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Don't get used by usury laws

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As difficult economic times continue, it is no surprise that private equity and venture capital firms are seeing many of their portfolio companies struggle. Some of these businesses need or likely will need additional cash infusions to meet near-term expenses. With banks still reluctant to lend, the portfolio company might have nowhere else to turn but to its current PE or VC owners. The PE/VC owners -- not wanting to lose their existing investment and perhaps believing that the company can, with only a modest infusion of cash, get past its current problems and achieve long-term growth and prosperity -- might be willing to front the company some needed cash.

The terms of any such loan the PE/VC owners might be willing to make in this type of situation will of course vary widely depending on the circumstances. However, it would not be shocking to envision a PE or VC lender asking for an up-front fee, and maybe a recurring administrative fee as well. The lender might also require the company to issue it warrants, preferred stock or other securities in exchange for the loan. While these terms may seem straightforward and reasonable, there is a potential legal trap lurking: If New York State law is applied to the transaction, and if the effective interest rate (which, depending on the terms, might include the fees, securities and other consideration paid to the lender on top of the nominal interest) exceeds 25% per year, the transaction might be in violation of New York's laws against usury.

That's right -- your friendly PE or VC lender, in trying to help out a troubled business, may have just broken the law. Not only that, the law in question is a criminal statute, violations of which constitute a Class B felony.

New York, like most other states, has had on its books laws against usury, or the charging of excessive interest, since the 19th century. There are separate civil and criminal usury statutes. These laws were passed to protect borrowers from loan sharking and other unscrupulous tactics. As one New York court put it, the statutes are intended "to protect desperately poor people from the consequences of their own desperation." New York's usury statutes have many exceptions, some of which are intended to differentiate the truly helpless, who are deemed in need of the laws' protections, from more sophisticated parties, who presumably can fend for themselves. However, these distinctions are imperfect, and there are more than a few examples of cases in which New York's usury laws have been raised by sophisticated businesses as a defense against claims by their lenders who were trying to recover their money.

In one recent case, Funding Group Inc. v. Water Chef Inc., a New York court ruled that a $25,000 45-day loan made to a corporation at a very high effective rate of interest was usurious. The terms of this loan, which included 10% interest per month, plus the issuance to the lender of shares of convertible preferred stock, were indeed rich for the lender, resulting in an effective interest rate of 363%, as noted by the court. However, it appears that the borrower was a sophisticated commercial entity and was eager to enter into this transaction. (The terms of the loan were contained in a letter agreement written on the borrower's letterhead and signed by the borrower's president.) Nonetheless, when the borrower failed to repay the loan and the lender sued, the borrower claimed that the loan was in violation of the criminal usury statute, and the court agreed.

An important limitation on New York's usury laws is that they apply only to loans of less than $2.5 million. Any loan over this amount is not subject to either the civil or criminal usury provisions. (Loans from more than one lender to a single borrower as part of a single financing will be aggregated for purposes of determining whether the total amount loaned meets or exceeds $2.5 million.)

New York's usury laws also carve out from their application any loan made to a corporation for business purposes in an amount of $100,000 or more that is secured under the Uniform Commercial Code. However, that is only if the interest rate is not greater than the prime rate plus 8%. Thus, for many types of transactions that a PE/VC lender might be contemplating that include fees, warrants or other securities, this interest rate ceiling will be too low to help.

If a VC/PE firm is contemplating making a loan of less than $2.5 million, it should consider whether New York's usury laws, as opposed to the laws of another state, would apply. Choice of law issues can be bedeviling, and neither time nor space permit even a broad overview of the potential issues. Suffice it to say that if the borrower is an entity formed under New York law, or if its business is based largely in New York, or if the loan documents choose New York as the governing law, then there is at least a possibility that New York's usury statutes will be implicated, and the parties will need to structure the transaction so that these laws are either complied with or avoided altogether.

If it appears that New York's usury statute will apply, then the parties need to consider not only the nominal interest rate stated in the loan agreement or promissory note, but possibly also the fees that the lender plans to charge, in computing the interest rate for usury purposes. Shares of the borrower's stock or warrants or other securities being issued to the lender as part of the consideration for the loan also need to be considered. One can easily see how the resulting interest rate could exceed the 25% maximum allowed under New York's criminal usury statutes.

Under the civil usury statute (which sets a 16% maximum rate for certain loans of less than $250,000) the answer is straightforward and draconian -- most lenders (other than certain types of banking or savings and loan institutions) forfeit all interest and principal and, as an added insult, must repay the borrower any interest previously received. In essence, the loan becomes a gift. So what happens if a loan transaction is indeed found to be usurious under New York's criminal usury law?

Interestingly, the answer is not at all clear. One would think that the New York criminal usury statute would specify a remedy to the borrower that is just as bad or worse for the lender. However, while the law specifically permits a borrower to raise violation of the criminal usury statute as a defense in a civil suit, it does not specify what remedies should be available to the borrower if such a defense is successful. One New York court pointed out this anomaly, but the legislature has yet to address it.

In an effort to avoid usury, lenders often include so-called savings clauses in their loan documents (that is, provisions indicating that, if the loan is found to be usurious, the interest rate will be deemed reduced to the highest rate permissible under law, and payments previously received in excess of

such rate will be deemed to be principal payments). New York courts have not tended to view these clauses with much sympathy.

So, a word to the wise for all prospective lenders out there: If you're thinking about making a loan of less than $2.5 million and the borrower or the transaction appears to have some nexus to New York, be careful how you put the deal together -- don't get used by New York's usury laws.

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