in *Union Capital, LLC v. Vape Holdings Inc.*, 2017 U.S. Dist. LEXIS 60445 (S.D.N.Y. 2017). The convertible note in *Union* provided for a principal amount due one year from issuance, 8% interest thereupon, 24% interest in the event of default, and a conversion right. It also stated that "[t]he Holder of this Note is entitled, at any time, to convert all or any amount of the principal face amount of this Note then outstanding into shares of the Company's common stock . . . at a price . . . for each share equal to 58% of the **lowest trading price** of the

Common Stock . . . for the thirteen prior trading days . . . ." *Union Capital, LLC v. Vape Holdings Inc.*, 2017 U.S. Dist. LEXIS 60445 *2 (S.D.N.Y. 2017). Thus, the only substantive differences in the conversion rights to those herein are the discount and the "look-back" provision. With regard to this provision, Judge Sullivan stated:

> [Defendant] argues that, in considering the effective interest rate, the Court should also include the potential profit [Plaintiff] might reap by converting shares at a 42% discount. The Court disagrees. [Plaintiff] simply held an option to convert shares, and it could have elected to obtain repayment in cash, which would clearly not have been usurious. Moreover, even if [Plaintiff] chose to convert the loan principal into shares, any potential profit [Plaintiff] might realize would still be dependent on the market price at the time of conversion and so, therefore, would be too uncertain to incorporate into an interest rate calculation. Furthermore, even if the discount rate could be considered, a usury defense could no longer be applied against the loan once the Note principal was converted into equity in [Defendant]. Accordingly, [Defendant] cannot meet its heavy burden in impeaching the transaction for usury.
>
> *Id*, at 12-13 (internal citations omitted).

Similar analysis was applied by the district court in *Beaufort Capital Partners, LLC v. Oxysure Sys.*, 2017 U.S. Dist. LEXIS 32335 (S.D.N.Y. 2017). The notes at issue in *Beaufort* provided that "'at any time after the Maturity Date . . . this Note, including interest and principal, shall be convertible into shares at the higher of (a) $.0004; or (b) the amount that is a 30% discount' from the average closing price." *Id*, at*6 (S.D.N.Y. 2017). Like Appellant, "Oxysure argue(d) . . . that a 30% discount in the equity conversion effectively increases the interest rate on the notes to a level that is usurious." *Id*. at 6-7. The Hon. J. Paul Oetken first found that because the

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

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

Following the decisions in *Sanomedics, Union,* and *Beaufort*, the district court below and numerous other district court decisions have agreed with and added to these principals. See SPA-21 (citing *Union* for the proposition that upon conversion, a usury defense would no longer apply.); *LG Capital Funding, LLC v. Aim Exploration, Inc.*, 2018 U.S. Dist. LEXIS 147411 *10 (S.D.N.Y. 2018) ("While 'the initial transaction took the form of a loan, upon conversion to equity, the loans likely have the character of an equity investment, and are thus no longer vulnerable to a usury defense."); *LG Capital Funding, LLC v. 5Barz International, Inc.*, 307 F. Supp. 3d 84, 98 (E.D.N.Y. 2018) ("The weight of authority indicates that once the holder of a convertible note exercises conversion rights, the converted portion of the loan takes on the character of equity, not debt, and is thus no longer susceptible to a usury defense.").

Having seen the same argument rejected several times, defendant corporations pivoted to arguing, as Appellant seems to here, that the conversion right is calculable as interest at the time that note is issued, rather than once the nature of the transaction shifts to an investment. The district court addressed and rejected this argument on multiple occasions, based on both the uncertainty of profits and the uncertainty of exercisability. With regard to the uncertainty, the Hon. Edgardo Ramos in *EMA Fin., LLC v. AIM Exploration, Inc.*, 2019 U.S. Dist. LEXIS 26141 (S.D.N.Y 2019) stated:

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

Below, the Hon. Victor Marrero reached the same conclusion, but rather than focusing solely on profits from the conversion, did so focusing on the uncertainty of

Plaintiff's willingness or ability to exercise the right altogether. Relying on the long-standing principal that "a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest," *Phlo v. Stevens*, 2001 U.S. Dist. LEXIS 17490 *13 (S.D.N.Y. 2001), Judge Marrero recognized that "[t]he conversion right was simply too uncertain at the time of contracting." SPA-22. The court acknowledged that plaintiff "could have elected to obtain repayment in cash, which would clearly not have been usurious," and that "Defendant could become delinquent in its filings, become delisted, experience sudden decreases in its stock price, experience no demand for its stock, or simply cancel the reserve or refuse a conversion." *Id*. Thus, like in *Phlo*, "it was not clear than any effective interest rate in excess of 25% would ever have to be paid." *Phlo v. Stevens*, 2001 U.S. Dist. LEXIS 17490 *13 (S.D.N.Y. 2001).

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

Appellant's argument is self-conflicting. It places heavy emphasis on the fact that "the time to judge whether a loan or note is usurious is at the time the loan is made," (DKT 42, p. 28), yet the conversion right cannot be exercised, or "taken," at the time of contracting by the very terms of the Note. Cavalierly, Appellant states "[m]ere supposition that the conversion right could become worthless later is irrelevant to the usurious nature of the loan subject to the conversion rights on the date of execution." (DKT 42, p. 28). This unsupported contention is Appellant's opinion, not law. While the tone mirrors what courts in this Circuit have stated, the substance is the opposite, as numerous District Courts have stated "a loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest." *Phlo v. Stevens*, 2001 U.S. Dist. LEXIS 17490 *13 (S.D.N.Y. 2001); *Adar Bays, LLC v. Aim Exploration, Inc.*, 285 F. Supp. 3d 698, 702 (S.D.N.Y. 2018); *EMA Fin. LLC v. Joey New York, Inc.*, 2019 U.S. Dist. LEXIS 161454 (S.D.N.Y. 2019); *EMA Fin., LLC v. AIM Exploration, Inc.*, 2019 U.S. Dist. LEXIS 26141 (S.D.N.Y 2019); *LG Capital Funding v. PositiveID Corp.*, 2019 U.S. Dist. LEXIS 126991 (E.D.N.Y. 2019)(arguments presented by the same counsel as counsel herein).

It cannot be understated that despite Appellant's insistence that the discount contained in the conversion right is guaranteed to such that it warrants treatment as

being charged at the time of contracting, Appellant admits brazenly that it terminated its transfer agent "to avoid an election for conversion to stock." (DKT 42, p. 14)

Also contained in this section are two arguments made in passing that should be addressed briefly. More specifically, Appellant argues that amounts charged for prepayment of the Note and amounts charged following default should also be considered in a usury determination. (DKT 42, p. 30)

Both can be addressed with the application of an established principle in usury law raised by Appellant itself – namely, that in order for a charge to be considered interest, it must be a contingency in the exclusive control of the lender. In *Bryan L. Salamone, P.C. v. Russo*, 129 A.D.3d 879 (2d Dep't 2015), the instrument at issue charged 18% interest upon default. The court determined that "the 18% annual interest rate . . . was not usurious because it involved interest to be paid based upon a contingency within the control of the debtor – in this case, default in the payment of an agreed-upon obligation – and the debtor could have avoided the imposition of such charges simply by paying promptly." *Id*. at 881; see also *Kraus v. Mendelsohn*, 97 A.D.3d 641 (2nd Dep't 2012); *Emigrant Mtge. Co. v. Markland*, 37 Misc. 3d 1230(A) (2012). Following *Salamone*, the Eastern District Court of New York stated "a payment may not be considered usurious where . . . said payment is 'based upon a contingency within the control of the debtor.'" *KBM World Wide, Inc. v. Hangover Joe's Holding Corp.*, 2017 U.S. Dist. LEXIS 15003 *10 (E.D.N.Y. 2017).

Accordingly, because Appellant could avoid either charge, by electing not to prepay the Note and by complying with the Note's terms such that it avoids an event of default, they cannot be considered in a usury determination.

With regard to whether default interest should be considered, Appellant points to *Madden v. Midland Funding, LLC*, 237 F. Supp. 3d 130 (S.D.N.Y.) to note that there is "a conflict among the district courts" and asks that this Court resolve it. It should be noted that the Court need not resolve this question because, like the attorneys' fees above, unless other elements of the Note are determined to be hidden interest, the default interest alone is below the 25% usury limit.

If the Court does wish to resolve this question, it should find that amounts charged following a default should not be included in a usury determination as the holding of *Madden* is both wrong and inapplicable here. First, as indicated above, *Madden* failed to consider that a default is a contingency within the exclusive control of the debtor.

Second, *Madden* has faced criticism for the great lengths to which the Court went to distinguish dozens of state and federal matters to reach the conclusion that the presiding Judge "believe[d] that the New York Court of Appeals . . . would hold that the criminal usury cap limits interest charged to 25% annually, even for defaulted debts." The Hon. Sterling Johnson of the Eastern District Court of New York stated "this Court does not find the *Madden* analysis so convincing as to

override the overwhelming authority to the contrary." *LG Capital Funding, LLC v. One World Holdings, LLC*, 2018 U.S. Dist. LEXIS 107369 *34 (E.D.N.Y. June 22, 2018).

Last, the procedural and factual postures of *Madden* are markedly different than the posture herein. *Madden* unlike the present matter, is an archetypal scenario that usury laws were intended to prevent. Plaintiff, an individual, was charged a variable periodic interest rate amounting to 32.24% by a credit card company. Ms. Madden filed a complaint in which she attempted to assert a private cause of action based on New York's criminal and civil usury statutes. Id. at *4. The Hon. Cathy Seibel ultimately granted the creditor's motion for summary judgment as to Plaintiff's usury claims because "criminal usury law does not provide a private right of action." *Id.* at 147. However, Judge Seibel then went on to find that amounts charged following a default in excess of 25% can be considered interest "as a predicate for Plaintiff's Fair Debt Collection Practices Act claims." *Id.*

Thus, because *Madden* created the rift in a well-established principle, the logic and applicability of the *Madden* holding are dubious, at best, the Circuit should find that amounts charged after default are not to be included in a usury determination.

D. THE SHARE RESERVE CANNOT BE CONSIDERED INTEREST BECAUSE IT REMAINS IN APPELLANT'S POSSESSION UNTIL AND ONLY IF APPELLEE EXERCISES ITS CONVERSION RIGHT, AT WHICH POINT THE TRANSACTION IS NO LONGER SUBJECT TO A USURY DEFENSE.

Appellant's next argument is a more-tenuous iteration of its prior argument. Appellant attempts to characterize a share reserve, meant to effectuate conversions discussed in the section above, as charged interest for the purposes of a usury determination.

Section 12 of the Note states:

> The Company shall issue irrevocable transfer agent instructions reserving 278,000 shares of its Common Stock for conversions under this Note (the "Share Reserve"). Upon full conversion of this Note, any shares remaining in the Share Reserve shall be cancelled. . . The company should at all times reserve a minimum of three times the amount of shares required if the note would be fully converted.

(JA-38)

Appellant's argument fails for numerous reasons. First, the shares are placed in the control of Appellant's own agent at the time of contracting, so Appellant remains in legal possession of them. Second, shares would only be delivered to Appellee if it exercises its conversion right, a speculative future event not to be considered in a usury determination. Third, if the Note is not converted or shares remain after the Note is fully converted, the reserve is cancelled and the shares are returned to Appellant. Fourth, Appellant's argument is premised on Gen. Obl. L. §5-

511, a statute applicable only to the defense of civil usury and unavailable to a corporation.

Appellant takes umbrage with the fact that the District Court "relied on the notion that a corporation cannot invoke the civil usury statute as a defense," calling it "irrelevant to [its] analysis." (DKT 42, p. 31) Then, Appellant cites the civil usury statute as the entire grounds for its argument. (DKT 42, p. 32). Surely, it is relevant.

Next, Appellant claims that the District Court "failed to conduct any independent analysis of the legal and economic impact of the share reservation on GeneSYS" because the court "quoted another district court opinion." (DKT 42, p. 31). The District Court stated:

> [Defendant's] argument does not hold. Chiefly, §5-511 is the *civil* usury statute, which 'cannot be asserted by a corporation' such as [Defendant]. In any event, [Defendant] is not giving up the shares in reserve. They remain in control of [Defendant's] agent while [Plaintiff] has the option to convert the shares, and are returned to [Defendant] if [Plaintiff] does not exercise its option. As a court found when evaluating a similar Note, 'the reservation of shares was not an independent payment to [Plaintiff], but merely a mechanism by which to effectuate the share conversion as envisioned by the Note and the SPA. Since the share conversion feature does not render the agreement usurious, neither does the reservation of shares provision' (SPA 22-23)

Thus, while perhaps not as sympathetic to the "economic impact" of the agreed-upon contract on Appellant as Appellant would like, the District Court's logic is sound and sufficient. Appellant's reliance on §5-511 is misplaced and the share reserve is not an independent payment to Appellee.

CONCLUSION

For the foregoing reasons, Appellee respectfully requests that the Circuit affirm the District Court's judgment in its entirety.

Dated: New York, New York
October 23, 2019

Respectfully Submitted,

Garson, Ségal,
Steinmetz, Fladgate LLP
Attorneys for Adar Bays, LLC,
Plaintiff-Appellee

By: /s/ Kevin Kehrli
Kevin Kehrli
164 West 25th Street
Suite 11R
New York, NY 10001
Telephone: (212) 380-3623
Facsimile: (347) 537-4540
Email: KK@GS2Law.com

CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because:

This brief contains 7995 words, inclusive of headings.

2. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(6) because:

This brief contains proportionally-spaced, size 14, Times New Roman Font.