UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF KENTUCKY
LEXINGTON DIVISION

IN RE:

TREASURE ISLES HC, INC., et al. **CASE NO. 10-50304**

DEBTOR(S)

TREASURE ISLES, INC. **PLAINTIFF**

VS. **ADV. NO. 10-5089**

A&W RESTAURANTS, INC.,
LONG JOHN SILVER'S, INC., and
YUM! BRANDS, INC. **DEFENDANTS**

ORDER

This matter is before the Court on the Defendants A&W Restaurants, Inc. ("A&W"), Long John Silver's Inc. ("LJS"), and Yum! Brands, Inc. ("Yum!") (collectively the "Defendants") Motion to Dismiss this adversary proceeding [Doc. 12]. The Court having considered the extensive arguments of counsel in the briefs filed by the parties, and being otherwise sufficiently advised, finds the following:

Facts and Procedural History

The Debtor Treasure Isles, Inc. ("Treasure Isles") commenced this adversary proceeding on September 16, 2010, alleging the Defendants' fraud, breach of contract and other tortuous and wrongful actions in connection with the sale and development of seven co-branded A&W and LJS restaurant franchises owned and operated by the Debtor resulted in the failure of the restaurants and ultimately the Debtors' bankruptcy.

A. Treasure Isles' Complaint

The Complaint alleges that starting in 2000, Treasure Isles, which owned a total of thirtysix LJS franchises during its thirty-eight year history, agreed to convert two of their Illinois restaurants into co-branded A&W and LJS restaurant franchises. In early 2000, A&W and LJS announced that they were merging and combining operations to expand the co-brand business. According to Treasure Isles, in an effort to induce LJS franchisees such as Treasure Isles to convert their existing LJS restaurants into co-branded A&W and LJS restaurants, the Defendants "publicly touted the co-branding of A&W and LJS products in a single restaurant as an incredible opportunity that would create operational efficiencies, reduce expenses and increase sales and promotional opportunities." (Compl. at ¶¶ 4-5, 35-44). A&W and LJS requested that Treasure Isles open the first two co-branded A&W and LJS restaurant franchises and, relying on the Defendants' representations, Treasure Isles agreed. (*Id.* at ¶ 8, 45-46). Between 2002 and 2007, again relying on the representations by the Defendants, Treasure Isles converted five additional Illinois restaurants to co-branded restaurants. Treasure Isles ultimately invested $5.4 million in making extensive changes to its existing LJS restaurants to meet the specifications and standards that it was required to follow as part of the conversion process. (*Id.* at ¶¶ 9-10, 47-50).

Treasure Isles alleges that prior to the conversion, the seven restaurants were operating successfully and profitably as stand-alone LJS restaurants, but this changed when the restaurants were converted to A&W and LJS co-branded restaurants. In Treasure Isles' words, the Defendants' effort to co-brand A&W and LJS products was an "abject failure," and in 2009, the Defendants decided to stop supporting the co-branding program. The Defendants stopped offering co-branded A&W and LJS restaurant franchises for sale and divested themselves of all 186 co-branded A&W and LJS restaurants they owned, while also removing the A&W brand from all their 100 co-branded A&W and KFC restaurants. Treasure Isles claims that the Defendants' decision severely injured Treasure Isles' restaurants, which were already crippled by poor performance, thus forcing it to file for bankruptcy protection. (*Id.* at ¶¶ 11-16, 129-138).

Treasure Isles' allegations revolve around the relationship between the Defendants and an organization known as the National A&W Franchisees Association ("NAWFA"), a non-profit Washington corporation formed for the express purpose of protecting and promoting the general interests of A&W franchisees. (*Id.* at ¶¶ 51-56). Treasure Isles alleges the Defendants entered into agreements with NAWFA, controlled primarily by single-brand A&W franchisees opposed to the co-branding program, that dictated how the co-branded restaurants were constructed and operated and in doing so, doomed them to failure. (*Id.* at ¶¶ 57-70).

Treasure Isles claims that in 1999 and 2002, the Defendants entered into two written agreements with NAWFA that gave control over all of the equipment, menu and operational standards for the co-branded A&W and LJS restaurants and allowed NAWFA to dictate the manner in which the co-branded A&W and LJS restaurants were constructed and operated. According to Treasure Isles, the terms of the Defendants' agreements with NAWFA were not disclosed to it in the franchise offering circulars that the Defendants were required by state and federal franchise law to provide to Treasure Isles before it invested in the co-branded franchises. Rather, Treasure Isles alleges the Defendants provided it with misleading and deceptive franchise offering circulars that made misrepresentations and omissions of material fact regarding the NAWFA agreements. (*Id.* at ¶¶ 17-23, 57-102).

Treasure Isles claims that the Defendants concealed this fraud by repeatedly failing to include the material information regarding the co-branded A&W and LJS restaurants to Treasure Isles and by providing incomplete, inaccurate, and misleading information regarding the NAWFA agreements in the franchise offering circulars. According to Treasure Isles, it did not discover the information regarding NAWFA's control and the NAWFA agreements until 2008, when the Chairman of Treasure Isles was elected to one of the two director seats that co-brand A&W franchisees are entitled to hold. (*Id.* at ¶¶ 103-105).

Treasure Isles further alleges that the Defendants breached their A&W, LJS, and co-franchise agreements (attached as exhibits to the Complaint) and violated their implied duty of good faith by failing to properly support, promote and develop the co-branded A&W and LJS restaurant franchises, ceding control to NAWFA, and failing to contribute and utilize millions of dollars that they were required to spend on advertising for the co-branded restaurants. According to Treasure Isles, the Defendants decision to abandon and stop supporting the co-branding program constructively terminated and materially breached Treasure Isles' co-branded A&W and LJS franchise agreements. (*Id.* at ¶¶ 24-25, 106-132).

Treasure Isles claims the Defendants breached their fiduciary duties in connection with the administration of an advertising trust fund to which Treasure Isles contributed, and aided and abetted NAWFA in its breach of fiduciary duties. Specifically, Treasure Isles takes issue with the fact that A&W agreed that NAWFA could take 3% of the funds contributed to the advertising trust fund as "compensation" for administering the fund but the administrative fee was in excess of the expenses actually incurred by NAWFA in administering the fund. Further, Treasure Isles alleges that A&W agreed to pay a secret rebate to NAWFA out of the royalties it received on A&W sales from only co-branded restaurants, equal to .6% of the net A&W sales of the co-branded restaurants, none of which was used to promote or develop the co-branded restaurants. (*Id.*).

Because of the NAWFA dictated plans, specifications and standards, Treasure Isles alleges that the cost of co-branded restaurants significantly increased, which reduced the revenues and profitability, and fatally undermined the success of the co-brand program. Treasure Isles alleges that it has incurred the loss of $5.4 million it invested in converting LJS restaurants into co-branded A&W and LJS restaurants, the interest expense it incurred in connection with moneys that it borrowed to fund the conversions, a loss of the substantial profits it would have earned had it continued to operate the seven restaurants as LJS restaurants, the loss of interest on those funds and the expenses it has incurred in connection with the bankruptcy proceeding. (*Id.* at ¶¶ 27, 133-138).

Treasure Isles' allegations give rise to the following Counts: (1) fraud (Count I); (2) breach of contract (Count II); (3) breach of the implied covenant of good faith (Count III); (4) breach of fiduciary duty (Count IV); (5) aiding and abetting a breach of fiduciary duty (Count V); (6) violation of the Illinois Franchise Disclosure Act (Count VI); (7) claims objection and disallowance (Count VII); and (8) equitable subordination (Count VIII).

B. The Defendants' Motion to Dismiss

On October 25, 2010, the Defendants moved to dismiss the Complaint. The Defendants' first argue (1) the Plaintiff's fraud (Count I), breach of implied covenant of good faith (Count III), breach of fiduciary duty (Count IV), and aiding and abetting the breach of a fiduciary duty (Count V) claims arising out of the co-branding of its Litchfield, Decatur, Mattoon and Bloomington, Illinois restaurants are time-barred pursuant to the 5-year statute of limitation in K.R.S. § 413.120; (2) the Plaintiff's breach of contract claim (Count II) regarding its Litchfield and Decatur, Illinois restaurants is time-barred because of a contractual 1-year statute of limitations; and (3) the Plaintiff's Illinois Franchise Disclosure Act claim (Count VI) is time-barred pursuant to 815 ILCS 705/27.

The Defendants' Motion to Dismiss is also based on a failure to state a plausible claim for relief for the claims of fraud (Count I), breach of implied covenant of good faith (Count III), breach of fiduciary duty (Count IV), and aiding and abetting the breach of a fiduciary duty

(Count V) . The Defendants argue the Plaintiff fails to plead (1) reasonable reliance; (2) intent to deceive; and (3) proximate causation. Further, the Defendants claim the Plaintiff's non-contract claims are barred by the economic loss doctrine.

Finally, the Defendants argue that the Plaintiff's contract-related claims arise out of improper delegation of contractual related duties under the franchise agreements, improperly permitting certain administrative payments, and misuse of funds. The Defendants assert that these claims fail because the common law and franchise agreements between the parties explicitly allowed the Defendants to delegate their contractual obligations and duties without providing notice to the Plaintiff and contemplated the uses of the funds at issue. Further, the Defendants claim the Plaintiff has not alleged any specific provision of the relevant franchise agreements that the Defendant breached.

Rule 12(b)(6) and *Iqbal*

The Defendants have moved to dismiss this proceeding pursuant to Fed. R. Civ. P. 12(b)(6), made applicable to this proceeding by Fed. R. Bankr. P. 7012. In order "[t]o survive a motion to dismiss [under Rule 12(b)(6)], a complaint must contain sufficient factual matter, accepted as true, to 'state a claim of relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 555 (2007)). "A pleading that offers 'labels and conclusions" or "a formulaic recitation of the elements of a cause of action will not do.'" *Id.* "Nor does a complaint suffice if it tenders 'naked assertion[s]' devoid of 'further factual enhancement.'" *Id.*

In defining the "plausibility" standard, the *Iqbal* Court stated,

> A claim has factual plausibility when the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged. The plausibility standard is not akin to a "probability requirement," but it asks for more than a sheer possibility that a defendant has acted unlawfully. Where a

> complaint pleads facts that are "merely consistent with" a defendant's liability, it "stops short of the line between possibility and plausibility of 'entitlement to relief.'"
>
> ...
>
> In keeping with these principles a court considering a motion to dismiss can choose to begin by identifying pleadings that, because they are no more than conclusions, are not entitled to the assumption of truth. While legal conclusions can provide the framework of a complaint, they must be supported by factual allegations. When there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement to relief."

Id. (citations omitted).

In determining whether a complaint states a plausible claim for relief, the Court may consider the facts alleged in the pleadings, documents attached as exhibits or incorporated by reference in the pleadings, and matters of which the Court may take judicial notice. *See First Mercury Ins. Co. v. Christopher K Corp*., 2010 WL 4683928, *2 (E.D. Mich. November 10, 2010) (citing 2 James Wm. Moore et al., *Moore's Federal Practice* § 12.34[2] (3d ed. 2000)).

Analysis

This court has jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (B), (C) and (O).

A. Statute of Limitations

The Defendants first argue that the Plaintiff's fraud, breach of contract, breach of implied covenant of good faith, breach of fiduciary duty, aiding and abetting a breach of a fiduciary and the Defendants' alleged violations of the Illinois Franchise Disclosure Act are time-barred and should be dismissed.

(1) Fraud (Count I)

The Defendants argue that Count I falls within the 5-year statute of limitations pursuant to K.R.S. § 413.120(12) and thus is time-barred. K.R.S. § 413.120(12) states,

> The following actions shall be commenced within five (5) years after the cause of action accrued:
>
> ....
>
> (12) An action for relief or damages on the ground of fraud or mistake...

K.R.S. § 413.120(12) (2010).

Treasure Isles does not dispute that there is a 5 year statute of limitations for fraud, but relies on the tolling provisions of the discovery rule, or K.R.S. § 413.130, in arguing that its cause of action for fraud was tolled until 2008, when it discovered the Defendants' fraudulent conduct. According to K.R.S. § 413.130,

> (3) In an action for relief or damages for fraud or mistake, referred to in subsection (12) of K.R.S. § 413.120, the cause of action shall not be deemed to have accrued until the discovery of the fraud or mistake. However, the action shall be commenced within ten (10) years after the time of making the contract or the perpetration of the fraud.

K.R.S. § 413.130(3) (2010).

Treasure Isles alleges the Defendants concealed their fraudulent conduct "by repeatedly failing to include material information" regarding the co-branded restaurants in the franchise offering circulars and by providing "incomplete, inaccurate and misleading information regarding the NAWFA agreements in the 1999 UFOC, the 2002 A&W UFOC, the 2004 A&W and LJS UFOC, and the 2006 A&W UFOC." (Compl. at ¶ 103). Treasure Isles further alleges that it reasonably believed that the Defendants would comply with federal and state law to provide this material information and that "in the exercise of due diligence, Treasure Isles did not discover the existence of defendants' fraud until 2008 when the Chairman of Treasure Isles was elected to one of the two director seats that co-brand A&W franchisees are entitled to hold. At that time, Treasure Isles was provided with information regarding NAWFA's control over the development of the co-branded program and copies of the NAWFA agreements" (Id. ¶¶ 104-105).

Pursuant to the standard set forth in *Iqbal, supra*, these allegations must be taken as true. The Complaint contains allegations of the time and means of discovery (i.e. in 2008, when the Chairman was elected to a director seat) and why other discovery did not occur (i.e. due to the Defendants misrepresentations). The Court may draw the reasonable inference that, based on these factual allegations, the Defendants' alleged failure to include accurate information in the franchise offering circulars for the period of 2000 to 2007 regarding the NAWFA agreements lulled Treasure Isles into believing that no such agreements existed. It is plausible that Treasure Isles did not search for what it did not believe to be in existence.

Treasure Isles has sufficiently alleged that material facts the Defendants were required to disclose by law were concealed by the Defendants and it did not discover the allegedly fraudulent conduct until 2008. Therefore, Count I is not time-barred.

(2) Breach of Contract (Count II)

In footnote 4 of the Defendants' Motion to Dismiss, the Defendants argue that the breach of contract claims arising out of the co-branding of Treasure Isles' Litchfield and Decatur restaurants are time-barred. The statute of limitations for claims of breach of a written contract is 15 years. K.R.S. § 414.090 (2010). But the Defendants rely on the following contractual limitations period of one year to support their argument that the breach of contract claims related to Litchfield and Decatur franchise agreements, both dated in the year 2000, are time-barred:

> Any and all claims arising out of or in any manner relating to this Agreement, or any other agreement between the parties, the relationship of the Company and the Licensee,

> or any communications or dealings between the Company and the Licensee shall be barred unless an action or proceeding is commenced within one (1) year from the date the complaining party (whether such party is the Company or the Licensee) knew or should have known of the facts giving rise to such claims.

(Compl. Exh. 1, 4 ¶ 17.5). See also *Burlew v. Fidelity & Cas. Co. of New York*, 122 S.W.2d 990, 995 (Ky. App. 1938) (holding where the parties are dealing at arm's length, and the period fixed is reasonable, contract limitation fixing a shorter period than that prescribed by statute will be enforced).

Treasure Isles' breach of contract claims for those restaurants arise under the LJS franchise agreements as well (Compl. at ¶¶ 150-151) and these agreements do not include the limitations period stated in the A&W franchise agreements (Compl. Exh. 2, 5). Because the Complaint makes breach of contract allegations pursuant to the LJS agreements that do not include this language, Treasure Isles' breach of contract claims arising out of the co-branding of its Litchfield and Decatur restaurants are not time-barred.

(3) Breach of Implied Covenant of Good Faith (Count III)

The Defendants argue that Count III, breach of implied covenant of good faith, is subject to a 5 year statute of limitations under K.R.S. § 413.120(1). *See Duke v. Pigman*, 62 S.W. 867, 868 (Ky. 1901). K.R.S. § 413.120 states, in relevant part,

> The following actions shall be commenced within five (5) years after the cause of action accrued:
>
> (1) An action upon a contract not in writing, express or implied.

K.R.S. § 413.120(1) (2010). Treasure Isles counters that Count III is subject to a 15 year statute of limitation pursuant to K.R.S. § 413.090. K.R.S. § 413.090 states in relevant part,

> [T]he following actions shall be commenced within fifteen (15) years after the cause of action first accrued:

....

(2) An action upon a recognizance, bond or written contract...

K.R.S. § 413.090(2) (2010). *See also Ranier v. Mount Sterling Nat'l Bank*, 812 S.W.2d 154, 156 (Ky. 1991) ("In every contract, there is an implied covenant of good faith and fair dealing").

Treasure Isles' avers that the Defendants breached an implied covenant of good faith in every contract. (Compl. at ¶ 155). As Treasure Isles allegations are based on a breach of the implied covenant of good faith that arise out of the franchise agreements, the 15 year statute of limitations of K.R.S. § 413.090 applies and Treasure Isles' Count III is not time-barred.

(4) Breach of Fiduciary Duty (Count IV) and Aiding and Abetting a Breach of Fiduciary Duty (Count V)

The parties agree that K.R.S. § 143.120(7) sets the statute of limitations for Counts IV and V related to breach of fiduciary duty. K.R.S. § 413.120 states, in relevant part,

> The following actions shall be commenced within five (5) years after the cause of action accrued:
>
> ....
>
> (7) An action for an injury to the rights of the plaintiff, not arising on contract and not otherwise enumerated.

K.R.S. § 413.120(7) (2010). *See also Ingram v. Cates*, 74 S.W.3d 783, 787 (Ky. App. 2002).

But Treasure Isles claims that Counts IV and V are tolled by the Defendants' fraudulent concealment pursuant to K.R.S. § 413.190(2).

K.R.S. § 413.190(2) provides:

> When a cause of action *mentioned in K.R.S. 413.090 to K.R.S. 413.160* accrues against a resident of this state, and he by absconding or concealing himself or *by any other indirect means obstructs the prosecution of the action*, the time of the continuance of the absence from the state or obstruction shall not be computed as any part of the period within which the action shall be commenced.

K.R.S. § 413.190(2) (2010) (emphasis added). "The 'other indirect means' of obstruction referred to must consistent of some act or conduct which in point of fact misleads or deceives plaintiff and obstructs or prevents him from instituting his suit while he may do so." *Adams v. Ison*, 249 S.W.2d 791, 792 (Ky. 1952). Further, the concealment must be an affirmative act and cannot be assumed; it is active not passive. *See Emberton v. GMRI, Inc*., 299 S.W.3d 565, 573 (Ky. 2009). That said, the most commonly recognized exception to the affirmative act requirement applies where a party remains silent when the duty to speak or disclose is imposed by law upon that person. *Mundy v. Mayfair Diagnostic Lab*, 831 S.W.2d 912, 915 (Ky. 1992).

Treasure Isles' alleges that the Defendants provided it with incomplete, inaccurate and misleading information regarding the NAWFA agreements in the various franchise offering circulars from 2000 to 2007 despite a duty to disclose this information under federal and state law. Treasure Isles further alleges that it was not provided with copies of the NAWFA agreements until 2008. (Compl. ¶¶103-105). Treasure Isles claims the NAWFA agreements contained relevant information regarding the administration of the advertising trust fund, which is the basis of Treasure Isles' breach of fiduciary duty claim (*Id*. at ¶¶ 57-70,163-170). Where Treasure Isles has alleged that the Defendants had a duty disclose this information imposed by law, but failed to do so, and further alleged the full scope of the agreements was unknown to it until 2008, Treasure Isles has alleged sufficient facts to support a reasonable inference that the Defendants concealed and thus obstructed Treasure Isles claim for breach of fiduciary duty and aiding and abetting a breach of fiduciary. Treasure Isles has therefore sufficiently alleged facts to support that its claims under Counts IV and V were tolled until 2008 pursuant to K.R.S. § 413.190(2). Counts IV and V are not time-barred by the 5-year statute of limitations in K.R.S. §

143.120(7).

(5) Illinois Franchise Disclosure Act (Count VI)

The Defendants argue that Treasure Isles' Illinois Franchise Disclosure Act Claim (Count VI) is time-barred pursuant to 815 ILCS 705/27 of the Illinois Franchise Disclosure Act.

815 ILCS 705/27 states, in relevant part,

> No action shall be maintained under Section 26 of this Act to enforce any liability created by this Act unless brought before the expiration of 3 years after the act or transaction constituting the violation upon which it is based, the expiration of one year after the franchisee becomes aware of facts or circumstances reasonably indicating that he may have a claim for relief in respect to conduct governed by this Act, or 90 days after delivery to the franchisee of a written notice disclosing the violation, whichever shall first expire.

The 3-year statute of limitations on a claim under the Illinois Franchise Disclosure Act for fraudulent practices occurring in connection with offer or sale of a franchise accrues no later than the date that the franchise agreement was entered into. *Dudley Enterprises, Inc. v. Palmer Corp.*, 822 F. Supp. 496 (N.D. Ill. 1993). Thus, the Defendants argue that this claim is time-barred.

Treasure Isles has alleged facts sufficient to support its claim that it did not discover the Defendants fraudulent concealment until 2008. But the Defendants point out that even if Treasure Isles didn't discover the alleged violations until 2008, 815 ILCS 705/27 still bars this Count because it wasn't brought within one year of discovery.

The statute of limitations is tolled until a plaintiff has "both knowledge of the factual basis for the claim as well as legal knowledge of the potential protection." *Pyramid Controls, Inc. v. Siemens Industrial Automations, Inc.*, 176 F.R.D. 269, 273 (N.D. Ill. 1997). The court in *Pyramid Controls, Inc*., noted that Illinois courts have recognized that a plaintiff may not be aware of the IFDA or its potential protection until consulting with an attorney, although the Illinois courts stop short of holding that the one-year time period will not begin to run until the attorney specifically advises his client that he has a possible claim. *Id.* The *Pyramid Controls* court concluded that "at a minimum, the one-year time limitation of section 705/27 begins to run once the plaintiff has presented sufficient facts and/or circumstances to his attorney that 'reasonably indicate' that the plaintiff might have a claim under the IFDA." *Id.* at 274.

Treasure Isles has not addressed in its Complaint any facts supporting when it may have consulted legal counsel as to its possible claims pursuant to the Illinois Franchise Disclosure Act. Where the pleadings failed to allege affirmative acts to conceal the causes of action, or any facts going to their due diligence, the allegations should be dismissed, but with leave to file an amended complaint to cure the defect. *See Hengel, Inc. v. Hot 'N Now, Inc*., 825 F. Supp. 1311, 1320 (N.D. Ill. 1993). Therefore, Count VI is dismissed, without prejudice, and with leave to amend the Complaint.

B. Treasure Isles' Tort Claims

The Defendants argue that Treasure Isles' tort claims must be dismissed because they are implausible in that (1) Treasure Isles has not alleged that it reasonably relied on the Defendants' misrepresentations and omissions and cannot do so; (2) Treasure Isles failed to allege facts to support that the Defendants acted with an intent to deceive Treasure Isles about the co-branding program and is unable to do so; and (3) Treasure Isles failed to plead that the Defendants' conduct was the proximate cause of any injury to Treasure Isles because it cannot plead the same. The Defendants further argue that the Plaintiff's tort claims are barred by the economic loss doctrine.

(1) Reasonable Reliance

The Defendants argue that Treasure Isles reliance is unreasonable because (1) Treasure Isles disclaimed reliance on any extra-contractual representations in its franchise agreements; (2) Treasure Isles knew or should have known the truth about the material facts that the Defendants misrepresented and omitted; and (3) Treasure Isles did not exercise its right to terminate its franchises after discovering the truth about Defendants' misrepresentations. These are issues of fact that should not be decided on a motion to dismiss. *See Druckzentrum Harry Jung GmbH & Co., KG v. Motorola, Inc*, 2010 U.S. Dist. LEXIS 66043, *28 (N.D. Ill. June 30, 2010); *W. Leasing, Inc. v. Acordia of Ky., Inc*., 2010 Ky. App. LEXIS 81, *14 (Ky. Ct. App. May 7, 2010); *Bass v. Janney Montgomery Scott, Inc*., 210 F.3d 577, 590 (6th Cir. 2000). Treasure Isles has alleged facts in its Complaint sufficient to support a reasonable inference that it reasonably relied on the representations made by the Defendants in converting its seven LJS restaurants to co-branded A&W and LJS restaurants.

(2) Intend to Defraud

The Defendants argue that Treasure Isles has failed to adequately plead an intent to defraud. Treasure Isles has pled that "Defendants' misstatements and omission of material fact were made deliberately, willfully, or with such gross negligence as to indicate a wanton disregard of the rights of Treasure Isles." (Compl. at ¶ 145). Fed. R. Civ. P. 9(b), made applicable to this proceeding by Bankruptcy Rule 7009, states

> **(b) Fraud or Mistake; Conditions of Mind.** In alleging fraud or mistake, party must state with particularlity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person’s mind may be alleged generally.

Treasure Isles’ has complied with Fed. R. Civ. P. 9(b) in generally alleging intent to defraud.

Treasure Isles has also alleged facts to support that the Defendants' alleged fraudulent intent was driven by economic motivation. (Compl. at ¶¶ 5, 39, 41-43, 93, 101). As the Court is required to take the factual allegations in the Complaint as true, Treasure Isles has stated facts to support a reasonable inference by this Court that the Defendants had the requisite intent to defraud.

(3) Proximate Causation

The Defendants argue that Treasure Isles failed to plead that Defendants' fraudulent conduct was the proximate cause of any injury to Treasure Isles. Treasure Isles has alleged the Defendants gave NAWFA the ability to dictate the operation of the co-branded restaurants and the promotion of their products. (*Id.* at ¶¶ 61-62). Treasure Isles further alleges that the Defendants permitted NAWFA to exercise its power to protect single-brand A&W franchisees and to undermine the co-branding program. (*Id*. at ¶ 117). Treasure Isles claims that instead of disclosing NAWFA's role, as the Defendants were allegedly required to do under the law, the Defendants misrepresented that they had developed the standards for co-branded restaurants in order to induce Treasure Isles and other franchisees to open co-branded restaurants. (*Id.* at ¶¶ 5, 78-79). Treasure Isles states it would not have opened any of its co-branded restaurants if the Defendants had not misrepresented NAWFA's role. (*Id.* at ¶¶ 80, 94, 96, 102, 134). Thus, according to Treasure Isles, because of the Defendants' conduct and its failure to disclose the full scope of its relationship with NAWFA, the cost of co-branded restaurants significantly increased, which reduced the revenues and profitability, and fatally undermined the success of the co-brand program, causing Treasure Isles to suffer (1) the loss of $5.4 million it invested in converting its restaurants as well as the interest expense it incurred in connection with moneys that it borrowed to fund the conversions; (2) a loss of profits it would have earned had it continued to operate the seven restaurants as LJS restaurants and the loss of interest on those funds; and (3) the expenses it has incurred in connection with the bankruptcy proceeding. (*Id.* at ¶¶ 27, 133-138).

"A fraudulent misrepresentation is a legal cause of pecuniary loss resulting from action or inaction in reliance upon it if, but only if, the loss might reasonably be expected to result from the reliance." *Eaton Corp. v. Easton Assocs., Inc.*, 728 F.2d 285, 293 (6th Cir. 1984) (quoting Restatement (Second) of Torts § 548A (1977)). Taking the Plaintiff's factual allegations as true, it is reasonable to infer that Treasure Isles' alleged losses may have flowed from its reliance on the Defendants' misrepresentations.

(4) The Economic Loss Doctrine

The Defendants argue that Treasure Isles' fraud (Count I) and breach of fiduciary duty claims (Counts IV and V) are barred by the economic loss doctrine. As an initial matter, the parties dispute whether Kentucky or Illinois law applies. As the parties are corporations with their principal place of business located in Kentucky, Kentucky has a significant connection and a interest in the application of its law. *See In re Davis*, 334 B.R. 874, 886 (Bankr. W.D. Ky. 2005) ("Under Kentucky choice of law rules, courts should apply Kentucky law if there is a significant connection to Kentucky, even if there might exist a more significant connection with another state."). Regardless of which law applies, though, this Court finds that the result would be the same - the economic loss doctrine does not bar Treasure Isles' fraud and breach of fiduciary duty claims.

The economic loss doctrine is a judicially created doctrine that prevents tort recovery for economic loss. Kentucky has not definitively adopted the economic loss doctrine. But courts have held that if the Court were to adopt the economic loss doctrine, the doctrine would not extend to claims of fraudulent inducement. The Kentucky Court of Appeals recently held that the economic loss doctrine applies in Kentucky, but it does not apply to claims of negligent misrepresentation or fraud because they "do not arise from the contract and, therefore do not fall within the Economic Loss Rule." *See Industrial Risk Insurers v. Giddings & Lewis, Inc*., 2009 Ky. App. LEXIS 106, *20 (Ky. App. July 2, 2009) (petition for review granted). Federal courts discussing Kentucky law prior to this decision have also predicted that Kentucky would adopt the economic loss doctrine but not expand the rule to bar a fraudulent inducement claim. *See, e.g., Davis v. Siemens Medical Solutions USA, Inc*., 399 F. Supp. 2d 785, 801 (W.D. Ky. 2005) ("To expand the rule so as to bar a fraudulent inducement claim in an employment contract without further guidance from the Kentucky courts would eviscerate the claim of fraudulent inducement and would contravene contrary Kentucky case law."). Illinois courts are in accord. *See First Midwest Bank, N.A. v. Stewart Title Guar. Co*, 843 N.E.2d 327 (Ill. 2006) (noting the economic loss rule does not apply "where the plaintiff's damages are proximately caused by a defendant's intentional, false representation.").

Neither Kentucky case law nor federal law applying Kentucky law has directly addressed whether the economic loss doctrine bars claims of breach of fiduciary duty. But in *Industrial Risk Insurers*, the Kentucky Court of Appeals cited with favor Justice Keller's concurrence in *Presnell Const. Managers, Inc. v. EH Construction, LLC*, 134 S.W.3d 575 (Ky. 2004), in which Justice Keller relied on the Colorado Supreme Court opinion of *Town of Alma v. Azco Const., Inc*., 10 P.3d 1256 (Colo. 2000) in concluding that for purposes of analyzing the application of the economic loss doctrine, “the focus should not be on the type of loss, i.e. economic loss vs. personal injury, but rather on the ‘source of duty.’” *Id.* at *17 (citing *Presnell*, 134 S.W.3d at 589). Justice Keller quoted a portion of the Colorado opinion that noted some torts, such as breach of fiduciary duty, are designed to remedy pure economic loss and should be precluded from the economic loss doctrine’s application. *Presnell*, 134 S.W.3d at 589 (citing *Town of Alma*, 10 P.3d at 1262-63). Further, Illinois courts have held that fiduciary duty claims are not barred by the economic loss doctrine. *St. Paul Fire & Marine Ins. Co. v. Great Lakes Turnings, Ltd.*, 774 F. Supp. 485, 488 (N.D. Ill. 1991) (holding the economic loss rule does not apply to fiduciary duty claims under Illinois law); *In re Edgewater Med Ctr. v. Rogan*, 344 B.R. 864 (N.D. Bankr. Ill. 2006) ("When fiduciary relationships arise as a result of a contract, Illinois law permits damages calculated based on a breach of that fiduciary duty"). Therefore, this Court concludes that Kentucky courts are likely to exclude breach of fiduciary claims from application of the economic loss doctrine as well.

C. Treasure Isles’ Contract Claims

Treasure Isles alleges that the Defendants breached their franchise agreements in four ways. According to Treasure Isles,

> (1) the Defendants breached the co-brand agreements by failing to contribute and use one-sixth of the royalties paid by co-branded A&W franchisees and to make a similar contribution for co-branded restaurants they owned for co-branded advertising and promotion (Compl. at ¶¶ 147-148);
>
> (2) the Defendants breached the A&W franchise agreements by agreeing that NAWFA could take a 3% administration fee from an advertising trust fund (*Id.* at ¶ 149);
>
> (3) the Defendants breached the A&W franchise agreements, LJS franchise agreements, and the co-brand agreements by allowing NAWFA to develop and control the co-branding and advertising programs and requiring Treasure Isles to utilize the plans, specifications, and operating standards that NAWFA developed (*Id.* at ¶ 150); and

(4) the Defendants constructively terminated their franchise agreements with Treasure Isles by abandoning the co-branding program (*Id* at. ¶ 129-32, 151).

The Defendants counter that Treasure Isles' breach of contract claims (Count II) should be dismissed because the Defendants acted in compliance with the contracts.

(1) One-Sixth of the Royalty Payments

The Defendants argue that they were entitled to use that one-sixth, or 1% of rebate, at their discretion pursuant to the co-branding agreements and that no damages actually flowed from this alleged breach. Treasure Isles has alleged that Defendants' failure to contribute one-sixth of the royalty payments as required by the co-brand agreement is part and parcel to the Defendants' failure to promote the co-branding program. (Compl. at ¶¶ 123, 125-126). These factual allegations, which are to be taken as true for purposes of this Motion to Dismiss, are sufficient to support a reasonable inference that the Defendants did not comply with their contractual agreements.

(2) NAWFA's 3% Administration Fee

The Defendants argue that paragraph 8.6 of the A&W agreements expressly provide that advertising fees "shall be expended solely upon advertising and promoting A&W Restaurants and related expenses." Further, the Defendants point out that Treasure Isles agreed in these contracts that the Marketing Committee has "final and binding" discretion "including, without limitation," the "type, quantity, timing, placement and choice of media, research and development, production costs, market areas and advertising agencies." (Compl. Exh. 1, 4 at ¶¶ 8.0, 8.6).

Treasure Isles alleges that the 3% administrative fee was "in excess of the expenses actually incurred by NAWFA in administering the fund." (Compl. ¶ 149). Therefore, even assuming the parties impliedly agreed administrative expenses could be compensated from the fund, it is plausible based on Treasure Isles factual allegations the 3% fee paid to NAWFA may still violate the provision. The Court agrees that it may reasonably infer that the Defendants' payment of the 3% administrative fee in excess of the expenses incurred by NAWFA may have been a breach of contract.

(3) Delegation of Duty

The Defendants argue that the franchise agreements allow the Defendants to delegate duties to NAWFA without notice to the franchisee and Treasure Isles agreed in the A&W agreements that NAWFA has the right to approve or disapprove changes to the standards about which Treasure Isles complains. The Defendants further argue that Treasure Isles has failed to cite to any contractual provisions that are breached by the administrative payments to NAWFA.

Treasure Isles relies upon the franchise agreements and avers that the Defendants had an obligation to establish the specifications and standards for the construction or conversion of a co-branded restaurant, including the selection of the equipment and the type of menu utilized. (Compl. at ¶¶ 106-115). Treasure Isles alleges that the Defendants failed to satisfy their obligations by allowing NAWFA to develop standards that were unreasonable, costly, and resulted in worse performance of the co-branded restaurants (*Id.* at ¶¶119-25). These facts, taken as true, are sufficient to support a reasonable inference that the Defendants breached their contract with the Plaintiff by delegating their duty to NAWFA.

Furthermore, when a duty is delegated, the delegating party continues to remain liable for performance. *See* 810 Ill. Comp. Stat. 5/2-210(1) (2010); *Olson v. Etheridge*, 686 N.E.2d 563, 567 (Ill. 1997); *Transp & Transit Assocs., Inc. v. Morrison Knudsen Corp.*, 255 F.3d 397, 399 (7th Cir. 2001). *See also* K.R.S. § 355.2-210(1) ("A party may perform his duty through a delegate unless otherwise agreed or unless the other party has a substantial interest in having his original promisor perform or control the acts required by the contract. No delegation of performance relieves the party delegating of any duty to perform or any liability for breach.")

Taking Treasure Isles' factual allegations as true, Treasure Isles has alleged facts sufficient to support an inference that the Defendants breached their contractual duties pursuant to *Iqbal, supra*.

(4) Damages

Finally, the Defendants argue the Plaintiff has failed to plead facts to show damages because the allegation that the Defendants "failed to contribute and utilize approximately $15 million that was required to be used for co-brand advertising" (Compl. at ¶ 148) is speculative and insufficient without further factual support. As a factual allegation, the allegation that the Defendants failed to contribute and utilize $15 million for co-brand advertising must be taken as true. Treasure Isles has pled facts sufficient to show damages for the Defendants' alleged breach of contract.

<u>Conclusion</u>

For the reasons stated herein, IT IS HEREBY ORDERED:

(1) the Defendant's Motion to Dismiss [Doc. 12] is DENIED as to Counts I (fraud), Count II (breach of contract), Count III (breach of implied covenant of good faith), Count IV (breach of fiduciary duty), and Count V (aiding and abetting a breach of fiduciary duty) and

(2) GRANTED, without prejudice, as to Count VI (violations of the Illinois Franchise Disclosure Act). Treasure Isles is granted leave to amend the Complaint and is further ORDERED to amend its Complaint within 14 days of entry of this Order to cure the defect in

Count VI in conformity with this Order.

The hearing scheduled on this matter for Tuesday, December 14th, 2010, is STRICKEN from the Court's docket.

Copies to:

Wayne Mack, Esq.
Clark Johnson, Esq.

The affixing of this Court's electronic seal below is proof this document has been signed by the Judge and electronically entered by the Clerk in the official record of this case.

Signed By:
<u>Joseph M. Scott, Jr.</u>
Bankruptcy Judge
Dated: Friday, December 10, 2010
(jms)