

UNITED STATES BANKRUPTCY COURT  
DISTRICT OF KANSAS  
KANSAS CITY DIVISION

IN RE:

BROOKE CORPORATION, et al.,  
Debtors

Case No.: 08-22786  
Chapter 7

Albert A. Riederer, Chapter & Trustee of  
Brooke Corporation, Brooke Capital  
Corporation, and Brooke Investments,  
Inc.,

Adv. #10-06165

Plaintiff,

vs.

L&L Financial Solutions, Inc.,

Defendant.

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**DEFENDANT'S MOTION TO DISMISS TRUSTEE'S COMPLAINT  
AND INCORPORATED MEMORANDUM OF LAW**

COMES NOW Defendant, L&L Financial Solutions, Inc. ("L&L") by and through its undersigned counsel and pursuant to Rule 7012 of the Federal Rules of Bankruptcy Procedure and Rule 12 (b)(6) of the Federal Rules of Civil Procedure, hereby moves this Court for entry of an order dismissing the Complaint (the "Complaint", Docket No. 1) filed in the above-styled adversary proceeding by the Plaintiff Albert A. Riederer, as Trustee for the Estate of Brooke Corporation, et al ("Trustee"), for failure to state a claim upon which relief can be granted, and in support thereof states as follows:

**I. INTRODUCTION**

The Trustee for the Estate of Brooke Corporation, et al ("Debtor") has brought this adversary proceeding to collect fraudulently obtained funds from former Franchisees whose Franchise Agreements were terminated by this Court in its Order dated November 17, 2008.

All of the franchisees entered into franchise agreements where the Debtor was the franchisor, manager, and lender for hundreds of insurance agency and funeral home franchisees. The Debtor's loans and franchise agreements contained illegal and substantial franchisee fees that fraudulently increased the loan principal by hundreds of thousands of dollars per franchisee. The franchisees paid substantial portions of the original debt subject to the loan agreements while the Debtor unilaterally and without consideration increased the franchisee's "debt" on its books by illegal fees, charge-backs and unauthorized management fees and commissions to the Debtor.

The Debtor characterized uncollected receivables of the franchisees' business as "debt" and increased the franchisee's loan balance with such amounts.

\* The Trustee in his own Complaint stated the Debtor's "policy of fully recognizing initial franchise fee revenues at the inception of the franchise relationship constituted a clear violation of GAAP and relevant SEC guidelines." (Docket No. ¶ 37).

The Trustee is now attempting to collect on the fraudulently obtained consulting fees, administrative fees, initial franchise fees and loans against the Defendants through this adversary proceeding via the Bankruptcy Court, even after the Trustee had the Franchise Agreements **rejected and terminated** in an Order issued by this Court on November 17, 2008. The Trustee completely ignores the fact that the Defendants have been the subject of fraud, paid millions of dollars to cover their losses and are struggling to keep their livelihood. The Trustee lacks the legal basis to bring this action and therefore the Trustee's Complaint should be dismissed with prejudice.

## II. FACTUAL BACKGROUND

1. Brooke Corp. and Brooke Capital filed voluntary Chapter 11 petitions on October 28, 2008 in the Bankruptcy Court for the United States District of Kansas. Brooke Investments filed

a voluntary Chapter 11 petition on November 3, 2008 in the Bankruptcy Court for the United States District of Kansas. (Docket No. 1 ¶ 7).

2. On October 29, 2008, the Court entered an Order appointing Albert Riederer as the Chapter 11 Trustee of Brooke Corp. and Brooke Capital. On November 13, 2008, the Court entered an Order appointing Albert Riederer as the Chapter 11 Trustee of Brooke Investments effective as of its petition date, November 3, 2008. (Docket No. ¶ 8).

3. On November 10, 2008, Trustee filed Trustee's Emergency Motion for Order Pursuant to 11 U.S.C. §365(a) Authorizing Rejection of Franchise Agreements as of Petition Date. The relief requested was a **termination** of all Franchise Agreements to which the Debtors were parties as of the October 28, 2008 petition date. (Docket No. 105 ¶ 17).

4. On November 17, 2008, the Court issued an Order Granting Trustee's emergency Motion for Order Pursuant to 11 U.S.C. §365(a) Authorizing Rejection of Franchise Agreements as of Petition Date. (Docket No. 155)

5. On June 29, 2009, this Court entered an Order converting these proceedings to Chapter 7 and noted the U.S. Trustee's decision to appoint Albert Riederer as Chapter 7 Trustee of the Debtors upon conversion of these cases. (Docket No. 700) (Docket No. ¶ 9).

6. This Court has entered orders directing the joint administration of the Debtor's three cases. (Docket No. ¶ 10).

7. Unless otherwise noted, Brooke Corp. and its various subsidiaries are collectively referred to as "Brooke". (Docket No. ¶ 12).

8. In 1996, Brooke established a franchise model for expansion and developed a lending program to facilitate acquisition of existing insurance agencies by Brooke franchisees. (Docket No. ¶ 13).

9. From 1996 to 2000, Brooke's revenues consisted almost entirely of a percentage of commissions earned by its franchisees, which Brooke retained in exchange for administrative services provided to the franchisees. (Docket No. ¶ 14).
10. In 2001, however, Brooke began to restructure its operations and create additional sources of revenue. Specifically, it:
  - a. Began charging consulting fees to prospective franchisees in conjunction with the franchisee's acquisition of a franchise (referred to as "BAP" fees); and
  - b. Began realizing gains on the sale of loans it had initiated. (Docket No. ¶ 15).
11. Through the end of 2003, all Brooke franchises were conversion agencies, meaning that the franchisee owned or acquired an existing agency when it signed up to become a Brooke franchisee. (Docket No. ¶ 16).
12. When a franchise was acquired, Brooke would typically loan the franchisee the entire amount it needed to purchase the franchise. Franchisees would then use the proceeds of the loan to pay any of the associated fees. (Docket No. ¶ 17).
13. Prior to 2003, Brooke employed a business model whereby it would fund loans by selling participation interests in individual loans. In 2003, however, Brooke started using loan securitizations as well as loan participations. Loan securitizations involve a finance process that distributes risk by aggregating assets into a pool and issuing new securities backed by those assets and their cash flows. The securities are then sold to investors who share the risks and rewards of the assets. (Docket No. ¶ 18).
14. By the end of 2007, approximately 45% of the total loans Brooke had initiated had been securitized in seven securitizations. Brooke was required to over-collateralize the securitizations, which meant it had to absorb the first 15-25% of losses in any given

securitization before investors would lose any of their interest in the remaining percentage of the loan. (Docket No. ¶ 19).

15. Of the remaining loans that had been initiated by Brooke, 35% had been sold without recourse to participating banks but another 20% remained unsold and on Brooke's books. (Docket No. ¶ 20).

16. Notwithstanding Brooke's apparent lessened exposures to the loans it had initiated, Brooke was under tremendous pressure for all the loans to perform because its business model depended on a continuous stream of willing buyers for its loans. (Docket No. ¶ 21).

17. Between 2004 and 2007, Brooke experienced tremendous growth in the number of its franchise agencies. (Docket No. ¶ 22).

18. In 2004, Brooke also began a program of start-up agencies (SUPs") where the franchisee was recruited and setup in a new agency without the benefit of existing business. Again, almost all of the costs for SUPs were financed through loans provided by Brooke. (Docket No. ¶ 23).

19. As of September, 2008, less than one-third of the SUPs were able to timely meet their payment obligations. (Docket No. ¶ 24).

20. In many instances, the commission revenues of Brooke franchisees in both conversion and SUP locations were not adequate to cover the agent's loan payments or other expenses. Brooke would absorb those costs or advance funds to the agent to cover them. (Docket No. ¶ 25).

21. While Brooke's payroll costs increased very quickly to support, manage and control the rapidly growing agency network, its other operating expenses increased even more dramatically, reflecting the cost of continued subsidization of an ever-growing portfolio of troubled agencies. (Docket No. ¶ 26).

22. Brooke periodically disclosed in its forms 10-K its practice of making advances to franchisees either as part of its “cash management services” or its provision of “additional assistance to franchisees coping with financial stress ...” or its financial cyclical fluctuations of revenues, receivables and payables with commission advances recorded on franchisees’ monthly statements and granting temporary extensions of due dates for franchise statement balances (*See* 2005 Form 10-K, page 49, 2006 Form 10-K, page 49 and essentially similar language in 2007 Form 10-K, page 60). (Docket No. ¶ 27).

23. Brooke was spending excessive amounts of money as it subsidized the expenses (including loan repayments and payment of insurance premiums) of underperforming agencies. By 2007, these operating expenses had grown so dramatically that, even with an increase of 144 agencies that year, the initial franchise fees were no longer sufficient to cover the year’s other operating expenses. (Docket No. ¶ 28).

24. Until the 4th quarter of 2007, Brooke failed to provide for any loan loss allowances that were needed to reflect the true value of the loans on its books. (Docket No. ¶ 29).

25. Starting in the fourth quarter of 2003 Brooke began, for the first time, to charge its franchisees a significant initial franchise fee. The revenue from such fees rapidly became the focus at Brooke and the driver behind Brooke’s reported financial results. (Docket No. ¶ 30).

26. In its 2004 Form 10-K Annual Report with the Securities and Exchange Commission (“SEC”), Brooke Corp. recognized the growing significance that initial franchise fees played:

Our dependence on initial fees creates an incentive for us to extend credit to borrowers that may not meet stringent underwriting guidelines.

A significant part of our revenues are derived from one time initial fees we receive from assisting franchisees and others with the acquisition of businesses. Generating fees is largely dependent on our franchisees’ and others’ ability to obtain acquisition financing from Brooke Credit. Our dependence on these initial fees creates an incentive for us to extend credit to borrowers that may not meet

stringent underwriting criteria. Our failure to follow stringent underwriting guidelines could adversely affect the quality of the loans we make and adversely affect our financial condition and results of operations.

(Emphasis in the original). (Docket No. ¶ 31).

27. Payment of initial franchise fees were made in exchange for substantial services to be provided by Brooke on an ongoing basis and throughout the franchise relationship. Critically, however, the services and rights provided by Brooke at the outset in exchange for the initial franchise fee were not discrete earnings events. (Docket No. ¶ 32).

28. Among the services Brooke provided to its franchisees were:

- a. Access to Brooke's business model
- b. Use of Brooke's registered trade names
- c. Access to products from Brooke's insurance companies and suppliers
- d. Advertising services
- e. Access to facility support and processing center support
- f. Access to an internet based document management system used by Brooke to maintain all franchisee records on behalf of franchisees and to distribute such records to franchisees
- g. Management and maintenance of franchisee licenses on behalf of franchisees
- h. Negotiation of contracts with insurance carriers on behalf of franchisees
- i. Cash management services whereby Brooke would collect from the franchisee policy premiums, distribute the premiums to the respective carriers who issued the policies, collect from the carriers commissions earned by the franchisee on the premiums, and distribute the commissions earned to the franchisee after allocating

the agreed upon amount to Brooke and deducting the franchisee's expenses.  
(Docket No. ¶ 34).

29. Each agency location was charged an initial franchise fee for basic services. Franchisees were also advanced working capital to fund the operations in the early months. (Docket No. ¶ 43).

30. Brooke controlled most of the cash flows for its franchise agencies. Its business practice was to pay most of the rent and other operating expenses for its agents, including loan payments, and to charge these payments (along with the percentage of ongoing commission revenues or recurring franchise fees) to the agents' monthly statements as offsets to the commission revenues earned. (Docket No. ¶ 44).

31. However, in many cases, commission revenues were not adequate to cover the costs. Because the agents generally did not have funds to settle the monthly deficits, unsettled "statement balances" due Brooke built up over time. Brooke would absorb those costs or advance funds to the agent to cover them. (Docket No. ¶ 45).

32. Periodically, Brooke would transfer these balances off the statements and re-characterize them as "non-statement balances" so as not to discourage or overwhelm the franchisees with the amount of their growing debt. From time to time, Brooke would write-off agent balances for accounting purposes. (Docket No. ¶ 46).

33. Pursuant to Generally Accepted Accounting Principles ("GAAP") and relevant SEC guidelines, initial franchise fee revenues must be systematically recognized over the expected life of the franchise relationship. The reason for this, among other things, is Brooke's continuing obligations to provide various services to franchisees. (Docket No. ¶ 35).

34. Brooke, however, fully recognized the revenues from the initial franchise fee at the inception of the franchise relationship. (Docket No. ¶ 36). The Company's revenues were a result of commissions through its franchisees and consulting, lending, and brokerage services provided to franchisee insurance agencies, franchisee funeral homes and Allstate insurance agencies. (Docket 105, ¶ 7).

35. Brooke's policy of fully recognizing initial franchise fee revenues at the inception of the franchise relationship constituted a clear violation of GAAP and relevant SEC guidelines. (Docket No. ¶ 37).

36. The Debtors were continuously insolvent from 2003 through their respective bankruptcy filings. (Docket No. ¶ 40).

### **III. MEMORANDUM OF LAW**

#### **A. STANDARD FOR DISMISSAL**

37. The purpose of a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6), made applicable to these proceedings by Federal Rule of Bankruptcy Procedure 7012, is to test the legal sufficiency of a complaint. In order to prevail on a motion to dismiss, the moving party must show that the plaintiff cannot show any set of facts in support of his or her claim that would entitle him or her to relief. Jones v. Board of Commissioners of the Alabama State Bar, 737 F.2d 996 (11th Cir. 1984) (Citations omitted); Valiant-Bey v. Morris, 829 F.2d 1441 (8th Cir. 1987). In addition, a court, in ruling on a motion to dismiss, must view the complaint in a light more favorable to the plaintiff. Sofarelli v. Pinellas County, 931 F.2d 718, 721 (11th Cir. 1991); Hafley v. Lohman, 90 F.3d 264 (8th Cir. Mo. 1996).

38. However, while a court must take the allegations of a plaintiff's complaint as true in reviewing a motion to dismiss, it **may not** read facts into the complaint which are not there.

Papasan v. Allain, 478 U.S. 265, 286 (1986); Beck v. Interstate Brands Corp., 953 F.2d 1275, 1276 (11th Cir. 1992). The Eighth Circuit holds that conclusory allegations, unwarranted deductions of facts or legal conclusions masquerading as facts will not prevent dismissal. Elam v. Neidorff, 544 F.3d 921 (8th Cir. Mo. 2008); Oxford Asset Management, Ltd. V. Jaharis, 297 F.3d 1182, 1188 (11th Cir. 2002).

39. These principles also require the courts to consider not only the complaint but also matters fairly incorporated within it and matters susceptible to judicial notice. Cruz v. Melecio, 204 F.3d 14, 21 (1st Cir. 2000); Beddall v. State St. Bank & Trust Co., 137 F.3d 12, 16-17 (1st Cir. 1998); Lovelace v. Software Spectrum Inc., 78 F.3d 1015, 1017-18 (5th Cir. 1996). The first part of this rule is consistent with the axiom that writing is the best evidence of its contents. See e.g., Beddall, 137 F.3d at 16.17. The second part of this rule is consistent with the hoary tenet that a court may look to matters of public record in deciding a Rule 12 (b)(6) motion, including documents from prior court rulings. Little Gem Life Scis. LLC v. Orphan Med., Inc., 537 F.3d 913, 916 (8th Cir. 2008); Porous Media Corp. v. Pall Corp., 186 F.3d 1077, 1079 (8th Cir. 1999) (internal citation and punctuation omitted); Boateng v. InterAmerican Univ., 210 F.3d 56, 60 (1st Cir. 2000).

**B. ALL COUNTS AGAINST DEFENDANT SHOULD BE DISMISSED  
BASED ON ORDER BY THIS COURT REJECTING ALL FRANCHISE  
AGREEMENTS AS OF PETITION DATE OF BANKRUPTCY**

40. Trustee filed Trustee's Emergency Motion for Order Pursuant to 11 U.S.C. §365 (a) Authorizing Rejection of Franchise Agreements as of Petition Date. (Docket No. 105).

41. Trustee stated Brooke, and approximately thirty other affiliated companies, are engaged primarily in the business of selling insurance and related services through franchisees. Most of the Brooke's revenues were traditionally derived from sales commissions on the sale of property

and casualty insurance policies through its franchisees, and consulting, lending brokerage services provided to franchisees, funeral homes and Allstate insurance agencies. (Docket No. 105, ¶7).

42. In Trustee's Motion, Trustee attached as Exhibit A to his Motion a listing of all entities that were parties to a Franchise Agreement with one of Debtors (or one of their subsidiaries). (Docket No. 105, Exhibit A) and (Docket No. 105, ¶12).

43. Per the Trustee, given the extreme business disruptions that occurred in the months leading up to the bankruptcy filing, the list (Docket No. 105, Exhibit A) had not been updated to identify entities that are currently parties to Franchise Agreements with the Debtors (or one of their subsidiaries).

44. The Trustee recognized that some of the agreements with franchisees on Exhibit A were terminated pre-petition. The Trustee further recognized that, to the extent a listed franchisee entered into an agreement with a subsidiary of the Debtors, it is unnecessary to seek authority to terminate the executory contract. Nonetheless, the Trustee identified all franchises that could be possibly covered by the scope of the relief requested in this Motion.

45. The Trustee stated, "Given the fact that the Debtors are unable to perform their obligations under the Franchise Agreements, there is thus no value to the estate in maintaining them. Indeed, continuation of the Franchise Agreements post-petition subjects the estates to unnecessary administrative expenses as it would deal with franchisee terminations on a piecemeal basis. **Immediate termination of all of the Franchise Agreements** will release all franchisees to pursue other business opportunities." (Docket No. 105 ¶17).

46. On November 17, 2008, this Court issued an Order granting Trustee's Emergency Motion for Order Pursuant to 11 U.S.C. §365 (a) Authorizing Rejection of Franchise Agreements as of Petition Date. (Docket No. 155).

47. A franchise or license agreement is an executory contract within the contemplation of 11 U.S.C.S. § 365. In re Tirenational Corp., 47 B.R. 647 (Bankr. N.D. Ohio 1985). Rejection of an executory contract, because it constitutes a breach, does not terminate the contract. Accordingly, the rights and obligations of the parties remain intact after a rejection because "rejection does not change the substantive rights of the parties to the contract, but merely means the bankruptcy estate itself will not become a party to it. In re Alongi, 272 B.R. 148, 153 (Bankr. D. Md. 2001) Pursuant to 11 U.S.C.S. § 365, rejection does not terminate or repudiate a contract but simply relieves the estate from its obligation to perform. In re HQ Global Holdings, Inc., 290 B.R. 507 (Bankr. D. Del. 2003). However, in this case the **Trustee expressly requested the immediate termination of all of the Franchise Agreements** and this request was **granted by this Court** on November 17, 2008.

48 11 U.S.C.S. § 365 applies only to executory contracts. Once a contract has been terminated it is no longer executory. OCA, Inc. v. Bush (In re OCA, Inc.), 378 B.R. 493 (Bankr. E.D. La. 2007). Because L&L Financial's franchise agreements were terminated on November 17, 2008 they are no longer considered executory contracts and 11 U.S.C. § 365 no longer applies and the Trustee is not entitled to pursue any of its claims as stated in the Complaint (Docket No. 1, Pages 10-13).

49. Defendant, L&L, is listed as a franchisee in Exhibit A (Docket No. 105, Exhibit A Page 9 of 25) of Trustee's Motion requesting **termination of all of the Franchise Agreements** as to the Debtors estate (Docket No. 105, ¶ 17) and on November 17, 2008 this Court **issued an order**

**granting the termination of L&L's Franchise Agreement.** (Docket No. 155). Therefore, the Trustee has no authority under the Bankruptcy Code, state law or laws of equity to pursue any claims under the Complaint (Docket No. 1). Trustee's Complaint should hereby be dismissed for failure to state a claim upon which relief can be granted.

**C. ALL COUNTS AGAINST DEFENDANT SHOULD BE DISMISSED AS TO ARBITRATION REQUIREMENT UNDER SECTION 31 OF FRANCHISE AGREEMENT**

50. An Arbitration provision in a contract survives a debtor's rejection of that contract under 11 USCS § 365. Societe Nationale Algerienne Pour La Recherche, etc. v Distrigas Corp., (1987, DC Mass) 80 BR 606, 18 CBC2d 865.

51. A copy of Brooke's Franchise Agreement is attached as Exhibit A and incorporated herein.

52. Section 31 of the Franchise Agreement states:

**31.0 DISPUTE RESOLUTION**

31.1 The parties agree that, except as otherwise provided in this Agreement, any issue, claim or dispute that may arise out of or in connection with or relating to in any way to this Agreement, including, but not limited to, its negotiation or any alleged breach of this Agreement (including addenda and exhibits hereto) and/or the relationship of the parties hereto, and which the parties are not able to resolve themselves by negotiation, shall be submitted to mediation pursuant to the Commercial Mediation Procedures of the American Arbitration Association. The parties agree to attempt to resolve such issue, claim or dispute by mediation prior to filing any arbitration proceeding, lawsuit, complaint, charge or claim. The costs of the mediation and fees of the mediator will be borne equally by the parties.

31.2 The parties agree that, except as otherwise provided in this Agreement, any and all issues, claims, disputes or controversies arising out of, in connection with or relating in any way to this Agreement (including addenda and exhibits hereto), the relationship of the parties, and/or the authority to determine whether this arbitration clause is valid and enforceable, as well as the scope of this arbitration clause, shall be settled by binding arbitration, on an individual basis, with no class proceedings permitted, administered by the American Arbitration Association under its Commercial Arbitration Rules and applying the Federal Arbitration Act

and Kansas substantive law. Notwithstanding the foregoing sentence, the Expedited Procedures of the American Arbitration Association shall not apply unless agreed to in writing by both parties, regardless of the amount in controversy. Notwithstanding any other provision of this Agreement, arbitration shall take place in the federal judicial district in which Franchisee is located, or in the Kansas City metropolitan area... The provisions of this paragraph 31.2 shall survive termination of this Agreement.

31.3 The parties agree that any action to assert any and all issues, claims, disputes or controversies arising out of, in connection with or relating in any way to this Agreement (including addenda and exhibits hereto), the relationship of the parties, and/or the authority to determine whether this arbitration clause is valid and enforceable, as well as **the scope of the arbitration clause must be brought, if at all, within two years from the date that the issue, claim, dispute or controversy becomes known or reasonably should have been known by the party asserting it.**

53. If for some reason this Court finds the Franchise Agreements were not terminated by this Court's Order issued November 17, 2008, the Trustee's claims were required to be settled by binding arbitration two (2) years from the filing of Bankruptcy as stated in the Arbitration clause of the Franchise Agreement.

#### IV. CONCLUSION

WHEREFORE, Defendant, L&L Financial Solutions, Inc., prays this Court dismiss Plaintiff's, Albert A. Riederer, as Trustee for the Estate of Brooke Corporation, Complaint in this cause with prejudice, and for such other and further relief as this Court deems just and proper.

Dated this 15th day of June, 2011.

/s/ Patricia R. Fitzgerald

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Patricia R Fitzgerald

Florida Bar No.: 13468

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**CERTIFICATE OF SERVICE**

I HEREBY CERTIFY that a true and correct copy of the foregoing has been furnished by electronically filing with CM/ECF this 15th day of June, 2011 to:

Michael D. Fielding, Esq., Husch Blackwell, LLP, 4801 Main St., Suite 1000, Kansas City, MO 64112

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/s/ Patricia R. Fitzgerald

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