EXHIBIT A

No. 18-3023-cv

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ADAR BAYS, LLC.,
Plaintiff/Appellee,
v.
GENESYS ID INC., FKA as RX Sales, Inc.,
Defendant/Appellant.

BRIEF OF AMICUS CURIAE CARDINAL ENERGY GROUP, INC., IN SUPPORT OF DEFENDANT-APPELLANT

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RULE 26.1 CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1, Amicus Cardinal Energy Group, Inc. discloses and certifies that it is a publicly held corporation, that no publicly held corporation owns 10% or more of its stock, and that it has no affiliates and/or subsidiaries which are publicly held.

Rule 29(a)(4)(D) STATEMENT OF IDENTITY OF AMICUS CURIAE

Amicus curiae, Cardinal Energy Group, Inc., ("Cardinal") has a case currently on appeal in this Circuit that deals with the identical issues in this case. See Case No. 19-22. Because a precedential ruling by this Court on the issues presented herein would directly affect the outcome of Cardinal's appeal, Cardinal's interests are directly affected by this case, and considers its outcome to be of grave importance.[1]

ISSUES PRESENTED FOR REVIEW

A. Under a Promissory Note, the Lender has the Sole Discretion to Take Repayment In Stock Instead of Cash. However, if the Lender Chooses to Take Repayment in stock, the borrower must pay $154 in stock for every $100 of debt it owes. Is the Excess Value Conferred via Payment in Stock Considered Interest?

B. When a loan contract is repaid with stock, is the loan repaid, or is the loan contract transformed into an equity investment?

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[1] Pursuant to F.R.A.P. 29(a)(4)(E): This brief was not authored, in whole or in part, by counsel to any party in this case. However, it must be noted that Mark Basile of the Basile Law Firm (1) represented Appellant Genesys at the district court level, and (2) originally filed this appeal for Genesys, but was thereafter replaced by substitute counsel on 12/26/2018. See ECF DKT #36. Mark Basile is also a GeneSYS shareholder.

No party to this case, nor any party's counsel contributed funds for the production of this brief. No other person contributed funds intended for the preparation or submission of this brief.

STATEMENT OF THE CASE

The Agreement in this case, referred to as a "convertible promissory note," is constituted by a Promissory Note and Share Purchase Agreement: That is, it is a loan that may be repaid in cash or in stock. This repayment feature is the defining characteristic of the "convertible" note: it reserves to the *lender* the exclusive right, if it wishes, to take repayment of the loan by "converting" the debt into shares of the borrower's stock (the borrower is always a publicly traded company).

What makes the Note in this case unique is that, instead of specifying conversion at a fixed stock price, the Note specifies conversion at a fixed discount rate to the market price of the stock.

In reference to conversion-discounts of this nature, the U.S. Securities and Exchange Commission actually gives a warning to borrowers:

> 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."

SEC Fast Answers- Convertible Securities, www.sec.gov/fastanswers/answers convertibleshtm.html, last accessed on Jan. 29, 2018.

The sole focus of Amicus is to address the conversion discount of the convertible promissory note and the related case law addressing convertible notes. The background and procedural history of this case is set forth in the Appellant's opening brief, the familiarity of which is presumed.

I. The Promissory Note

This case concerns a "convertible" promissory note issued by borrower GeneSYS ID, Inc. ("GeneSYS") to lender Adar Bays, LLC. ("AB"). The Promissory Note in this case ("Note") is for $35,000, with a stated 8% annual interest rate, and a maturity date of May 24, 2017. Note at 1 (A284). Paragraph 4(a) of the note addresses **conversion,** providing in part:

> **4. (a)** The Holder of this Note is entitled, at its option, at any time, after full cash payment for the shares convertible hereunder, **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 "Common Stock") at a price ("Conversion Price") for each share of Common Stock equal to 65% of the **lowest trading price** of the Common Stock as reported on the National Quotations Bureau OTCQB exchange which the Company's shares are traded or any exchange upon which the Common Stock may be traded in the future ("Exchange"), for the ***twenty*** prior trading days including the day on which the Notice of Conversion is received . . . .

Note at 4(a), (A 285).

As noted above, "conversion" simply refers to the process by which the lender takes repayment of the loan in company stock (instead of waiting for the borrower

to repay the loan in cash on the maturity date). In this regard, the Note provides that AB has the choice, after 180 days[2] from the date of the Note, to "convert all or any amount" of the debt into shares of GeneSYS company stock as repayment for the loan.

Importantly, if AB chooses to take repayment in stock, the repayment rate is not dollar for dollar: The lender gets the stock at a price "equal to 65%" of the baseline "fair market value"[3] established in the contract, (or, put differently, a 35% discount to the baseline value). Accordingly, for every $100 of debt, borrower GeneSYS must repay lender AB with $154 worth of stock, which constitutes a 53.85% increase (or interest rate), in addition to the stated 8% interest.[4] On an annualized basis, the 53.85% interest rate would translate into an APR of between 108.58% (conversion on day 181) to 53.85% (conversion on day 365).

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[2] Pursuant to Rule 144, the shares would still be restricted prior to day 180. 17 C.F.R. § 230.144(d)(3)(ii).

[3] The baseline "fair market value" for establishing share price under the Note (lowest trading price from the previous 20 trading days) is substantially lower (and more favorable for the lender) than the standard used by the IRS, which defines "fair market value" as "the mean between the highest and lowest quoted selling prices on the valuation date," 26 C.F.R. § 20.2031-2. (Valuation date is the date of the transfer.)

[4] This is calculated as $\frac{100}{65}$=1.5385, or 1.54. The 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 seller must give two dollars for every one dollar it borrowed, which translates to a 100% interest rate.

A. The Value of the Stock Received is Always a Minimum of 53.85% in Excess of the Amount of Debt, Regardless of the Stock Price

Because the Note provides for conversion at a fixed 35% discount rate 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.

For example, from the face of the Note one may calculate that, if AB chose to convert $5000 worth of debt, that amount of debt would be repaid with stock with a minimum fair market value of $7,692 ($5000 x 1.5385 = 7,692). Because the discount rate is a percentage, not a price, the amount of return is completely insulated from price fluctuations (as noted by the SEC in the quote above) even if AB *itself* causes the fluctuations. That is, if AB were to take $5000 of debt and "convert' it into stock on day 181, when the trading price of the stock was (for example) $1.00 per share, under the discount AB would receive 7,692 shares of stock (valued at $7,692), for a guaranteed gain of 54%.

If AB then carelessly flushed all of the shares into the market and drove down the price to $.80 per share, it would be of little concern to AB, because the next tranche of stock to be converted would be at 65% of the lower $.80 price, *i.e.*, they would receive 9615 shares—still worth $7,692— if they converted a second $5000 of debt. This could proceed in the same manner for every subsequent tranche of debt

AB chooses to convert. The lower the stock price goes, the more shares they receive for the same dollar amount converted in the next tranche.[5]

As it happens, this calculation is reproduced almost exactly in AB's November 28, 2016 Notice of Conversion, which shows:

Notice of Conversion

Date of Conversion	**November 28, 2016**		
Conversion Amount	**$5,000**		
Applicable Conversion Price:	**.011375**	**=**	**439,560 shares.**
Lowest Trading Price 11/22/16=	**.0175**		

Notice of Conv., R. at ECF DKT #40; *Appendix* A-42.

The Notice of Conversion shows that AB sought to convert $5,000 of GeneSYS debt (above shown as "Conversion Amount"). The "Applicable Conversion Price" is shown as .011375 per share. Per the terms of the Note, this price is calculated by taking 65% of the 20-day low price (shown as .0175 on 11/22/16) which renders an "applicable conversion price" of .011375. Using that discounted share price, $5,000 worth of debt is repaid with 439,560 shares of stock—but that stock, per the terms of the Note, has a *minimum* fair market value of $7,692.30. For every dollar GeneSYS owes, it must pay (approximately) $1.538 worth of stock. $5,000 x 1.538 = $7,692. Hence, the 35% conversion discount automatically gave AB an *extra* $1,692.30 worth of stock. Applied to the entire

[5] Hence the colloquialism of "toxic" or "death spiral" loans.

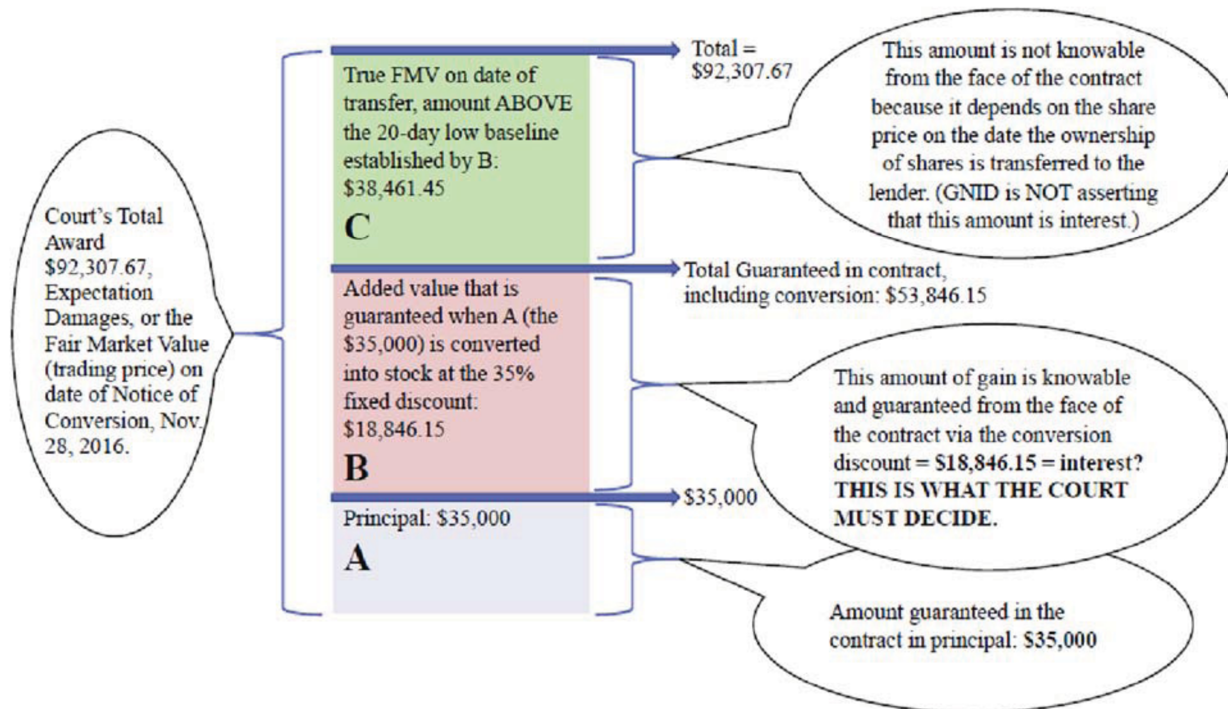
$35,000 debt, the approximate[6] equation would be thus: $35,000 x 1.5385 = $53,847.50. (Shown as **B** in Diagram 1 below.)

To add insult to usury, the market price on the date of conversion was well above the baseline fair market value, at .03 per share. Hence, on that date, 439,560 shares were worth $13,186.80, for a gain of 164%. If the entire debt were converted (which is how the district court calculated damages) AB would receive 3,076,922 shares (baseline value $53,846.15, shown as **B** in Diagram 1, below) multiplied by the .03 per share market price, for a total of $92,307.67 (shown as **C** in Diagram 1, below).

As noted elsewhere, GeneSYS failed to honor the Notice of Conversion and AB brought suit in the district court to enforce the Notice of Conversion and the Note. After the district court rejected GeneSYS's usury defense (for reasons discussed below) it awarded to AB expectation damages based on the Notice of Conversion, not just for the single $5,000 conversion, but for the entire $35,000 Note. The total expectation damages for the loan was awarded at $92,307.67, using the calculation explained above.

[6] Because of rounding of both the discount rate percentage and the share price, the numbers do not match up perfectly.

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



As noted above, although the "spread" between the 20-day low price (.0175) and the price on date of conversion (.03) may be enormous, ***that number*** (**C** in the diagram above) fluctuates based on daily trading price and cannot be known from the face of the Note. Because that number is legitimately an unknown, Amicus is **NOT** arguing for this number to be included in the interest calculation. Repayment in stock guarantees to the lender repayment of the principal (**A**) plus gains from the discount rate (**B**), and the gains imparted by **B** itself are usurious.

The extra value imparted by the discount can be easily calculated from the face of the contract, which is the extra $18,846.15 noted in **B** (giving $53,846.15 in stock to repay a $35,000 loan). The only amount that cannot be known in advance

is the actual trading price of the stock on the date of conversion; all we know from the contract is that the trading price on that date is almost by definition *higher* than the baseline ('20-day low') used to calculate the discount[7].

SUMMARY OF THE ARGUMENT

The district court cases analyzing convertible notes for usury follow a familiar pattern. In response to a Lender's suit to enforce a Note, Defendant asserts a usury defense based on the extra value conveyed via the conversion discount. The court, relying on *Union Capital, Adar Bays*, and the like[8], dismisses the usury claim on the ground that the value conveyed by discount rate is "too uncertain" to include as interest.

Then, in complete contradiction, the court, typically in the same Opinion, awards expectation damages to the lender – damages that somehow *always include gains from the conversion discount*. One must ask, if the gains from the conversion

[7] 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.

[8] *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).

discount rate are so uncertain, *why does the lender always get them*? If gains from the conversion discount are so uncertain, how can they also be deemed to be part of what the lender "reasonably anticipated from a transaction?" How can this be right?

In this case, the court's rejection of the conversion discount as interest is set forth on pages 20-22 of the Opinion (found in Appellant's Br., Appx. A). The errors in the court's analysis are noted below and discussed more fully 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". Slip Op. at 20.

The court's observation misses the point. The cases GeneSYS relies on are proffered to show that stock given in consideration for a loan is always assigned a value, which is considered part of the interest rate. The court does not explain why stock given as an up front payment should be valued any differently than stock given in repayment of the loan. This error is addressed in **Section A.2.b**.

Errors 2, 3, and **4**: The court relies on the passage, quoted below, from *Union Capital*. As shown below, 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 lender only had an "option" to receive the excessive interest rate is contrary to well established caselaw. This is discussed in **Section A.5.c.**

Error 3: Here, the *Union Capital* court is attempting to value the conversion discount based on lender's *profits*. That is, the profits lender might reap if and when it sold the stock it received as repayment of the loan. This method of valuation is contrary to law. The stock itself was the payment, 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 A.5**.

Error 4: This statement is attributed to *Beaufort Capital Partners*, *LLC*, *v. Oxysure Sys., Inc*., 2017 US Dist. LEXIS 32335, (SDNY 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 B**.

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

> As courts have noted, a myriad of circumstances could decrease the price of the stock, 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 5)]***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 6)].**

Slip Op. at 22.

Error 5: This statement is problematic because each listed impairment of the conversion right is an incident that puts the borrower *in breach of contract*. The claim that Lender's compensation is "uncertain" because the borrower might breach the contract is absurd. This is discussed in **Section A.5.b.**

Error 6: The citation to *Phlo Corp*. (S.D.N.Y. 2001) as analogous to this case is problematic because *Phlo* addressed a type of stock option, which is entirely different from a fixed conversion discount. Because the right to take a conversion discount is frequently referred to as an "option," the citation to *Phlo* raises a suspicion that either the mechanics of the conversion discount was misunderstood

or the law of option contracts was (wrongly) applied. This error is discussed in **Section A.4**

ARGUMENT

Answer to Issue A:

A. If the lender chooses to take repayment in stock, the borrower must pay $154 in stock for every $100 of debt it owes. The Excess Value Conferred via Payment in Stock Must be Considered Interest.

1. The Usury Statutes Contemplate that a Lender May Take Property as Interest on a Loan

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. It cannot be overemphasized that section 190.40 specifically recognizes 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 used as a form of loan repayment, the value of the property conveyed to the lender must be determined; if the value of the property to be conveyed under the contract is *expressly designated* to exceed the amount loaned, that excess value must be counted as interest.

2. Standard Property Valuation is Fair Market Value on the Date of Transfer

"Fair market value" is the benchmark 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). Income received 'in a form other than cash' is taxed at its fair market value at the time of its receipt. *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).

It is further undisputed that property received is valued on the date of transfer. *See* I.R.C. § 83(a); Treas. Reg. § 1.83-3(b); *Gudmundsson v. United States*, 634 F3d 212 (2d Cir. 2011); 26 U.S.C. § 2512(a) (providing that for gifts made in property, "the value thereof at the date of the gift shall be considered the amount of the gift.").

These valuation rules are in no way limited to tax cases. The same rules hold true in bankruptcy law, where courts hold that "the proper measure . . . 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 or some other valuation**." *Comm. of Unsecured Creditors of Interstate Cigar Co. v. Interstate Distribution, Inc. (In re Interstate Cigar Co.)*, 2003 U.S. Dist. LEXIS 21845, at *8-9 (E.D.N.Y. Nov. 24, 2003). *See also 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.").

New York courts use the same method of valuation, where the courts consistently hold that "the value of the consideration has to be determined at the time of the transfer . . . [s]ubsequent events do not alter the value that the consideration had at the time of the transfer." *Cheltoncort Co. v. Tax Appeals Tribunal*, 185 A.D.2d 49 (App. Div. 1992) (discussing 20 NYCRR 590.26)); *Forty Second St. Co. v. Tax Appeals Tribunal*, 219 A.D.2d 98, 100 (Sup. Ct. App. Div. 3rd Dept. 1996) (holding that "[t]he fair market value of the property is "immutably fixed" on the date of transfer. That value "is in no way contingent on indeterminate future events.").

a. The Value of Securities is Easily Determined : Market Price at the time of the Transfer

It is incontrovertible that 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).

The same holds with IRS rulings, damages calculations, and almost every other ruling that involves stock valuation. In general, "the value of stocks and bonds is the fair market value per share or bond on the applicable valuation date." 26 C.F.R. § 20.2031-2(a). "If there is a market for stocks or bonds, . . . the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond." 26 C.F.R. § 20.2031-2(b)(1); *Gillespie v. United States*, 23 F.3d 36, 39 (2d Cir. 1994). For damages, it is "fundamental that, where the breach involves the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages." *Sharma v. Skaarup Ship Mgmt. Corp.*, 916 F.2d 820, 825 (2d Cir. 1990); *see also Laurus Master Fund, Ltd. v. Valcom, Inc.*, 2002 U.S. Dist. LEXIS 4631(S.D.N.Y. Mar. 19, 2002) (observing that "the market price for publicly traded stocks . . . is generally considered to be ascertainable.").

b. New York Case Law Holds that the Value of Securities Given As Consideration for A Loan Is Interest

Given that stocks have "readily ascertainable" fair market value, it should be no surprise that when stock is given in consideration of a loan, the value of that stock is factored into the interest payment. *See 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%.") As evidenced by the facts in *Sabella*, this is true even where the exact value of the stocks is not immediately apparent. *See also Hillair Capital Invs.,L.P., v. Integrated Freight Corp*., 963 F. Supp. 2d 336 (SDNY 2013) (restricted stock also assigned value).

When stocks are conveyed using a dollar amount, their value is "unambiguous." This was the case in *American Equities Grp., LLC v. Livewire Ergrogenics, Inc*., 2018 LEXIS 184683 (SDNY Oct. 27, 2018), which also involved calculation of interest precipitated by a usury defense. As the court observed:

> The Note called for Plaintiff to be provided assets [(restricted stock)] worth $50,000 as consideration for the loan . . . [t]he monetary value of the Restricted Stock to be delivered pursuant to the Note is unambiguous, therefore the implied interest rate can be determined from the face of the Note.

Livewire, at *12-13. (holding that a loan with a 120% interest rate, where interest was paid in shares of company stock, was usurious on its face, but upholding the contract on other grounds). *See also Funding Group, Inc. v. Water Chef, Inc.*, 852 N.Y.S. 2d 736 (Sp.Ct. N.Y. County, 2008).

Likewise in this case now on appeal, the additional stock value AB gains through conversion is unambiguous and can be determined from the face of the Note. The fixed discount unambiguously ensures that for every 100 dollars of debt converted, AB will receive a minimum of $154 in stock. The only difference between this case and *Livewire/Sabella/Hillair* (*all supra)* is the point in time that the lender takes the stock. In those cases the stock was conveyed as an up-front payment, in this case the payment occurs upon conversion when the loan is repaid.

The district court does not agree, and in this case appears to distinguish "Notes that required loan repayment *and* deliveries of shared stock, as opposed to delivery of stock *in lieu of* loan repayment". Slip Op. at 20. It must be clarified at the outset that the stock in this case is not given "in lieu" of repayment, *it is the repayment*. But in either case, it is unclear why, (and the court does not explain why) stock given as repayment, or even "in lieu" of repayment, should be valued any differently than stock given as up-front consideration.

3. Contrary to Holding of the District Court, the Value of Stock Conveyed by the Fixed Conversion Discount is Not Uncertain and Not Dependent Upon the Market Price

The district court held that 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. The court's assessment simply cannot be squared with the concept of the **fixed** conversion discount. As explained above, the 35% discount guarantees that AB will receive a minimum of $154 worth of stock for every $100 of debt that it converts. That minimum amount *never* fluctuates and does *not* depend on the market price of the stock. The number of shares needed to fill the monetary amount due might fluctuate, but the minimum value conveyed would not. The Securities and Exchange Commission itself recognizes that the fixed conversion discount "protects the holders of the convertibles against price declines". *SEC Fast Answers*, *supra*.

a. *Phlo Corp*. Concerned Stock Options, and Does Not Support the Holding in this Case

Both *Union Capital* and the district court cite to *Phlo Corp*. for the proposition that "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." Slip Op. at 21, (quoting *Union Capital*).

This reference, combined with the constant reference to the conversion right as an "option" raises the suspicion that the courts may have applied the wrong body of law to these cases. To be clear: **A fixed-rate conversion discount is not, *in any respect* an "option" as that term is used in the finance industry**; an "option" is a derivative security that has no relation to the agreement at issue in this case[9].

Phlo Corp. concerned stock purchase warrants, which *are* essentially a type of stock option. Warrants are derivative securities that afford the holder the opportunity to purchase a stock at particular "exercise price" for a set period of time. Because warrants are issued in anticipation of a rising stock price, the 'exercise price' of a warrant is (almost) always higher than the trading price of the stock at the time the warrant is issued (known as "out of the money"). The warrant only becomes valuable when– or *if*– the stock price rises above the "exercise price," and it is not unusual for warrants to expire valueless.

Given that such a contingency cannot be known in advance, the value of warrants (and options) cannot be determined from the face of the contract.

[9] If the conversion discount were viewed as an option, it would be an option with a strike price guaranteed to be 35% less than the share price ***at any given time***. Such an option, if it existed, would be immensely (and precisely) valuable. Stock options– as that term is used in the finance industry– always have a fixed exercise price. *See McMillan, Lawrence G.*, OPTIONS AS A STRATEGIC INVESTMENT (NYIF Corp., 1986) at 4-5.

Accordingly, the court in *Phlo Corp* correctly held that the value of "out of the money" warrants could not be considered interest because their value was uncertain; with the fluctuating stock price, "it was not clear that any effective interest rate in excess of 25% would ever have to be paid." [10] *Phlo Corp.*, 2001 U.S. Dist. LEXIS 17490 at *14.

4. *Union Capital* and *Adar Bays* find Uncertainty based on an Assessment of Future Profits, Erroneously Rejecting Fair Market Value at the Time of Transfer

The district court relies heavily on the ruling in *Union Capital*. *Union Capital* appears to be the progenitor of a line of cases that erroneously focus on **potential profits that the Lender might realize** from selling the stock it received via repayment instead **of the fair market value** of the stock it received at the time it was repaid.

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[10] Even warrants are treated as compensation if they are "in the money" at the time of transfer. *See United States v. Deutsch*, 451 F.2d 98, 114 (2d Cir. 1971) (addressing warrants sold at a discount when, at the time they were conveyed, the exercise price was 60% of the stock's trading price, *i.e.*, "in the money.").

Federal securities laws, as well as federal tax laws view "the opportunity to purchase securities at a discounted price" as compensation in itself. *United States v. Ostrander*, 999 F.2d 27, 30 (2d Cir. 1993).

The federal tax laws also treat shares of stock sold to an employee at a bargain price as compensation. *See Commissioner of Internal Revenue v. Lo Bue*, 351 U.S. 243, 247, (1956) ("It makes no difference that the compensation is paid in stock rather than in money.").

In *Union Capital*, the defendant-borrower might be blamed for essentially starting the problem by arguing (wrongly) that the interest calculation should include the immense profits that the lender would ultimately reap from the sale of stock it received in repayment of the loan. In responding to this 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 . . . . . 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. *See Phlo Corp. v. Stevens,* 2001 U.S. Dist. LEXIS 17490 (S.D.N.Y. Oct. 25, 2001) ("[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.").

Union Capital, at *12-13. The *Union Capital* court's above observation– that the exact profits could never be known in advance– is obvious; the same could be said for *any property conveyed in repayment of a loan*. Under Penal Law § 190.40, 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.[11] If this "future

[11] Focus on ultimate profits is not only unknowable, it would lead to absurd results. A lender stating a de minimis discount rate for the conversion of debt could be found liable for usury if the share price spiked after receipt; alternatively, if the property received as payment is never sold, the lender could never be accused of usury no matter how valuable.

profits" inquiry were used in every usury case, the courts would effectively *read payment in property out of the usury statutes.*

Moreover, under any legal analysis the proper measure of compensation has never been "profits" but ***value received***, to wit, fair market value of the property received on the date of transfer. The measure of what the lender receives 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 or some other valuation." 2002 Bankr. LEXIS 1362 at 19 (citations omitted) *In re Interstate Cigar Co.*, 2003 U.S. Dist. LEXIS 21845, at *8-9.

In fact, courts in this Circuit *explicitly reject* arguments on profits in calculating damages—and have never accepted the "potential profits" valuation of stock in any other circumstance. *See e.g., Hillair* and *Sabella*, *supra*. Courts rely on the fair market value of the asset at the time of breach in calculating damages, and therefore "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). The Second Circuit has made clear that New York's rule for "measuring contract damages by the value of the item at the time of the breach is eminently sensible and actually takes expected lost future profits into account." *Lucente v. IBM*, 310 F.3d 243, 262 (2d Cir. 2002).

a. To Calculate Damages, *Union Capital* REJECTS Profits Measure in Favor of Fair Market Value at the Time of Transfer

Frustratingly, not more than four paragraphs after the *Union Capital* court found that the value lender received by virtue of a 42% conversion discount was "too uncertain to incorporate into an interest calculation," that court reached the ***exact opposite conclusion*** when valuing the stock in the damages calculation. In calculating the damages for the defendant (Vape)'s failure to deliver the 'stock of uncertain value', the court held that:

> It is "fundamental that, where the breach involves the deprivation of an item with a determinable market value, the market value at the time of the breach is the measure of damages." As relevant here, "the market price for publicly traded stocks . . . is generally considered to be ascertainable." . . . . Since Vape is, and at all relevant times was, a publicly traded company, any damages associated with a breach by Vape in failing to deliver converted stock pursuant to Union's notices would be ascertainable through expectation damages, calculated by subtracting the contract price - the price at which Union is entitled to convert shares under the Note - from the market price of the shares on the date of the breach.

Union Capital, 2017 US Dist. LEXIS 60445, at *15-16.

It is unclear how the court could conclude (a) that *Vape*'s stock has a determinable market value and (b) that the measure of damages is the market value of the stock at the time of the breach, but fails to recognize that (c) the measure of the borrower's payment in stock (which was stated expressly in the contract) is the market value of the stock at the time of the payment. Unfortunately, as described

above, the district court in this case did precisely the same thing: It determined that the gains from the conversion discount were "too uncertain" to be calculated as interest, but when calculating damages, the court was somehow able to determine the amount owing down to the last cent.

In awarding monetary damages, the court in *Union Capital* gave no consideration to the profits the lender may or may not reap in selling the stock; the award simply reflected the industry-wide standard of valuing stock at its fair market value on the date of transfer. In sum: the *Union Capital* court embraced an unusable method of valuation for the stock to calculate for usury (finding it too uncertain to value) then turned around and found the stock value completely ascertainable for the damages calculation.

b. *Adar Bays* finds Uncertainty based on Future Profits and . . . Because the Borrower Might Breach the Contract.

In the case below, the district court further concluded:

> As courts have noted, a myriad of circumstances could decrease the price of the stock, 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."

Slip Op. at 22 (quoting *Adar Bays*, 285 F. Supp. 3d at 702-03). In terms of 'uncertainty of valuation,' the "circumstances that could decrease the price of the stock" noted in the passage above pose several problems.

First, as abundantly explained above, and as the SEC observes, the value conferred by the conversion discount is immune to stock price decreases. To the extent that the court is again referring to profits, whether or not a lender realizes a profit from the selling property received in consideration of a loan is *necessarily immaterial* to the calculation of fair market value at the time it was received. Lender AB argues that "it is possible that the price of the stock would decrease" once it comes into its possession. However, it is just as likely that the stock price would *increase* after the lender receives it. This is the reason that guessing "future profits" or losses to value stock has been repeatedly rejected.

Second, the potential "events" that are claimed to devalue the conversion right *are all "Events of Default" under the Note*. That is, GeneYS is in default if (1) it became delinquent in filings (Note at 8 (m)); (2) was delisted from a stock exchange—(Note 8(i)); (3) it cancelled the reserve (Note 8(b)) and (4) refused a conversion—(Note 4(a)). To make clear: if any of the "devaluing" events occurred, GeneSYS ***would be in breach of contract***.

Accordingly, the *Adar Bays* court (as well as the district court in this case) found uncertainty because (a) estimated profits from sale of the stock are unknown and (b) *GeneSYS might breach the contract*. Neither of these reasons have anything to do with a proper measure of valuation, or with usurious interest rates.

c. *Union Capital's* Holding that the Discount Rate Should Not be Considered Interest Because the Lender's Right to Convert Debt Was Only an "Option" is Erroneous and Contrary to Well-Established Law.

In the *Union Capital* passage quoted by the district court, it was proposed 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." Slip Op. at 21 (quoting *Union Capital*).

By almost any reading, this holding is contrary to law and cannot be accepted. It is beyond dispute 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.); *Phlo Corp. v. Stevens*, 2001 US Dist. LEXIS 17490; *Cusick v. Ifshin*, 334 N.Y.S.2d 106 (N.Y. County, June 8, 1972).

The rationale for this rule should be obvious. Without it, a lender could charge any rate it wanted to, 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.

In general contractual parlance, the lender's apparent promise of permitting the 8% interest rate is simply a prime example of an "illusory promise." *See* 2 *Arthur L. Corbin, Corbin on Contracts* § 5.28, at 142 (defining an illusory promise as "words in promissory form that promise nothing" and "do not purport to put any limitation on the freedom of the alleged promisor"). Promises of this nature, particularly in relation to consideration for a loan, has never been accepted by New York courts. *See Cleveland v. Loder*, 7 Paige Ch. 557 (1839); *Leavitt v. DeLauny,* 4 NY 364 (1850) (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. But he cannot legally reserve to himself a right to determine in future, which it shall be").

Issue B Answered:

B. <u>When a Loan is Repaid With Stock, Is the Loan Repaid, or is the Loan Contract Transformed Into an Equity Investment? Why *Beaufort* is Wrong.</u>

a. The *Beaufort* Dictum is Speculative and Unreasoned

The question posed in the heading above comes directly from *Beaufort Capital Partners*, 2017 US Dist. LEXIS 32335, a case widely followed by the district courts of this Circuit. Although the court in this case passed on the question of

whether the Note in this case was a loan or otherwise, it, approvingly referenced *Beaufort*, so a discussion of that case is appropriate here.

Beaufort involved a fixed discount rate convertible promissory note very similar to the one in this case, with one important difference: the *Beaufort* note provided the lender the right to convert debt *only after the maturity date*. Focusing on this post-maturity date feature alone, the *Beaufort* court ruled in favor of the lender on the ground that the usury statutes did not apply to post-maturity (or default) interest rates.

However, after finding for the lender on those grounds, the *Beaufort* court made the following observation concerning convertible notes generally:

> Even focusing on the post-maturity interest rate, as Oxysure does, 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, 598 N.E.2d 7, 586 N.Y.S.2d 240 (N.Y. 1992).

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

The conclusion set forth in the passage above is problematic. First, it is obviously not the result of any pointed analysis, but a single sentence speculating that "the usury defense would *likely* fail" and that "the loans *likely* have the character of an equity investment." *Id.* (emphasis added).

Second, the *Beaufort* discussion is questionable because the *Seidel* case, which *Beaufort* cites in support of its speculation, actually rejects the notion that the means of repayment could transform a loan into something else. Although the S*eidel* court begins by stating the widely-recognized proposition that "[I]f the transaction is not a loan, 'there can be no usury,'" its observations did not end there. After analyzing the specific facts of the transaction under scrutiny in that case, the *Seidel*, court held:

> 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 (quoting *Meaker v Fiero,* 145 NY 165, 170 (1895)).

Likewise, the mere presence in this case of a unilateral option permitting the lender to take repayment in the form of a publicly traded stock does not transform a lender into an investor, nor does it transform what is clearly a loan into an 'equity investment'.

b. <u>Payment Does Not Transform the Contract, It ENDS the Contract</u>

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.” *Spreckels,* 120 F.2d at 517; *Kohn,* 16 T.C.960, *affd*., 197 F.2d. 480.

With this in mind, falsity of the *Beaufort* statement— that “upon conversion to equity, the loans likely have the character of an equity investment”— becomes obvious. This statement overlooks that upon conversion to equity, the loans are ***repaid*** and the **contract *discharged***. Accordingly, the *Beaufort* statement must be rejected.

CONCLUSION

In consideration of the foregoing, Amicus Cardinal Energy respectfully requests that the Court rule in favor of the Appellant GeneSYS on the grounds discussed herein.

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Respectfully Submitted,

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CERTIFICATE OF COMPLIANCE

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