

**Medallion Fin. Corp. v Weingarten**

2014 NY Slip Op 30493(U)

February 26, 2014

Sup Ct, New York County

Docket Number: 653095/12

Judge: Melvin L. Schweitzer

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This opinion is uncorrected and not selected for official publication.

SUPREME COURT OF THE STATE OF NEW YORK  
COUNTY OF NEW YORK : PART 45

-----X	
MEDALLION FINANCIAL CORP., MEDALLION	:
FUNDING LLC, MEDALLION BANK and	:
FRESHSTART VENTURE CAPITAL CORP.,	:
	:
Plaintiffs/Counterclaim Defendants,	:
	:
-against-	:
	:
VICTOR WEINGARTEN, ATOM TRANSIT LLC,	:
ET AL.,	:
	:
Defendants/Counterclaim Plaintiffs.	:
-----X	

Index No. 653095/12  
DECISION AND ORDER  
Motion Sequence No. 002

**MELVIN L. SCHWEITZER, J.:**

In 2006 the plaintiffs (or lenders) and defendants entered into an approximately \$16 million credit arrangement to finance the purchase of 34 taxi medallions. Financing was made available by the lenders to 17 LLCs set up by Victor Weingarten (Mr. Weingarten) to purchase and hold the medallions. Each financing was structured as two simultaneous transactions: an "A Piece" and a "B Piece." The B Piece provided initially for fixed interest at 6.375 percent, which rate was reset in November 2011 at 3 percent for 13 loans and 2.674 percent for four loans. The LLCs entered into Investment Agreements with the B Piece lender providing:

"[A]s partial consideration for the Lender's entering into the Loan and related agreements, the Borrower has agreed to pay to the Lender certain additional interest in the form of the profit from the appreciation in the value of the [medallions] pursuant to the terms and conditions set forth herein."

The Investment Agreements referred to this as a Participation Interest. In December 2011 the lenders exercised their Participation Interest rights. The LLCs did not pay the approximately

\$7 million due pursuant to the Participation Interest rights and the lenders declared a default and subsequently initiated this suit.

The lenders move for summary judgment.

### **Discussion**

Defendants assert the defense of usury, claiming that interest payable on the B Piece, including the amount due from the Participation Interest, is usurious under New York law and the federal Small Business Investment Act of 1958 (SBIA).

The lenders argue that the defense of usury is not available under either New York State or federal law. It is not necessary to analyze the parties position with respect to New York law, as the court holds that New York usury law is preempted by the SBIA. The court also holds that the financing arrangements, including the Participation Interest of the B Piece, are not usurious under the SBIA. The courts reasoning with respect to preemption and usury under the SBIA follow.

### **Preemption**

The SBIA was passed by Congress:

to improve and stimulate the national economy in general and the small-business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply.

15 U.S.C.A. § 661.

The goals of the SBIA are implemented by the U.S. Small Business Administration (SBA), which is an independent agency of the federal government. Under the SBIA, the SBA

oversees the licensing of the lender that issued the “B Piece” financing, which is a regulated entity that is authorized to provide financings to qualified small businesses pursuant to the regulatory requirements of the SBIA.

With respect to preemption, the SBIA provides:

A State law or constitutional provision shall be preempted for purposes of paragraph (2) with respect to any loan if such loan is made before the date, on or after April 1, 1980, on which such State adopts a law or certifies that the voters of such State have voted in favor of any provision, constitutional or otherwise, which states explicitly and by its terms that such State does not want the provisions of this subsection to apply with respect to loans made in such State, except that such State law or constitutional provision shall be preempted in the case of a loan made, on or after the date on which such law is adopted or such certification is made, pursuant to a commitment to make such loan which was entered into on or after April 1, 1980, and prior to the date on which such law is adopted or such certification is made.

15 USC § 687 (i) (3). New York has not opted out of this statutory scheme.

The court measured defendants’ arguments that preemption was not intended with respect to the circumstances here. The arguments are not persuasive. Congress’ intent was to stimulate the small-business economy and benefit small-business borrowers by increasing the availability of small-business loans. Congress attempted to accomplish this by adopting a flexible usury protocol, which the court discusses below. Defendants’ contention that Congress’ intent certainly did not extend to removing New York’s usury protocol, as this would remove a “benefit” for small-business borrowers is without merit.

### SBIA

Preliminary to discussing the structure of the SBIA, the court examined the inherent nature of the Participation Interest. It is a grant to the lender of a risk interest in the appreciation of the

value of property. This is universally understood to be equity. There is no other way such a risk interest can be defined or construed.

Defendants' argument that the Participation Interest renders the financing usurious under the SBIA relies on the simple and incorrect premise that the financings provided to defendants were structured solely with simple interest payments, such as one might have in applying for a car loan or mortgage. While the components of principal and interest are certainly present here, the Participation Interest is a contingent obligation which is exempt from the SBIA's definition of interest and is a type of equity security exempted under the definition of "Cost of Money." 13 C.F.R. § 107, 855.

Defendants contend that the Participation Interest was not an equity security, and more specifically, a cash-settled warrant. Generally, the term "equity security" brings to mind the purchase of shares of stock or an ownership interest in a company. The definition of equity securities under the SBIA incorporates that concept, but also includes "warrants." 13 C.F.R. § 108.50. While a stock warrant requires the issuer to provide shares if the warrant is exercised, a cash-settled warrant merely requires a cash payment based on the value of those shares.

The Participation Interest, which was based on the appreciation of the value of property, unquestionably is what is widely known in financial terms as a cash-settled warrant. When the terms of the Participation Interest are compared to the requirements under the SBIA regarding the redemption of equity securities, it is evident that the Participation Interest meets the SBIA's requirements. The SBIA states, in pertinent part:

- (a) A Portfolio Concern [defined as a company receiving funding from an SBIC] cannot be required to redeem Equity Securities earlier than one year from the date of the first closing unless:

\* \* \*

- (2) You make a follow-on investment, in which case the new securities may be redeemed in less than one year, but no earlier than the redemption date associated with your earliest Financing of the concern.

\* \* \*

- (b) The redemption price must be either:
- (1) A fixed amount that is no higher than the price you paid for the securities; or
- (2) An amount that cannot be fixed or determined before the time of redemption. In this case, the redemption price must be based on:
- (i) A reasonable formula that reflects the performance of the concern (such as one based on earnings or book value); or

\* \* \*

- (c) Any method for determining the redemption price must be agreed upon no later than the date of the first (or only) closing of the Financing.

13 C.F.R. § 107.850.

Section 2.1 of the Investment Agreement did not permit the lenders to exercise the Participation Interest unless the defendants chose to refinance for “an amount in excess of the Initial Principal Amount” (which tracks the requirement of 13 C.F.R. § 107.850 (a) (2)), or the defendants sold the collateral (which tracks the requirement of 13C.F.R. § 107.850 (a) (1)), or a period of five-years had passed (which is in excess of the period required by 13C.F.R. § 107.850 (a)). In addition, the amount of the Participation Interest was not “fixed or determined” before the time of redemption (which tracks the requirement of 13 C.F.R. § 107.850 (b) (2)), and was based on “a reasonable formula that reflect the performance of the

concern.” 13 C.F.R. § 107.850 (b) (2) (i). The formula for the Participation Interest was determined at closing, as required by 13 C.F.R. § 107.850 (c).

Importantly, in calculating the Cost of Money, SBIA regulations exclude equity securities. Specifically, the SBIA states:

- (a) Financings to which the Cost of Money rules apply. This section applies to all Loans and Debt Securities. As required by § 107.800 (b), you must include as Debt Securities any equity interests with redemption provisions that do not meet the restrictions in § 107.850.

13 C.F.R. § 107.850 (a). As described above, the Participation Interest met the requirements of § 107.850, and as a result, would not be included in the Cost of Money.

In addition to making straight loans to small businesses, lender is permitted to provide financings to small businesses that are a combination of debt and equity financings. These financings are referred to in the SBIA as “Debt Securities” and are defined as “instruments evidencing a loan with an option or any other right to acquire Equity Securities to a Small Business or its Affiliates.

Under the SBIA, the “interest and other consideration” an SBIC receives from a small business is called the Cost of Money. The Cost of Money regulation in the SBIA places a ceiling on the interest rate an SBIC can charge on a loan (19%) and on a Debt Security (14%). 13 C.F.R. § 107.855(c). The Cost of Money ceiling is determined at the inception of the financing. 13 C.F.R. § 107.855 (b).

The SBIA has excluded from the definition of “interest,” contingent obligations such as the Participation Interest. Specifically:

In the case of a business loan, the small business investment company making such loan may charge interest on such loan at a rate which does not exceed the

maximum rate prescribed by regulation by the Administration for loans made by any licensee (determined without regard to any State rate incorporated by such regulation). In this paragraph, the term "interest" includes only the maximum mandatory sum, expressed in dollars or as a percentage rate, that is payable with respect to the business loan amount received by the small business concern, and does not include the value, if any, of contingent obligations, including warrants, royalty, or conversion rights, granting the small business investment company an ownership interest in the equity or increased future revenue of the small business concern receiving the business loan.

15 USC § 687 (i) (2) (emphasis added).

In calculating the Cost of Money ceiling, the SBIA excludes certain categories of consideration. For example, excluded from this ceiling are "Equity Security" interests under the SBIA. 13 C.F.R. § 107.855 (g) (12). The SBIA defines Equity Security as "stock of any class in a corporation, stock options, warrants, limited partnership interests in a limited partnership, membership interests in a limited liability company, or joint venture interests." 13 C.F.R. § 107.800 (b). As noted, the Participation Interest was what is a cash settled warrant. The Participation Interest was exercisable at a fixed point (i.e. it was exercisable at any time after a trigger date) and provided a defined cash benefit to the lender when it was exercised. The "B Piece" provides the lender with a monetary payment contingent on an increase, if any, in the value of the medallions during the term of the financing. The final form of the Participation Interest as a cash settled warrant excludes the Participation Interest from the Cost of Money calculation. *See* 13 C.F.R. § 107.800 (b).

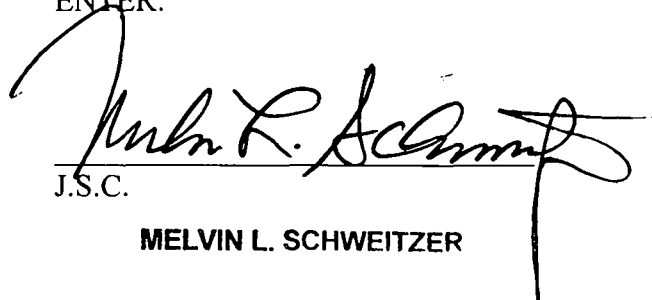
As noted above, the Cost of Money is calculated at the inception of the financing. 13 C.F.R. § 107.855 (b). At the inception of the financing, the Participation Interest was worth zero. There was no guarantee that the Participation Interest would increase in value, and no way to fix the unknown future value of the Participation Interest.

The B Piece was not usurious under the SBIA.

ORDERED that plaintiffs' motion for summary judgment is granted.

Dated: February 26, 2014

ENTER:



A handwritten signature in black ink, appearing to read "Melvin L. Schweitzer", is written over a horizontal line. The signature is stylized and cursive.

J.S.C.

MELVIN L. SCHWEITZER