

Client Alert

November 2021

Recent Decision on New York's Usury Laws

On October 14, 2021, the New York Court of Appeals published a decision that has major implications for corporate lenders who use convertible loans. In *Adar Bays, LLC v. GeneSYS ID, Inc.*, No. 51, 2021 WL 4777289 (N.Y. Oct. 14, 2021), the Court held that a stock conversion option, one that permits its lender to convert any outstanding loan balance into shares of stock at a fixed discount, may be treated as interest for purposes of determining whether the transaction violates New York's usury laws. Accordingly, if the interest charged on a loan is higher than the threshold set under New York's criminal usury law, the loan may be deemed void and unenforceable.

Facts

Adar Bays loaned GeneSYS \$35,000. In exchange for the loan, GeneSYS provided Adar Bays a note with 8% interest that would mature in one year. The note included an option for Adar Bays to convert some or all of the debt into shares of GeneSYS stock at a discount of 35% from the lowest trading price within twenty days of requested conversion. Months after the note was issued, GeneSYS was trading for \$0.024 per share, and the conversion price was \$0.011. Adar Bays sought to exercise its option to convert \$5,000 of the debt into 439,560 shares of stock. When GeneSYS refused, Adar Bays sued for breach of contract in the U.S. District Court for the Southern District of New York. The District Court ruled largely in Adar Bays' favor and reasoned that, at the time of contracting, the value of the lender's conversion option was too uncertain and speculative to be added to the stated interest on the note and therefore it was not a usurious loan.

The Appeal

On appeal, the Second Circuit observed that despite the number of cases from New York State and federal courts confronting this issue, no definitive resolution has emerged regarding whether contingent and uncertain future recoveries qualify as "interest" under New York's usury statute. The Second Circuit also noted that there was an additional ambiguity as to whether a loan made to a corporation, that exceeded the

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criminal usury rate, would be void or subject to reformation. Due to the lack of clarity, the Second Circuit certified the following two questions to the Court of Appeals:

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.
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.

In a surprising decision, the Court of Appeals ruled “We answer both questions in the affirmative.”

Criminally Usurious Interest Rate Leads to Void Contracts

The Court of Appeals began with the second question and concluded that an analysis of the text, history, and legislative purpose behind New York’s usury laws demonstrate that if the borrower establishes the defense of usury in a civil action, the usurious loan transaction is deemed void and unenforceable. As a result, both the principal and interest become uncollectible. The same result is reached when there is a corporate loan under \$2.5 million and the interest charged on that loan exceeds the 25% interest cap. Thus, in such instances, the corporate borrower may raise the defense of criminal usury, even in civil actions. If the borrower successfully proves its defense, the usurious loan is deemed void and unenforceable for both the principal and the interest. While the Court acknowledged that its holding might be harsh, it found that the forfeiture of interest and capital is necessary to serve as a strong deterrent and protect those in weaker bargaining positions from being taken advantage of by those in much stronger bargaining positions. Furthermore, the Court suggested that loans proven to violate the criminal usury statute should be “subject to the same consequence as any other usurious loans: complete invalidity of the loan instrument.”¹

The Conversion Right in the Note is Considered When Calculating Interest Charged

Returning to the first question, the Court held that the value of the floating-price convertible options, such as stock conversion options, should be considered in determining whether the interest charged on a loan exceeds

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¹ *Adar Bays, LLC v. GeneSYS ID, Inc.*, No. 51, 2021 WL 4777289, at *6 (N.Y. Oct. 14, 2021).

the 25% interest cap. The Court supported its holding by referencing an earlier Court of Appeals decision, which held that all consideration paid in exchange for a loan should be valued when determining if a transaction is usurious. Since floating-price conversions have intrinsic value that was bargained for, they should also be treated as part of the interest. The value of such conversion, to the extent that it can be ascertained, is a question of fact to be determined at the time of contracting.

The Court addressed the District Court's concern that valuation would be too speculative and uncertain by citing prior case law, which guide valuations of future contingent payments in the usury context. Although the Court left the determination of appropriate valuation methods for convertible options to the fact finders (a judge or jury), it did note that the mere possibility that a future exercise of a floating-price conversion option may result in a return exceeding 25% does not necessarily render the loan usurious. Instead, the relevant consideration is whether there was usurious intent at the time of the loan and what was the overall value of the conversion option at the time of bargaining. The Court did not establish a hard and fast valuation method but instead outlined certain principles to take into account. Regarding risks of the loan, the Court observed that the valuation of a contingent future payment must be tailored to the risks involved in a particular investment and should exclude contingencies or risks that are part of any loan transaction, such as future insolvency. Likewise, if a lender has contractually protected itself in the loan instrument against other risks by use of default rate of interest or similar protections, those risks also should not be used to discount the value of the conversion option. Finally, the Court observed that the risk of a borrower refusing conversion should also not affect the value of the option as ordinary contract remedies exist and such refusal neither renders the loan uncertain nor impacts the value of the consideration exchanged.

In concluding its decision, the Court held that its decision pertains to loans and not equity investment, which are not subject to usury laws. In determining whether a transaction is a loan that is subject to a usury defense, substance rather than form controls. As a result, loans with the option of repayment in property rather than cash remain loans and not equity investment.

Conclusion

The Court of Appeals' decision that convertible loans may be subject to New York's usury laws may have wide ranging implications and unintended consequences for existing and future convertible loan transactions that are subject to New York's usury statutes. The decision puts at risk of challenge any convertible debt deals, especially one at a discount or with a warrant or equity kicker. Going forward, lenders should be prepared to justify or evaluate the expected returns from their loans

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with floating-price conversion options. Such justification or evaluation may be evidence against usurious intent and may be vital in preventing a successful usury defense for loans under \$2.5 million.

The implications of *Adar Bays* go beyond convertible loans and extend to any debt transactions with warrants offered as a kicker as well as any financing arrangement where the lender's right of recovery is contingent on future performance. The Court of Appeals has effectively overruled longstanding precedent, and market expectations, that uncertainty as to the future value of consideration, such as out of the money warrants, is not considered "interest" under a usury analysis. The Court now requires a valuation for all consideration in connection with a loan. Lenders will be wise to make such a valuation at the time of the loan so as to avoid having been found to have the requisite intent of making a criminally usurious loan.

Some possible unintended consequences? First, the ruling may limit access to capital particularly to smaller public companies that have often relied on convertible debt financing as a way to raise needed capital that is not otherwise readily available. Second, lenders may need to rethink loan amounts and only lend amounts large enough to remove the loan from the \$2.5 million criminal usury cap in New York. Loans that exceed this amount are generally not subject to criminal usury in New York. Finally, for smaller sized loans that are subject to the usury caps in New York, lenders may begin to rethink choice of law and choice of forum provisions, which have historically used New York as the guiding law and forum for disputes. As the dissent suggests, lenders can avoid the impact of *Adar Bays* by choosing the law of a jurisdiction other than New York and requiring litigation to be brought in a state other than New York. If all parties are in New York, or the borrower is located there, the choice of law provision may not provide protection from New York policy.

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