

Is It an Equity Investment or Usury? Second Circuit, *Nostra Sponte*, Certifies Two Questions to New York Court of Appeals

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On June 11, 2020, the Second Circuit Court of Appeals confronted the question whether an option in a commercial note that allows the lender to convert the remaining balance into the borrower's common stock at a 35% discount violates New York's usury law.

This case is rooted in a loan transaction between Adar Bays LLC and GeneSYS ID Inc. Adar Bays loaned GeneSYS money memorialized by a convertible redeemable note. The note allowed the conversion of any outstanding loan balance into GeneSYS common stock at a 35% discount from the stock's market price. GeneSYS defaulted and Adar Bays sued. GeneSYS moved to dismiss, arguing that the note violated New York's usury law. That motion was denied, and the district court granted summary judgment to Adar Bays.

The Second Circuit succinctly explained the issues on appeal as follows:

The first issue presented is whether the Note violates New York's criminal usury law because it contains a conversion option with a 35% discount that, if treated as interest, raises the interest rate above the statutory maximum (25%). Adar Bays, on the other hand, contends that upon conversion, the transaction becomes an equity investment to which usury laws do not apply. The second issue presented is, if the interest rate does violate § 190.40, whether the Note is void *ab initio*, as it would be if New York's civil usury law, N.Y. Gen. Oblig. Law § 5-511, applied. If the Note is void, GeneSYS would be relieved of its obligation to repay the money it borrowed.

In their briefing, the parties offered starkly different views of the case. GeneSYS explained that, "[h]ad the District Court conducted the necessary analysis with a proper application of the usury statutes, then it would have been clear to it that the Note is (1) absolutely repayable = no risk = a "loan," and (2) the charges as a percentage of the money GeneSYS received under the loan were in excess of 25%." It went on to opine that, in its view, Adar Bays "is a 'vulture' lender specializing in financing negative cash flow or insolvent OTC companies, structuring its loans to take advantage of the corporate borrower's fiscal distress to tack onto nominal interest rates unreasonable expenses, penalties and, ultimately, equity conversion rights designed to allow Adar Bays to circle, swoop in and nab parts of the company in the likely event of its default."

In contrast, Adar Bays denied that there was anything usurious about the transaction: "[A]t 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." That is, "there is no point in the life of the transaction where the 35% discount could be considered interest." Moreover, Adar Bays observed, GeneSYS "is a sophisticated, publicly traded entity that issued a convertible redeemable 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, ... seeking a windfall."

The court granted Cardinal Energy Group Inc. leave to file an amicus brief. Cardinal Energy explained its interest by stating that it currently has a pending appeal concerning "nearly identical" issues pending in the Second Circuit. Its amicus brief focused on describing how the conversion discount rate works.

After hearing oral argument on February 26, 2020, the Second Circuit determined that it would benefit from guidance on New York law from the New York Court of Appeals: "Because the resolution of both issues turns on questions of state law for which no controlling decisions of the New York Court of Appeals exist, we certify two questions to the Court of Appeals. Although the parties did not request certification, we may seek it *nostra sponte* and we do so here." Thus, it certified the following two questions:

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.

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.

Consequently, this important case now will move over to the New York Court of Appeals. We will keep our eyes on it.

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