

SUPREME COURT OF THE STATE OF
COUNTY OF NEW YORK: COMMERCIAL DIVISION

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AJW PARTNERS, LLC, AJW OFFSHORE, LTD.,
AJW QUALIFIED PARTNERS, LLC, NEW MILLENNIUM
CAPITAL PARTNERS II, LLC, and
AJW MASTER FUND, LTD.,

Plaintiffs,

Index No. 602987/08

-against-

ITRONICS INC., WHITNEY & WHITNEY, INC.,
ITRONICS METALLURGICAL, INC., ITRONICS
CALIFORNIA, INC., AMERICAN HYDROMET,
NEVADA HYDROMETALLURGICAL PROJECT, and
ITRONICS GOLD'N MINERALS, INC.,

Defendants.



Charles Edward Ramos, J.S.C.:

Plaintiffs AJW Partners, LLC, AJW Offshore, Ltd., AJW
Qualified Partners, LLC, New Millennium Capital Partners II, LLC,
and AJW Master Fund, Ltd. (collectively, "AJW"), move to dismiss
counterclaims 1 through 3, and 5 through 8, of defendants
Itronics Inc., Whitney & Whitney, Inc., Itronics Metallurgical,
Inc., Itronics California, Inc., American Hydromet, Nevada
Hydrometallurgical Project, and Itronics Gold'N Mineral, Inc.
(collectively, "Itronics"), pursuant to CPLR §§ 3211(a)(1) and
3211(a)(7).

Background

AJW consists of a group of investment funds that have lent
over \$6 million to Itronics, a publicly traded company located in
Texas. AJW first entered into a Securities Purchase Agreement
(the "Agreement") in July 2005, where, along with setting forth
certain covenants, Itronics agreed to issue Callable Secured
Convertible Notes (the "Notes") in the amount of \$3.25 million.

After this transaction, AJW purchased additional Notes from Itronics between July 2006 and July 2008, totaling approximately \$3 million.

Fourteen separate financings, including forty-four Notes, were issued to, or purchased by, AJW, totaling \$6.83 million (Affidavit of Michael Horsley, ¶ 15). While all of these Notes are for different rates of interest, maturity dates, and principal amounts, the terms and obligations of their agreements are primarily the same (Itronics Memorandum of Law, pg 9).

All of the Notes had a conversion right, whereby AJW could convert the debt instruments into Itronics' common stock by submitting a conversion notice to Itronics. As of the date of this motion, AJW has converted \$2,802,784.70 worth of notes into 1,317,694,738 shares of Itronics common stock (Affidavit of Michael Horsley, ¶ 15).

This action ensued after Itronics failed to honor a conversion notice submitted by AJW in August 2008. AJW claims that Section 3.2 of the Notes defines an "Event of Default" as, among other things, "[failure] to issue shares of Common Stock to the Holder (or announces or threatens that it will not honor its obligation to do so) upon exercise" of AJW's notice of conversion. Section 3.10 of the Notes further states that upon an "Event of Default" under any Note, an "Event of Default" occurs under every other Note.

Itronics claims they refused to convert the requested shares because AJW is in direct breach of the Notes. Itronics asserts

nine counterclaims against AJW, including: fraud, negligent misrepresentation, breach of fiduciary duty, two counts of breach of contract, breach of the implied covenant of good faith and fair dealing, conversion, and declaratory judgment on the issue of usury.

Discussion

CPLR §§ 3211(a)(1) and 3211(a)(7) provide two separate standards of review. Under CPLR § 3211(a)(1), only submitted documentary evidence that "conclusively establishes a defense to the asserted claims" warrants dismissal as a matter of law. *Leon v Martinez*, 84 NY2d 83, 87-88 (1994). Under CPLR § 3211(a)(7), while assessing the adequacy of the complaint, the court must recognize all factual allegations as correct, "accord plaintiffs the benefit of every possible favorable inference," and simply determine whether the facts alleged state a plausible cause of action. *Leon*, 84 NY2d at 88. Pleadings deserve a liberal construction under these motions. *Id.*

First Counterclaim - Fraudulent Inducement

"The essential elements of a cause of action for fraud are 'representation of a material existing fact, falsity, scienter, deception and injury.'" *New York Univ. v Cont'l Ins. Co.*, 87 NY2d 308, 318 (1995), quoting *Channel Master Corp. v Aluminum Ltd. Sales Corp.*, 4 NY2d 403, 407 (1958).

Itronics alleges that AJW "materially misrepresented that they would act in good faith and not employ fraudulent means for self-gain in its execution of" the covenants contained in the

Agreement (i.e., AJW would not participate in the "short selling" of Itronics' common stock) (Affidavit of Thomas Fleming, Exhibit B ¶ 58). However, "general allegations that [the] defendant entered into a contract while lacking the intent to perform it are insufficient to support" a claim based on fraud. *New York Univ.*, 87 NY2d at 318.

In support of the fraudulent inducement claim, Itronics alleges AJW represented that they were "long-term investors... and would in no way prejudice Itronics or damage the value of its stock" (Itronics Counterclaims, ¶ 31). However, Itronics cannot rely upon such a statement. Although the pleading standard is more flexible under CPLR § 3211(a)(7), "allegations consisting of bare legal conclusions, as well as factual claims...*flatly contradicted by documentary evidence*, are not entitled to such consideration." *Sud v Sud*, 211 AD2d 423, 424 (1st Dept 1995) (*emphasis added*). Here, the Agreement states that AJW does "not agree to hold any of the Securities for any minimum or other specific term and reserves the right to dispose of the Securities at any time in accordance with or pursuant to a registration statement" (Affidavit of Thomas Fleming, Exhibit C § 2(a)). This is exactly what AJW did: once a registration statement was filed and approved by the Securities and Exchange Commission ("SEC"), no matter if it was more or less than a year, AJW proceeded to sell its shares of stock - as was their right under the Agreement.

Finally, AJW is correct to state that these allegations

"sound in contract, not fraud." (AJW Memorandum of Law, pg 6). A proper claim of fraud must "arise from circumstances extraneous to, and not constituting elements of, the contract" by of which "represent the breach of a legal duty independent of the contract itself." *Baker v Norman*, 226 AD2d 301, 304 (1st Dept 1996). Here, the representations that AJW would not sell Itronics' stock short, and would not exceed the volume trading restrictions, are set forth within the Agreement (Affidavit of Thomas Fleming, Exhibit B ¶¶ 30-32). Therefore, the fraud cause of action is more appropriately covered under the fourth counterclaim of breach of contract, and is dismissed.

Second Counterclaim - Negligent Misrepresentation

A necessary element of negligent misrepresentation is to "adduce facts tending to show a special or fiduciary relationship with [the] defendant." *FAB Indus., Inc., v BNY Financial Corp.*, 252 AD2d 367 (1st Dept 1998). No such facts are provided here by Itronics.

"There is no fiduciary duty...arising out of the contractual arm's length debtor and creditor legal relationship...which would give rise to a cause of action for negligent misrepresentation." *Banque Nationale de Paris v 1567 Broadway Ownership Assocs.*, 214 AD2d 359, 360 (1st Dept 1998). Section 3(o) of the Agreement expressly states that AJW is "acting solely in the capacity of arm's length purchasers," and that AJW is not acting "as a financial advisor or fiduciary of [Itronics] (or in any similar capacity)." The claim for negligent misrepresentation is

dismissed.

Third Counterclaim - Fiduciary Duty

Itronics contends that whether a fiduciary duty is owed is a question of fact. This statement is not baseless, just misapplied. While the question of "whether a particular defendant owes a duty to a particular plaintiff is a question of fact," the existence and nature of a duty, which must be determined first, is an issue of law. *Kimmell v Schaefer*, 89 NY2d 257, 263 (1996).

The relationship between "one of debtor and note-holding creditor...is purely contractual." *SNS Bank, N.V. v Citibank*, 7 AD3d 352, 354 (1st Dept 2004). Itronics argues that the language of Section 3(o) of the Agreement is not dispositive (Itronics Memorandum of Law, pg 27). However, the claim of fiduciary duty is "flatly contradicted" by Section 3(o), which explicitly states the parties' intent that neither was acting as fiduciaries, but at arm's length (Affidavit of Thomas Fleming, Exhibit C § 3(o)). See *CIBC Bank & Trust Co. (Cayman) Ltd. v Credit Lyonnais*, 270 AD2d 138, 139 (1st Dept 2000) (dismissed the claim of breach of fiduciary duty because the agreement between the parties stated they were astute investors that "acted in the capacity of an arm's-length contractual counterparty and not as [the other's] financial advisor or fiduciary"). Because this claim is rooted in contract, the counterclaim of breach of fiduciary duty is dismissed.

Fifth Counterclaim - Breach of Contract

Itronics alleges that AJW breached Section 1.1 of the Notes by holding over 4.99 percent of Itronics' common stock. Section 1.1 provides, in pertinent part:

In no event shall [AJW] be entitled to convert any portion of this Note in excess of that portion of this Note upon conversion of which the sum of (1) the number of shares of Common Stock beneficially owned by [AJW] and its affiliates...and (2) the number of shares of Common Stock issuable upon the conversion of the portion of this Note... [that] would result in beneficial ownership by [AJW] and its affiliates of more than 4.99% of the outstanding shares of Common Stock... For purposes of this proviso...beneficial ownership shall be determined in accordance with Section 13(d) of the Securities Exchange Act of 1934, as amended, and Regulations 13D-G thereunder.

By way of an SEC filing, Itronics provides an explanation of the possible impact of Section 1.1:

Although [AJW] may not convert their secured convertible notes... if such conversion...would cause them to own more than 4.99% of our outstanding common stock, this restriction does not prevent [AJW] from converting...some of their holdings and then converting the rest of their holdings. In this way, [AJW] could sell more than this limit while never holding more than this limit.

SEC filing Form SB-2, August 26, 2005.

Thus, Section 1.1 merely requires that more than 4.99 percent of Itronics' common stock never be held by AJW at *any one single time*, not 4.99 percent in the aggregate of already accumulated shares. Due to this, AJW could, as they have done, convert up to 4.99 percent of the outstanding Itronics shares, sell a portion of those shares, and then convert an equal portion of the amount sold so that the 4.99 percent limit is not

breached.

Itronics fails to allege anywhere in their Answer with Counterclaims or motion papers that AJW has ever held more than 4.99 percent, individually or collectively, of Itronics stock at any single point in time. Such allegation would lead to a possible breach of Section 1.1. Rather, Itronics states that "[AJW] collectively assumed greater than 4.99% ownership of Itronics under a unified common ownership structure between all [AJW counterparts (i.e., its subsidiaries)] without any intention of reporting its greater than 4.99% ownership interest to the SEC as required by law and engaged in a scheme that would be effectively an unregistered underwriting" (Defendant's Counterclaims, ¶ 43). This statement does not allege that AJW held more than 4.99 percent of stock *at a single point in time*. It simply alleges that all of AJW's parts, collectively, held more than 4.99 percent over a period of multiple conversions.¹

¹ At oral argument, Mr. Ernest Badway, counsel for Itronics, was asked specifically if AJW's "position at some point in time exceeded 5 percent" (Trial Record, pg 47) (*emphasis added*). Mr. Badway responded, "Yes." *Id.* In light of this response, on June 22, 2009, this Court asked Itronics' counsel whether they were planning to submit an affidavit swearing to the assertion that AJW has held over 5% of Itronics' common stock at some single point in time, or if it intends to move to amend the pleadings accordingly. In response, in a letter dated July 2, 2009, Mr. Badway asserted that "the pleadings, together with the affidavits submitted to date, create a sufficient record to support [Itronics'] allegations..." In his assertion, Mr. Badway relied on the affidavit of Mr. Horsley, and that the fourth counterclaim "established a prima facie cause of action for Breach of Contract based upon [AJW's] ownership of more than 4.99% of outstanding shares in Itronics stock at a given time." Such reliance does not fulfill this Court's request. First, Mr. Horsley avers that AJW converted stock totaling 77% of the total outstanding shares of Itronics, but not that AJW held more than 5% of any of that

Sixth Counterclaim - Breach of Implied Covenant of Good Faith and Fair Dealing

"All contracts imply a covenant of good faith and fair dealing." *511 W. 232nd Owners Corp. v Jennifer Realty Co.*, 98 NY2d 144, 152 (2002). However, "a breach of the implied duty of good faith and fair dealing is intrinsically tied to the damages allegedly resulting from the breach of the contract," and should be held as duplicative of the breach of contract claim. *Levi v Utica First Ins. Co.*, 12 AD3d 256, 257-258 (1st Dept 2004).

Itronics alleges that AJW "breached their commitment to act as long-term business partners by operating in a fashion detrimental to Itronics, and instead, focused on squandering the equity of Itronics" (Itronics Memorandum of Law, pg 31). This allegation refers to AJW's potential breach of the Agreement to not sell Itronics' shares short, and thus is covered under their fourth counterclaim of breach of contract. Therefore, the sixth counterclaim for breach of implied covenant of good faith and fair dealing is dismissed.

Seventh Counterclaim - Conversion

Itronics bases their conversion counterclaim on two things: alleged misrepresentations made by AJW that they would not short

portion at a single time. Second, the allegations made in the fourth counterclaim, which are included by reference into the fifth counterclaim, still only purports that AJW agreed to "not collectively own more than 4.99%" of Itronics' common stock, rather than at a single point in time (Defendant's Counterclaims, ¶ 73) (*emphasis added*). For these reasons, Mr. Badway's assertion that the pleadings and affidavits suffice to adequately support his statement during oral argument is meritless.

sell Itronics' stock, and that AJW held more than 4.99 percent of Itronics' stock at a single point in time. However, "a claim to recover damages for conversion cannot be predicated on a mere breach of contract." *Wolf v National Council of Young Israel*, 264 AD2d 416, 417 (2nd Dept 1999). Being that such an alleged misrepresentation and accusation is covered under the fourth counterclaim asserted by Itronics, the seventh counterclaim is dismissed as duplicative.

Eighth Counterclaim - Declaratory Judgment for Usury

The eighth counterclaim is for a declaratory judgment that the Notes were usurious under New York Penal Law § 190.40, which provides:

A person is guilty of criminal usury in the second degree when, not being authorized or permitted by law to do so, he 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 twenty-five per centum per annum or the equivalent rate for a longer or shorter period.

On their face, the Notes are not usurious. They do not require a repayment of interest higher than 12 percent. However, Itronics focuses on the conversion feature of the Notes to determine usurious implications.

Itronics argues that the Notes charged "apparent" interest on the principal and "hidden" interest through the discounted conversion prices, due to, among other things, a 70 percent discount applying to all of the Notes (Itronics Reply Memorandum of Law, pg 33). Itronics claims that "when the 70% discount is amortized over the three year term of the loan, it creates an

interest rate of 77.78% per annum" (Affidavit of Michael Horsley, ¶ 52). Itronics further claims that in addition to that, the 12 percent per annum "would also be converted to stock at the 70% discount, thereby resulting in additional interest of 28% per annum." *Id* at ¶ 54. Therefore, Itronics alleges that the combined interest on the Notes is 117.78 percent per annum. *Id* at ¶ 55. Such arithmetic provides Itronics with the contention that the Notes are usurious on their face.

The New York Penal Law requires a transaction by one who "knowingly charges, takes or receives any money or other property as interest on the loan." New York Penal Law § 190.40 (*emphasis added*). "A loan is not usurious merely because there is a possibility that the lender will receive more than the legal rate of interest." *Lehman v Roseanne Investors Corp.*, 106 AD2d 617, 618 (2nd Dept 1984) (*emphasis added*). The underpinning of Itronics' reasoning is based on hindsight and speculation of the future value of Itronics' stock. By way of example, Itronics shares of stock could not be sold until the SEC approved a registration statement. It is not known when approval can be obtained, if at all.

Lastly, General Obligations Law § 5-501 provides:

No law regulating the maximum rate of interest which may be charged, taken or received, including section 190.40...of the penal law, shall apply to any loan or forbearance in the amount of two million five hundred thousand dollars or more. Loans or forbearances aggregating two million five hundred thousand dollars or more which are to be made or advances to any one borrower in one or more installments pursuant to a written agreement by one or more lenders shall be deemed to be a single loan or forbearance for the total

amount which the lender or lenders have agreed to advance or make pursuant to such agreement on the terms and conditions provided therein.

The Agreement calls for \$3.25 million, in the aggregate, to be loaned to Itronics (the Agreement, ¶ B). Therefore, the Notes are exempt from the criminal usury law. See *Tides Edge Corp. v Central Federal Savings, F.S.B.*, 151 AD2d 741, 742 (2nd Dept 1989) (holding a transaction consisting of over \$2.5 million exempt from "any law regulating the payment of interest" due to General Obligations Law § 5-501). The eighth counterclaim is denied.

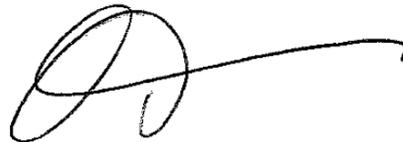
Accordingly, it is

ORDERED that plaintiff's motion to dismiss defendant's counterclaims 1 through 3 and 5 through 8 is granted; and it is further

ORDERED that the remainder of the action shall continue.

Dated: July 16, 2009

ENTER:



J.S.C.

HON. CHARLES E. RAMOS

