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Reporting on Significant Court of Appeals Opinions and Developments in New York Practice

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CASE LAW DEVELOPMENTS

Court of Appeals Holds That Where Loan Interest is Criminally Usurious the Contract is Void *Ab Initio*

Treats Stock Conversion Option as Interest

In *Adar Bays LLC v. GeneSYS ID, Inc.*, 2021 N.Y. Slip Op. 05616 (October 14, 2021), the Court of Appeals was asked to answer two certified questions from the Second Circuit:

- Whether a stock conversion option permitting a lender, in its sole discretion, to convert any outstanding balance to stock shares at a fixed discount is to be treated as interest for the purposes of New York's criminal usury statute, Penal Law § 190.40.
- Where the interest is criminally usurious, is the contract void *ab initio* under General Obligations Law § 5-511?

Plaintiff Adar Bays and defendant GeneSYS had executed a note, under which the plaintiff lent the corporate defendant $35,000 for one year at 8% interest. The note included a conversion option which could be exercised by the plaintiff at any time after 180 days following issuance of the note. The option permitted some or all of the debt to be converted into defendant's stock at a 35% discount from its lowest price in the 20-day period prior to the request. The conversion could be done all at once or in multiple partial conversions. A little over six months after the note was issued, plaintiff sought conversion of $5,000 of debt. The defendant refused and sought to renegotiate the loan.

Plaintiff brought a breach of contract action in federal court. Defendant moved to dismiss on the ground that the rate of interest, including both the stated interest and the conversion option, exceeded the criminal usury rate (i.e., 25%). Plaintiff opposed the motion and filed its own summary judgment motion. The trial court granted plaintiff's motion, finding that the conversion option "was simply too uncertain at the time of contracting" to be added to the stated interest rate for the purpose of determining if the loan was usurious. The court awarded the plaintiff over $92,000 in "expectation damages" based upon a calculation of the full conversion of the note on the day of the breach.

The Second Circuit then certified the two questions above. Dealing with the second question first, the Court of Appeals referenced the myriad relevant statutory provisions. Specifically, it discussed Banking Law § 14-a(1) (permitting a 16% maximum annual loan rate), Penal Law § 190.40 (A person who "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" 25% commits a class E felony); General Obligations Law (GOL) § 5-501 (prohibiting a rate above 16% to individuals); GOL § 5-511 (providing that a loan exceeding the civil usury level is void); and GOL 5-521 (not permitting the defense of usury to corporations but not precluding a corporate borrower from raising the criminal usury defense—over 25%—in a civil action).

Looking at these interlocking statutory provisions and the history of the usury law, the Court concluded that where the interest rate charged is criminally usurious, the contract *is* void *ab initio*. It noted that corporations fall within the purview of GOL 5-501 with respect to usurious loans whose interest rate exceeds 25%. The fact that Penal Law § 190.40 does not void a loan charging more than 25% interest is irrelevant:

> Penal Law § 190.40 is a penal statute imposing criminal liability and it is not the purview of the Penal Law to define defenses in civil actions. Rather, General Obligations Law § 5-521 provides that corporations cannot raise a defense of usury in any action unless the corporation relies on the defense of criminal usury "as described in section 190.40 of the penal law" (id. § 5-521 [3]). As regards civil usury, Penal Law § 190.40 merely specifies the rate of criminally usurious interest. General Obligations Law § 5-511 (1) provides that all loans charging an interest rate greater than that permitted in section 5-501 "shall be void." A criminally usurious rate higher than 25% is an interest rate greater than the

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> civil usury limit of 16% prescribed in section 5-501. The legislature provided no exceptions to the voiding of usurious loans if the borrower is a corporation. Rather, the General Obligations Law treats corporate borrowers differently only to the extent that corporate borrowers may raise criminal usury, but not civil usury, as a defense. The statutory authority, coupled with the legislative intent behind the 1965 amendment, requires the conclusion that the legislature intended for criminally usurious loans made to corporate borrowers to be void when a successful usury defense, based on the criminal usury rate, is raised.

Id. at *16–17.

The Court stressed the inconsistency of finding that "the legislature intended a more forgiving remedy against those who lend at or above the criminal usury rate than those who violate only the civil usury standard." *Id.* at *17.

On the first question, the Court concluded that the conversion option should be treated as interest for purposes of a usury determination. The Court maintained that the transaction was a loan, not an equity purchase or joint venture, and looked toward the following facts, among others, for support:

- The plaintiff was not directly exposed to market risk, to which an equity investor or a joint venture partner would be exposed.
- The parties executed a "traditional loan instrument."
- The "floating-price conversion option" was an "intrinsic" part of the consideration for the loan.
- A prior holding of the Court supports the conclusion that floating-price convertible notes are loans.

The Court insisted that interest is to be construed broadly in deciding whether a loan is usurious. "[T]he legislature has defined interest to include the value of all goods and promises exchanged in consideration for a loan in the usury analysis." *Id*. at *22. Thus, all consideration to be paid in exchange for a loan are to be valued and considered in determining whether a transaction is usurious. That includes all fees, exchanges of other forms of property substituted for money, and other charges. As a result, the value of the conversion option should be included in the calculation.

The Court found that conversion options are not so speculative that they cannot be valued as a matter of law. The fact that the plaintiff may have never exercised the conversion option does not make the value of the option too uncertain to be counted as interest. Moreover, "a technical concern about valuation methods and the certainty of these options should not facilitate evasion of the usury laws." *Id*. at *32.

Judge Garcia agreed with the majority that where the loan interest is criminally usurious, the contract is void. However, he felt that the majority's conclusion "making this type of discounted stock option a per se interest rate," shifted the burden of proof, "effectively voiding all commercial loans like the one at issue here." *Id*. at *34. This will enable future borrowers to reap windfalls and thus, New York, a "preeminent commercial center," will become "off limits for this type of lending."

Court Holds There to be No Implied Private Right of Action for Damages for Violation of Public Health Law § 18(2)(e)

Finding Such a Right Would Not be Consistent with the Legislative Scheme

In *Ortiz v. Ciox Health LLC*, 2021 N.Y. Slip Op. 06425 (November 18, 2021), the Court of Appeals was asked to consider yet another certified question from the Second Circuit. This concerned whether there is an implied private right of action for damages for a violation of Public Health Law § 18(2)(e). That section limits the reasonable charge for paper copies of medical records to a maximum of $0.75 per page.

The plaintiff requested medical records and was charged twice the statutory rate by the hospital's contractor. The plaintiff paid under protest and brought suit in state court. Defendant removed the action to federal district court and moved for summary judgment on the ground that an express private right of action did not exist under the statute and implying one would be improper. The district court granted the motion. The Second Circuit then presented the Court of Appeals with the certified question referenced above.

The Court of Appeals noted that, as originally enacted in 1986, the relevant statute merely allowed for a "reasonable charge" for the duplication of medical records. Via a 1991 amendment, the maximum charge was fixed at $0.75 per page. The Public Health Law does have enforcement mechanisms in place for violations of the statute: (i) the Commissioner of Health can recover a fine in "any court of competent jurisdiction"; (ii) the matter can be referred to the Attorney General to impose the fines or to seek injunctive relief; and (iii) the Department of Health, a local board of health, or an individual can file an Article 78 proceeding to enforce the "performance of any duty or the doing of any act enjoined, prescribed or required by" the Public Health Law.

What the Public Health Law does not provide for is an express private plenary action where there is a PHL §18(2)(e) violation. However, as the Court noted, a private right of action can be implied. In making such a determination, a court is to consider the following three factors, each of which must be satisfied: "(1) whether the plaintiff is one of the class for whose particular benefit the statute was enacted; (2) whether the recognition of a private right of action would promote the legislative purpose; and (3) whether creation of such a right would be consistent with the legislative scheme." *Id.* at *6 (citations omitted).

The Court stressed that the third factor is considered the most important one and "the presence of alternative enforcement mechanisms is frequently determinative." *Id.* at *7. It cited to its prior pronouncements in *CPC International v. McKesson Corp*, 70 N.Y.2d 268 (1987), *Sheehy v. Big Flats Community Day*, 73 N.Y.2d 629 (1989) and *Cruz v. TD Bank N.A.*, 22 N.Y.3d 61 (2013), as support, among others. In these cases, there were efforts to seek a private right of action under GBL § 352-c (criminalizing fraudulent and deceptive practices in connection with the distribution and sale of securities), Penal Law provisions (prohibiting the sale of alcohol to minors), and a law limiting the restraint of private bank accounts. In each, the Court held there to be no implied private right of action.

With respect to the facts here, the Court found that the plaintiff was clearly part of the class that the statute was

designed to protect (first factor), and it was unclear whether a private right of action would promote the legislative purpose (second factor). Regardless, however, the Court insisted that the third factor—consistency with the legislative scheme—was not satisfied. First, as in the other cases noted, enforcement mechanisms are already provided for in the relevant statute, as described above. Moreover, "the legislature affirmatively provided mechanisms for enforcing other related provisions of the Public Health Law, but did not here." *Id.* at *12. For example, a related PHL statute enacted contemporaneously with the 0.75 cap provides for refunds to Medicare patients of service overcharges, while the relevant statute here has no such provision. This suggests that the legislature felt that the existing remedies for overcharges under PHL § 18(2)(e) were adequate.

Judge Wilson concurred with the majority's conclusion but took issue with the majority's analysis of the second factor, "which, although not meaningful for resolving this appeal, will be in some case, someday."

Motion to Dismiss on Standing Grounds in Residential Foreclosure Action Does Not Meet Burden of Proof by Relying on Defects in Certificate of Merit Alone

Second Department Finds CPLR 3012-b Certificate Arises out of Ethical, Not Evidentiary, Obligation

Generally, the plaintiff is not obligated to establish the *merits* of its claim in the complaint. However, with respect to particular actions, a certificate of merit is required to be filed *with* the complaint. One example is in medical, dental and podiatric malpractice actions, governed by CPLR 3012-a. Here, we are concerned with CPLR 3012-b, requiring a certificate of merit in a residential foreclosure action involving a home loan.

The certificate, which is to be signed by plaintiff's counsel, certifies

> that the attorney has reviewed the facts of the case and that, based on consultation with representatives of the plaintiff identified in the certificate and the attorney's review of pertinent documents, … to the best of such attorney's knowledge, information and belief there is a reasonable basis for the commencement of such action and that the plaintiff is currently the creditor entitled to enforce rights under such documents.

CPLR 3012-b(a).

The issue in *Wilmington Sav. Fund Socy., FSB v. Matamoro*, 2021 N.Y. Slip Op. 05741 (2d Dep't October 20, 2021), was whether the proponent of a motion to dismiss on standing grounds meets its burden of proof by merely relying on defects in the certificate, if it fails to address all aspects of standing. A majority of the Second Department answered the question in the negative.

Plaintiff-lender brought a mortgage foreclosure action against the defendants. The complaint was accompanied by a certificate of merit, which in turn annexed various documents, including a "purported copy" of the note and mortgage, an assignment of the note and mortgage to J.P. Morgan, and an assignment of the note and mortgage from J.P. Morgan to the plaintiff. In lieu of an answer, defendant moved to dismiss under CPLR 3211(a)(1), (3), and (7), alleging that plaintiff lacked standing at the time of commencement of the action because the copy of the note annexed to the certificate did not contain any indorsement or allonge conferring rights on the plaintiff; the chain of assignment was defective because MERS (the lender, as nominee for Fieldstone, holding the mortgage and note prior to J.P. Morgan) did not have authority to assign the note; the certificate of merit contained language defects; and plaintiff's counsel had failed to make certain that there was a reasonable basis for initiating the action (providing a separate basis for dismissal under CPLR 3012-b(e)). In opposition, plaintiff provided proof that the note and mortgage had been transferred by assignment to the plaintiff prior to commencement of the action.

The trial court denied defendants' motion, finding that plaintiff had standing in that it *physically possessed* the note at the time the action was brought. Following service of the answer, which included a standing defense, plaintiff moved for summary judgment, producing for the first time a copy of the note with an indorsement in blank. Defendants cross-moved for summary judgment. Both motions were denied. Defendants then moved for leave to renew or reargue their CPLR 3211(a) motion, contending that the court was mistaken with regard to its finding that plaintiff physically possessed the note when it brought the foreclosure action. Defense counsel noted that the copy of the note that supported plaintiff's summary judgment motion was indorsed in blank and, as such, did not resemble the copy of the note accompanying the certificate of merit. Defendants alleged that the fact that the latter note lacked the indorsement in blank militated in favor of dismissal of the action for lack of standing. The trial court denied the motion.

The Appellate Division affirmed and, in doing so, gave a fairly thorough review of the history of the enactment of CPLR 3012-b. It noted that the statute was a reaction to the flood of foreclosure actions precipitated by the "bursting of the housing bubble" in 2008. This crisis resulted in attorneys filing scores of foreclosure actions without the requisite due diligence ("robo-signing"). Robo-signing created "shadow dockets" where many residential foreclosure cases languished in limbo. A series of Administrative Orders were initially promulgated, but ultimately the legislature stepped in, enacting CPLR 3012-b, which is similar but not identical to the Administrative Orders. The primary purpose of both the AOs and the statute, however, was

> to require foreclosure counsel to undertake a consultation with the plaintiff and a review of pertinent documents, and to certify to the best of counsel's knowledge, information, and belief that there is a reasonable basis for the commencement of the action, including that the plaintiff is entitled to enforce its rights under the relevant documents.

Id. at *10.

Significantly (at least from the majority's point of view), while the AOs mandated that attorneys submit *affirmation*s (under the penalty of perjury), CPLR 3012-b only required a "weaker" unsworn *certificate.* The court stressed that the certificate here, much like the CPLR 3012-a certificate in medical, dental, and podiatric malpractice actions, is submitted for *ethical*, rather than *evidentiary*, purposes (a point disputed by the lone dissenter). To support its conclusion, the majority pointed to the "fact that the legislature located

the statutes within CPLR article 30 [Remedies and Pleading], rather than placing them among the disclosure provisions of CPLR article 31." *Id*. at *12–13.

Moreover, the certificate is not "attached" to the complaint; rather it "accompanies" it. Thus, it "has an existence separate from the complaint itself." The court maintained that the certificate did not go to the merits of the action, but is "ministerial" and ethical in nature. It merely shows that counsel has taken the necessary steps to investigate and to represent that there is a "reasonable basis" for the commencement of the action and that the plaintiff has standing to bring the claim. Here, the documents in question were attached to the certificate of merit. They were not annexed to the complaint. While the court acknowledged that documents attached to a certificate of merit can be used to support a CPLR 3211(a) motion,

> a deficiency in a certificate of merit will not, in and of itself, provide a basis for the dismissal of a complaint if the defendant, as the moving party, fails to affirmatively address in its motion papers all relevant legal issues required for a CPLR 3211 dismissal, including any that go beyond the contents of the certificate of merit itself.

Id. at *15–16.

On the specific motion here, the Appellate Division held that the defendants' CPLR 3211(a) motion under subdivisions (a)(1) (documentary evidence), (a)(3) (lack of capacity, which includes standing), and (a)(7) (failure to state a cause of action) lacked merit. First, the plaintiff is not required to address standing in the complaint: "lack of standing" is an affirmative defense to be pled and proven by the defendants. Here, the defendants cited the defective documents accompanying the certificate of merit to allege lack of standing. The party opposing the motion need not prove standing; it must merely show that a question of fact exists regarding the issue.

Standing in a mortgage foreclosure action can be established in three ways: *direct privity* between the plaintiff as the original lender and the defendant, which the court said is "rarely seen" because of the practice of selling, assigning, or bundling of loans; where the plaintiff is in *physical possession* of the note prior to the action's commencement with an allonge or indorsement in blank; or the *note is assigned* to the plaintiff prior to commencement of the action. The documents in question here did not totally disprove standing. While they did establish lack of direct privity, and did raise questions about the assignment from MERS to JP Morgan, they did not show that JP Morgan *was not* in physical possession of the note prior to assigning it to plaintiff. To prevail, the defendants would have had to have refuted all three bases for standing. According to the majority, they did not, but instead impermissibly tried to shift the burden to the plaintiff to prove standing. The court here noted the pitfalls of moving to dismiss without having the benefit of discovery.

Finally, the court found that the motion for leave to renew was properly denied. Defendants alleged that since the copy of the note with the indorsement in blank was not submitted until after the action was commenced, the indorsement occurred after the action was commenced, and the plaintiff therefore lacked standing prior to the commencement of the action. "The defendants, as the moving parties, bore the burden of establishing that the indorsement in blank was not placed upon the note until some time after the commencement of the action—a burden they could not address, much less meet, absent discovery on the issue or an admission from the plaintiff. Thus, the Supreme Court properly did not grant renewal." *Id*. at *25.

The sole dissenter (at least partially), Judge Barros, asserted that the majority ignored the fact that in addition to serving ethical concerns, one of CPLR 3012-b's principal purposes was to expedite the resolution of the standing issues at the outset of the case, so that homeowners in foreclosure could benefit from mandatory settlement conferences. The Judge also looked at the plaintiff's three-year delay in amending the certificate to "miraculously" produce the note indorsed in blank, and questioned how the majority had concluded that the defendant had not proved willful non-compliance under CPLR 3012-b (e), militating dismissal.

Here the defendants submitted documents, including the note and mortgage and the chain of assignments that were attached to the certificate of merit, as representing all the documentation underpinning the plaintiff's claim of standing. The dissent maintained that those documents, "plaintiff's own documents," established that plaintiff lacked standing and the plaintiff failed to raise a question of fact.

CPLR 2001 Again Comes to the Rescue, This Time with Respect to Certificate of Merit Defects

In *Wilmington*, the majority also held that the trial court did not err in failing to direct dismissal of the complaint for noncompliance with CPLR 3012-b. Plaintiff cured the technical defects in the certificate raised by the defendants pursuant to CPLR 2001. This was permissible because the court could find no prejudice to defendant caused by the submission of the amended certificate.

Beware (Again) of Pitfalls of Appealing an Order Denying a Motion for Leave to Reargue

As we have noted in the past, a denial of a motion for leave to reargue is not appealable. Sometimes the issue is not so straightforward. Thus, where the court purports to deny the motion, but considers the merits of the arguments, the resulting order is appealable because the court has, in effect, granted reargument, but adhered to its original decision. In *Wilmington*, however, the Appellate Division found that the trial court had denied the motion to reargue and thus that order was not appealable.

As we have stressed in the past (see, for example, the October 2017 edition of the *Law Digest*), good practice is always to serve and file your notice of appeal (and any supplementary papers required by the appellate court) from the *original* order in a timely fashion. In that circumstance, if leave to reargue is denied, you are protected.

Wishing each of you a happy and healthy holiday season.

David

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