

NEW YORK COURT OF APPEALS ROUNDUP

‘ADAR BAYS’ CLARIFIES USURY LAW APPLICATION

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The Court of Appeals recently clarified the application of state usury laws to corporations and to stock conversion options. In *Adar Bays v. GeneSys ID*, the U.S. Court of Appeals for the Second Circuit certified two questions to the court:

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

962 F.3d 86, 94 (2020).

In a majority opinion written by Judge Rowan Wilson and joined by Chief Judge Janet DiFiore and Judges Jenny Rivera, Eugene Fahey, Madeline Singas and Anthony Cannataro, the Court of Appeals answered both questions in the affirmative.

Background

In May 2016, Adar Bays, a Florida limited liability company, loaned \$35,000 to GeneSYS ID, a publicly held medical supply corporation. In exchange, GeneSYS signed a note providing for 8% interest maturing in one year. The note also provided Adar Bays with an option, in its sole discretion, to convert all or part of the debt into shares of GeneSYS stock at a 35% discount. Six months into the life of the loan, Adar Bays sought to convert \$5,000 of the debt into 439,560 shares of GeneSYS stock. GeneSYS refused to effect the conversion and tried to renegotiate the loan.

Adar Bays sued GeneSYS in the U.S. District Court for the Southern District of New York. GeneSYS moved to dismiss on the grounds that the contract was void because the interest rate, including the stated rate of interest and the conversion option, exceeded the 25% criminal usury rate. Adar Bays opposed the motion and filed its own motion for summary judgment.

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The Southern District rejected GeneSYS's argument that the conversion option should be added to the stated interest rate on the grounds that it was too uncertain at the time the parties entered into the loan. 341 F. Supp. 3d 339, 356 (2018). The Southern District accordingly granted Adar Bays's summary judgment motion and awarded damages based on the number of shares Adar Bays would have received if it had converted the entire debt into equity at the time of the breach. *Id.* at 350.

GeneSYS appealed and the Second Circuit noted that most federal district courts have found that similar conversion options did not constitute interest under New York usury laws but that some New York courts had added the value of future, contingent payments to a note's stated interest rate. See 962 F.3d 86, 91 (2020). The Second Circuit also found some ambiguity as to whether a usurious loan to a corporation was void or, instead, subject to reformation. *Id.* at 92-93. Accordingly, it certified the two questions to the Court of Appeals. *Id.* at 94.

The Majority Opinion

The majority started its analysis with the second question. It noted that if a borrower establishes the defense of usury in an action applying the 16% civil usury cap, the loan transaction is deemed void and unenforceable and the lender is precluded from collecting the interest or the principal. The majority went on to conclude that the same result should obtain with respect to the 25% criminal usury cap set forth in Penal Law §190.40 that is applicable to corporations.

The majority opinion describes the somewhat complex interplay of the various General Obligations Law, Banking Law and Penal Law provisions that create the usury law regime in New York. In general, New York law provides that loans of less than \$250,000 cannot exceed 16% annual interest, loans between \$250,000 and \$2.5 million cannot exceed 25% annual interest, and loans in excess of \$2.5 million are exempt from the usury laws. In addition, it is a class E felony to charge more than 25% annual interest on a loan.

Finally, while corporations cannot assert a usury defense to loans that violate the 16% "civil" cap, they are permitted to raise the defense of criminal usury to loans that exceed the 25% "criminal" cap in the Penal Law.

The majority then discussed the history of usury laws in New York dating back to the 1700s and pointed to the laws' purpose of protecting people in weak bargaining positions from being taken advantage of by those in much stronger bargaining positions and to the increase in loan sharking activity by organized criminal groups after the Second World War. Although the Penal Law does not provide that a loan violating the 25% criminal usury rate is void and unenforceable, the majority concluded that the Legislature intended that result in creating the complicated legislative scheme of usury law. Accordingly, the majority answered the second certified question in the affirmative.

The majority then turned to the first certified question—whether a conversion option entitling the lender to convert the debt into equity at a fixed discount should be treated as interest in determining if a loan is usurious. The majority concluded that all property exchanged in consideration for a loan, including the value of a conversion option, should be included in the determination of whether the interest rate violates usury statutes. The conversion option did not transform the loan into an equity investment and its intrinsic value formed part of the consideration Adar Bays received in exchange for its loan to GeneSYS despite the fact that the option might never be executed. The majority was not asked to, and did not, determine the

actual value of the conversion option and noted that this was a question of fact that should be determined as of the date the parties entered into the loan agreement.

The Dissent

Judge Michael Garcia dissented. He agreed with the majority's conclusion that a usurious loan to a corporate borrower is void and precludes the lender from recovering interest or principal. The harshness of this result, however, causes Judge Garcia to focus on the burden of proof imposed on a borrower to establish that a loan is usurious. Judge Garcia views the majority's ruling about the inclusion of the conversion option value in the calculation of the interest rate as essentially and unfairly shifting that burden to the lender. Judge Garcia would reframe the Second Circuit's first question to ask whether a stock conversion option renders a loan agreement usurious on its face, and answers that question in the negative.

Conclusion

The law in New York is now clear that corporations successfully asserting a criminal usury defense to a lender's collection action are entitled to a finding that the loan is void and unenforceable, and that the value of a stock conversion option should be factored into the interest rate calculation in making that determination despite its contingent nature.

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