

# Local Dunkin' Donuts franchisee faces lawsuit among woes

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As a Dunkin' Donuts franchisee, Kainos Partners had big plans for the Buffalo market.

Long Island-based Kainos aimed to open 40 Dunkin' Donuts stores in the region, and set up a central doughnut bakery in Cheektowaga. Its first area store debuted in 2006. Kainos later added star power when ex-Buffalo Sabre Pat LaFontaine became an investor.

But things turned stale for Kainos Partners, culminating in a Chapter 11 bankruptcy filing last summer. A Kainos executive was fired and has been charged with grand larceny. And LaFontaine, who invested \$1.75 million in Kainos, has filed a fraud suit in state Supreme Court against Kainos principals and Dunkin' Brands.

In the wake of Kainos' woes, Dunkin' Brands, the Massachusetts-based parent company of Dunkin' Donuts, has acquired 11 Dunkin' Donuts stores in the Buffalo area and nine in Las Vegas that Kainos had owned. Kainos is heading to liquidation in bankruptcy court.

The Buffalo Niagara region has 27 Dunkin' Donuts stores operated by other franchisees.

The outlook for Kainos was far more promising four years ago. Dunkin' Donuts already had stores here, but Kainos aimed to ramp up the chain's presence and become the largest local franchisee, competing with the likes of Tim Hortons and Krispy Kreme. At the time of the 2009 bankruptcy filing, Kainos had 17 area stores and opted to close four of them.

LaFontaine's lawsuit, filed by his company, High Tides LLC, said he first came into contact with Kainos principals in August 2005, while he was at a golf tournament with Jon L. Luther, who was then chief executive officer of Dunkin' Brands.

Luther, a local native, is not a defendant in the suit. But he and LaFontaine used to be neighbors, when LaFontaine was playing for the Sabres in the 1990s and Luther was an executive with Delaware North Cos. Luther would later serve on the board of a foundation created by LaFontaine.

LaFontaine says Luther at the 2005 tournament introduced him to three Kainos principals, Christopher Cortese, Bart D. Thorne and Don DeMichele. As they discussed a possible equity investment, LaFontaine said he learned Kainos was working with Luther on developing Dunkin' Donuts shops in Buffalo and other places.

"It was also suggested to LaFontaine that his status as a former Buffalo Sabres hockey icon would assist Kainos in developing and growing the Buffalo market," according to court papers. LaFontaine was a beloved Sabre and is a member of the Hockey Hall of Fame, and his No. 16 was retired by the team in 2006.

Kainos in May 2005 purchased the rights to develop 40 Dunkin' Donuts stores in the Buffalo area. Its plans did not stop there. In November 2006, it signed an agreement to build 37 shops in South Carolina, and in March 2007, it struck a deal to build 41 stores in Las Vegas.

In July 2007, LaFontaine says that after consulting again with Luther, he was "induced" to invest \$500,000 in Kainos, making him the owner of 500 shares. Two months later, LaFontaine made public appearances at Buffalo-area Dunkin' Donuts stores.

LaFontaine says in October 2007, Cortese, Kainos' chief financial officer, approached him about increasing High Tides' investment in Kainos. The ex-Sabre decided to make an additional \$1 million investment, saying he relied on financial documents supplied to him by Cortese, as well as Luther's "representations" as chairman and CEO of Dunkin' Brands. Luther, who is today executive chairman of Dunkin' Brands, had praised Kainos and other award-winning franchisees at a 2007 event.

In June 2008, Kainos told investors it was pursuing rights to open up to 75 stores in

Houston. LaFontaine says he received additional financial statements from Cortese before deciding to invest an additional \$252,000 in August 2008, bringing his total investment to about \$1.75 million.

In December 2008, LaFontaine says Cortese told him Kainos' board was seeking another round of funding to support its "incredible growth," and says Cortese claimed the value of Kainos would jump from \$40 million to \$77 million after the closing.

But LaFontaine said in February 2009, he learned from another Kainos investor about serious financial trouble at the company and allegations of fraud and embezzlement.

That same month, Kainos fired Cortese after he was accused of misusing \$420,000 in company funds. Cortese was charged earlier this year with grand larceny by the Nassau County District Attorney's Office and faces up to 15 years in prison if convicted.

"The level of this defendant's deception, arrogance and sheer greed is shocking," said Kathleen Rice, the Nassau County district attorney, in a statement. Cortese is due back in court on July 15. His lawyer declined to comment on the case.

Kainos filed for Chapter 11 bankruptcy in summer 2009, closing four of its Buffalo area stores while continuing to operate 13 others. (One of the remaining 13 was later sold and another one was closed.) Kainos shut down the Cheektowaga baking facility, eliminating 78 jobs, and scrapped plans to expand into Houston.

In filing for bankruptcy, Kainos cited problems such as missed sales targets, rapid

expansion and the money-losing bakery, which was a \$4 million project. At the time of the filing, Kainos owned and operated 56 franchise stores in New York, South Carolina and Nevada.

Kainos did attempt to reorganize in bankruptcy, said Kathleen Murphy, an attorney for Kainos in Delaware, where the case was filed. But eventually it became clear that effort wouldn't succeed, due to cash flow problems and difficulty obtaining additional financing, she said. The stores were then sold at a bankruptcy court auction. (Another franchisee acquired the South Carolina stores.)

Kainos attorneys have asked court approval to convert the case from a Chapter 11 case to a Chapter 7 liquidation case. "We basically didn't have any assets any more," Murphy said.

Dunkin' Brands through an affiliate acquired the 20 Dunkin' Donuts stores Kainos had owned in Buffalo and Las Vegas.

"Since Dunkin' Brands took ownership of these restaurants, all have shown financial improvement," Dunkin' Brands said in a statement. "It is our intent to identify new franchisees to own and operate these restaurants in the near future."

In Nassau County, Judge Stephen A. Bucaria recently ruled High Tides LLC's case could move forward, while dismissing some of the claims in the suit.

Robert Salkowski, an attorney for High Tides, said the company is seeking \$5 million in the lawsuit, to recoup the \$1.75 million plus damages due to alleged fraud.

Named as defendants are Dunkin' Brands, former Kainos principals and Jeffrey Serkes, chief operating officer of Pallisade Capital Management. Serkes was a Kainos board member, and Pallisade was Kainos' largest single stakeholder, with a \$14 million investment.

A key point of disagreement is Dunkin' Brands' level of responsibility. Salkowski said of the judge's decision to allow the case to move forward, with one cause of action against Dunkin' Brands intact: "I think it evidences the idea that Dunkin' [Brands] was obviously aware of what was going on and took no steps to stop it."

Under its franchise agreements, Dunkin' Brands receives regular documentation from its franchisees, Salkowski said. "They know the financial condition of each store." The suit contends Dunkin' Brands was focusing on developing more stores, particularly in the Buffalo market.

Dunkin' Brands denies it had knowledge of the fraud allegedly perpetrated by co-defendants in the case. It noted it was one of Kainos' largest creditors, and was owed \$4.2 million as of the bankruptcy filing.

"While we have great respect for Mr. LaFontaine, his investment was not with us, but with Kainos Partners Holding Co. LLC," Dunkin' Brands said in a statement.

The relationship between LaFontaine and Luther went beyond Dunkin' Donuts. Luther served two, three-year terms as a board member of LaFontaine's Companions in Courage Foundation, starting in 2004. The second of those terms expired last March, said Jim Johnson, executive director.

Has the lawsuit impacted the friendship between LaFontaine and Luther?

"I think there's probably been a bit of a wedge put in that," Johnson said. "I would suspect over time, things might heal."