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United States Court of Appeals
Tenth Circuit

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PUBLISH

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

ZUBAIR KAZI; KFC OF PUEBLO, INC.

Plaintiffs - Appellees,

v.

KFC US, LLC,

Defendant - Appellant.

No. 22-1017

Appeal from the United States District Court for the District of Colorado (D.C. No. 1:19-CV-03300-RBJ)

Daniel Weiss (Clifford W. Berlow and Daniel W. Bobier, with him on the briefs), Jenner & Block, Chicago, Illinois for Defendant - Appellant.

Bruce Rohde (William C. Brittan and Margaret R. Pflueger with him on the brief), Campbell Killin Brittan & Ray, LLC, Denver, Colorado for Plaintiffs - Appellees.

Before **HARTZ**, **TYMKOVICH**, and **MATHESON**, Circuit Judges.

HARTZ, Circuit Judge.

Plaintiff Zubair Kazi, through co-plaintiff KFC of Pueblo, Inc., owned the only Kentucky Fried Chicken restaurant in Pueblo, Colorado. In 2019 Defendant KFC US, LLC licensed a second Kentucky Fried Chicken restaurant in Pueblo. Mr. Kazi believed that KFC acted improperly in how it went about licensing this second restaurant and sued KFC for breach of contract, bad faith (breach of the implied covenant of good faith and fair dealing), promissory estoppel, and unjust enrichment. His lawsuit went to trial on his bad-faith claim only, and the jury found in his favor.

KFC appeals. Exercising jurisdiction under 28 U.S.C. § 1291, we hold that Mr. Kazi's claim for breach of the implied covenant of good faith and fair dealing is barred by Kentucky law because KFC's alleged bad faith did not undermine any benefit or protection afforded to Mr. Kazi by his franchise agreement with KFC. We therefore vacate the judgment and remand for entry of judgment in favor of KFC and against Mr. Kazi and KFC of Pueblo, Inc.

I. BACKGROUND

A. Factual background

KFC licenses the recipes, marketing systems, and trademarks for Kentucky Fried Chicken to franchisees across the United States. This dispute concerns two licensed Kentucky Fried Chicken restaurants in Pueblo, Colorado: Mr. Kazi's south Pueblo restaurant, which he has owned since 1986, and a north Pueblo restaurant that KFC licensed in 2019.

Mr. Kazi has over four decades' experience owning Kentucky Fried Chicken franchises. He currently owns over 80 franchise restaurants, with a yearly franchise revenue exceeding $100 million. Like all KFC franchisees, his south Pueblo restaurant is licensed under the Kentucky Fried Chicken Franchise Agreement (the Franchise Agreement or the Agreement). The Agreement grants his restaurant a license to trade names, trademarks, and service marks owned by KFC, and it requires

Mr. Kazi to operate his restaurant as a Kentucky Fried Chicken, sell specific items, meet certain quality standards, and pay royalties to KFC. It also requires Mr. Kazi to join the KFC National Council and Advertising Cooperative (NCAC)—the national organization of KFC franchise owners—and to pay a percentage of his sales into NCAC's advertising fund. The Agreement expressly states that KFC has made no representation to Mr. Kazi "as to the anticipated profitability" of his restaurant. Aplt. App. at 53. In June 2017 Mr. Kazi renewed the Franchise Agreement with KFC for a term of ten years. The Agreement provides that it is governed by Kentucky law.

It is not uncommon for a franchisor and a franchisee to have competing interests, as when a franchisor wants to license a new store that could encroach on the franchisee's market. But the Franchise Agreement provides Mr. Kazi with two express protections against encroachment: (1) under § 3.6, KFC is prohibited from licensing a new store within a 1.5-mile radius of Mr. Kazi's restaurant, creating an exclusivity zone of about seven square miles; and (2) under § 19, if Mr. Kazi's restaurant is the closest to a proposed new location, KFC is required to (a) give Mr. Kazi 30 days' written notice before approving the proposed restaurant, (b) allow Mr. Kazi to apply to operate it, and (c) negotiate in good faith regarding that application.[1]

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[1] Section 19 of the Franchise Agreement states in full:

> **<u>Right to Apply for New Franchised Outlets.</u>** Before permitting the establishment any new of franchised outlet (defined below) at a location closer to the Outlet than to any other franchised outlet (except pursuant to commitments made before the Effective Date of this Agreement), KFC shall be obligated to give Franchisee 30 days prior written notice of such proposed action. During such 30-day period, Franchisee may apply to KFC

The notice of the new location is provided through a "Section 19 Letter," and these rights are known as the franchisee's "Section 19 rights."

Mr. Kazi and the district court have also relied on the terms of a special incentive program instituted by KFC and NCAC. From the mid-2000s to the mid-2010s, over a thousand Kentucky Fried Chicken restaurants closed across the United States. In 2016 KFC and NCAC launched a program to encourage the opening of new Kentucky Fried Chicken restaurants, with KFC and NCAC each contributing 50% of the program's funding. The NCAC board, which is controlled by franchisees, unanimously supported the program, believing new restaurants were critical to the health of the brand and would bring in more advertising money. But some franchisees were concerned that new nearby locations might cannibalize sales from their existing restaurants. In response to these concerns, KFC and NCAC leadership developed the "KFC Impact Study Guidelines," which describe procedures to reduce the impact of new restaurants on franchisees.

> for a franchise to operate an outlet at such proposed new location and KFC shall negotiate in good faith with Franchisee regarding said application, taking into consideration all relevant factors, including, without limitation: (a) the established past and present operational performance and financial capacities of Franchisee, (b) whether he is currently in compliance with financial and other obligations to KFC and under this and other franchise agreements, and (c) efforts of Franchisee that have contributed to the development of consumer demand for Kentucky Fried Chicken locally and elsewhere. As used herein "new franchised outlet" means an outlet not previously in existence, whether franchised or owned by KFC or its affiliates, and which will not be owned by KFC or its affiliates.

Aplt. App. at 50–51.

Under the guidelines, when KFC proposes a new location, the closest franchisee is given the option to request an impact study which analyzes the potential impact of the proposal on the existing franchisee's sales. If the study finds an impact of more than 15%, KFC will not approve the new location; if the impact is between 10% and 15%, KFC will perform further review before deciding whether to approve the location; and if the impact is under 10%, the new location will be approved. With the guidelines in place, the NCAC members voted to approve the incentive program. Two third-party vendors, selected by KFC in consultation with NCAC, have been approved to perform the impact studies.

Mr. Kazi had owned and operated four Kentucky Fried Chicken restaurants in Pueblo, but in 2012 and 2013 three of the four closed, leaving his south Pueblo location as the only KFC in town. By 2019, however, KFC wanted to expand its presence in Pueblo. As part of its efforts to add locations, KFC had developed an internal analytics tool to identify potentially successful locations. This tool identified the north Pueblo trade area as a prime location, giving the area its highest possible rating. And the tool's sales and cannibalization algorithm predicted that a new restaurant in north Pueblo would impact Mr. Kazi's sales by only 8.1%.

In February 2019 Denis Schoenhofer, a franchisee who owned several KFC restaurants in the Southwest, applied to open a restaurant at the new location in the north Pueblo trade area. The following month KFC's site-review committee approved a location 4.6 miles from Mr. Kazi's restaurant, and in April 2019 KFC sent Mr. Kazi a Section 19 Letter notifying him of the approval. The letter informed Mr. Kazi that under § 19 of the Franchise Agreement he had the right to apply to operate the new restaurant, and that he could also request an impact study under the guidelines. Mr. Kazi did not apply to operate the new restaurant because he did not have a good relationship with KFC and he did not think his application would be approved.[2] Instead, he requested an impact study under the guidelines, believing that the impact would be more than 15%.

The impact study was performed by James Andrew Group (JAG), one of the two vendors approved by KFC and NCAC. It followed the methodology JAG had presented to KFC and NCAC during the approval process. The study found that the proposed north Pueblo restaurant would impact Mr. Kazi's sales by 13.4%. KFC undertook the further review required under the guidelines and on June 18, 2019, it notified Mr. Kazi and Mr. Schoenhofer of its decision to approve the north Pueblo KFC.

Mr. Kazi disagreed with the results of the JAG impact study. Thinking that the methodology used by JAG was flawed, he sent a list of his concerns to KFC. In August 2019 Mr. Kazi hired a different company—not one approved by KFC and

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[2] At trial Mr. Kazi testified that he had been sued successfully by KFC and NCAC for failure to pay advertising fees, and one KFC witness testified that Mr. Kazi was viewed by KFC leadership as a "blocker to growth." Supp. Aplt. App. at 551. Mr. Kazi also testified that in 2017 he approached KFC to re-open his previously closed north Pueblo store but was told that "no matter what you do, the management will not allow you to grow. They don't want you to grow." *Id.* at 149. KFC's chief of development testified that there was no prohibition on Mr. Kazi submitting an application for the new location, and under § 19 of the Franchise Agreement, KFC would have been required to negotiate in good faith on Mr. Kazi's application.

NCAC—to conduct a second impact study, which found an impact of 35%. He sent those results to KFC, but nothing came of it.

In October 2019 Mr. Schoenhofer informed KFC that there was a real-estate issue with the approved site, and he planned to purchase a substitute parcel that was 5.3 miles away from Mr. Kazi's restaurant (0.8 miles farther than the old site). KFC's director of development strategy and construction testified at trial that this was not an uncommon occurrence, and because both sites were in the previously approved north Pueblo trade area, KFC needed only to review the site change. KFC nonetheless asked JAG if the change would affect the results of its impact study, and JAG said that if there was a difference in the result, it would be a lower impact. Mr. Kazi was not sent a new Section 19 Letter and he was not otherwise notified of the site change.

B. Procedural History

Invoking federal diversity jurisdiction under 28 U.S.C. § 1332, Mr. Kazi and KFC of Pueblo sued KFC in November 2019 for breach of contract, breach of the implied covenant of good faith and fair dealing, promissory estoppel, and unjust enrichment. The complaint alleged that KFC failed to properly follow the impact-study guidelines and knowingly relied on JAG's flawed impact study when it approved the north Pueblo restaurant.

KFC responded to the complaint with a motion to dismiss all claims. KFC first argued that the complaint failed to state a claim for breach of contract because it alleged a breach of only the impact-study guidelines, and the guidelines were not a contract, or part of any contract, between the parties. Mr. Kazi responded that the parties had modified the Franchise Agreement to include the impact-study guidelines.

The district court agreed with KFC, holding that Mr. Kazi did not "have a cognizable claim for breach of contract based on the express terms of the parties' agreement." *Kazi v. KFC US, LLC* (*Kazi I*), No. 19-cv-03300, 2020 WL 6680361, at *6 (D. Colo. Nov. 12, 2020). Under § 20.5 of the Agreement, "[n]o interpretation, change, termination or waiver of any provision hereof, and no consent or approval hereunder, shall be binding upon the other party or effective unless in writing and signed by Franchisee and KFC's President, Vice President in charge of franchising or franchise services or General Counsel," Aplt. App. at 52; but, as the court noted, the impact-study guidelines, although in writing, were not signed by Mr. Kazi or a KFC executive. Thus, there was "no question that the guidelines did not become part of the contract by amendment in compliance with the contract's own provisions." *Kazi I*, 2020 WL 6680361, at *5. The court also considered whether the parties had otherwise "mutually assented to modification [of the Agreement] and provided new consideration." *Id.* It determined that they had not because there were no facts suggesting that KFC intended to be legally bound by the impact-study guidelines and no facts indicating that Mr. Kazi had provided consideration in exchange for the benefits of the guidelines. The court concluded that the Franchise Agreement was the only contract between the parties and that Mr. Kazi had "point[ed] to no explicit term or provision in that document that KFC allegedly breach[ed]." *Id.* at *4.

KFC next argued that Mr. Kazi's claim for breach of the implied covenant of good faith and fair dealing should be dismissed under Kentucky law. KFC asserted that Kentucky would not permit a claim for breach of the implied covenant of good faith and fair dealing in the absence of a cognizable claim for breach of the express terms of the Agreement. It also argued that its actions could not be a breach of the implied covenant as a matter of law because it had complied with §§ 3.6 and 19 of the Franchise Agreement, which governed the licensing of new locations, and therefore Mr. Kazi had received all the benefits provided by the agreement.

The district court rejected these arguments. As for whether Kentucky would allow an independent claim for breach of the implied covenant, the district court noted that the Sixth Circuit (applying Kentucky law) had found independent claims permissible and that a "'breach of this covenant can be the basis of a viable breach of contract claim.'" *Id.* at *6 (quoting *State Auto Prop. & Cas. Ins. Co. v. Hargis*, 785 F.3d 189, 196 (6th Cir. 2015)). It acknowledged that some Kentucky decisions suggested that there can be no breach of the covenant without breach of an express contract term, but at least one decision by the Kentucky Court of Appeals "suggest[ed] the opposite." *Id.* at *7. The court thus determined it could reach the merits of Mr. Kazi's bad-faith claim.

The court then considered whether Mr. Kazi had sufficiently alleged a breach of the implied covenant of good faith and fair dealing. It stated that the implied covenant "requires a party vested with contractual discretion to exercise that discretion reasonably and with proper motive, and not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties." *Id.* at *6 (brackets and internal quotation marks omitted). And it reasoned that the licensing of additional restaurants, such as the north Pueblo location, was a matter of discretion under the Agreement because § 3.6 was "silent with respect to any activity outside th[e] one and one-half mile zone." *Id.* at *8. Thus, "the covenant of good faith and fair dealing require[d] that KFC exercise that discretion reasonably and not inconsistently with the parties' reasonable expectations." *Id.* The court concluded that Mr. Kazi had a reasonable expectation that KFC would follow the impact-study guidelines, and applying the guidelines in bad faith therefore could constitute a breach of the implied covenant.

KFC also challenged Mr. Kazi's claims for promissory estoppel and unjust enrichment, arguing that these equitable claims could not be pursued where a contract governed the subject of the dispute. Mr. Kazi had expressly brought these claims in the alternative, asserting (1) that even if the impact-study guidelines had not been made part of the Franchise Agreement, they were a promise upon which he reasonably relied, and (2) that KFC had unjustly benefitted from its improper licensing of the north Pueblo restaurant. The court dismissed these claims because Mr. Kazi had adequately alleged a claim for breach of the implied covenant and he could not "proceed on both his quasi-contract claims and his breach of contract claim." *Id.* at *10.

When KFC later moved for summary judgment, it renewed its argument that Mr. Kazi's bad-faith claim was barred under Kentucky law. The district court again rejected this argument and denied summary judgment. It held that a breach of the impact-study guidelines "could constitute a breach of the implied covenant" and that there was sufficient evidence in the record that "a reasonable jury could conclude that KFC acted in bad faith when assessing the impact of the new franchise, and thus that it violated the covenant of good faith and fair dealing." *Kazi v. KFC US, LLC* (*Kazi II*), No. 19-cv-03300, 2021 WL 1978754, at *1–2 (D. Colo. May 17, 2021).

A five-day trial was held in the United States District Court for the District of Colorado on Mr. Kazi's single claim for breach of the implied covenant of good faith and fair dealing. The jury found in favor of Mr. Kazi and his company and awarded damages of $792,239. After trial, KFC filed a motion under Federal Rules of Civil Procedure 50(b) and 59, arguing, among other things, that Kazi had not proved bad faith. The court denied the motion and entered final judgment. KFC timely appealed the final judgment and the district court's rulings on its motion to dismiss, motion for summary judgment, and posttrial motion. Mr. Kazi has not challenged the district court's dismissal of his express-breach-of-contract, promissory-estoppel, or unjust-enrichment claims.

II. DISCUSSION

On appeal KFC challenges the sufficiency of the evidence, the jury instructions, and the award of damages; complains of an allegedly prejudicial statement by the district court in the presence of the jury; and contends that the district court erred in determining that Mr. Kazi's claim for breach of the implied covenant of good faith and fair dealing was permitted under Kentucky law. All but the last issue are moot because KFC is entitled to judgment under Kentucky law.

A. Applicable Law

On issues of state law that have not been specifically addressed by the state's highest court, our task is to predict how that state's highest court would rule. *See Rocky Mountain Prestress, LLC v. Liberty Mut. Fire Ins. Co.*, 960 F.3d 1255, 1259 (10th Cir. 2020). "To make this prediction, we may look to lower state court decisions, decisions of other states, federal decisions, and the general weight and trend of authority." *Id.* (internal quotation marks omitted); *see also Jordan v. Maxim Healthcare Servs., Inc.*, 950 F.3d 724, 731 (10th Cir. 2020) (to predict state law we may look to "persuasive state authority, such as dictum by the state's highest court and precedential decisions by a state's intermediate appellate courts" (brackets and internal quotation marks omitted)).

B. Analysis

Kentucky, like most jurisdictions, recognizes that "[w]ithin every contract, there is an implied covenant of good faith and fair dealing." *Farmers Bank & Tr. Co. of Georgetown v. Willmott Hardwoods, Inc.*, 171 S.W.3d 4, 11 (Ky. 2005); *see also* Restatement (Second) of Contracts § 205 (1981) (the Restatement) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); *id.* cmt. d (examples of bad faith performance of a contract include "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance"). The Kentucky Supreme Court has held that under the implied covenant, "contracts impose on the parties thereto a duty to do everything necessary to carry them out." *Farmers Bank*, 171 S.W.3d at 11. But "carrying out" a contract does not mean providing the other party with benefits not bargained for. Indeed, the implied covenant "does not prevent a party from exercising its contractual rights." *Id.* Its purpose is to ensure that the benefits and duties bargained for are not undermined by bad-faith conduct.

This interpretation of the implied covenant has been routinely upheld by Kentucky courts. In *Ligon v. Parr*, 471 S.W.2d 1 (Ky. 1971),[3] Ligon and Parr had entered into a 10-year option agreement giving Ligon the right to purchase from Parr the stock of L & B Express. *See id.* at 2. But Parr did not own the company's stock at the time the agreement was executed. *See id.* The stock had been acquired by an L & B employee and Parr was in the process of buying it from the employee under an installment contract. *See id.* Ligon's option rights were apparently conditional on Parr's acquiring the stock from the employee. *See id.* at 2–3.

> The business of L & B prospered, its debts were paid, and for 10 months Parr made the installment payments due (plus more than were currently due). Parr then deliberately defaulted in his payments to [the employee], apparently with [the employee's] connivance, and, under the terms of that

[3] *Ligon* is a decision of the Kentucky Court of Appeals, but at the time of the decision, the court of appeals was the only appellate court in Kentucky. When the Kentucky Supreme Court was created in 1975, the prior court of appeals decisions were adopted as binding precedent for Kentucky's lower courts. *See* Ky. Sup. Ct. R. 1.040(5).

> contract, this terminated the latter's obligation to transfer the L & B stock to Parr.

Id. at 2. Parr refused to recognize the option agreement as binding and Ligon sued for breach of contract. *See id.*

The Kentucky Court of Appeals determined that Parr had breached the implied covenant of good faith and fair dealing. It held:

> If Ligon's rights were circumscribed by the purchase agreement between Parr and [the employee], then Parr was required to act in good faith and could not in fairness lawfully terminate his contract with [the employee] for the purpose of destroying Ligon's rights under the option contract with him. We believe the evidence established that this maneuver between Parr and [the employee] was a rigged transaction to defeat Ligon's rights, that actually there was no default, but even if there was, in equity and good conscience it should not be recognized.

Id. at 3. The court explained that the implied covenant "prevent[s] one party from impairing the right of the other party to receive the fruits of the contract." *Id.* (internal quotation marks omitted).

The Kentucky Supreme Court applied this principle in *Ranier v. Mount Sterling National Bank*, 812 S.W.2d 154 (Ky. 1991). Ranier had granted homeowners a $200,000 loan secured by a mortgage on their home. *See id.* at 155. The owners later sought a home-improvement loan from Mount Sterling National Bank to repair fire damage. The bank loan was also to be secured by a mortgage on the home, and the bank required that Ranier's mortgage be subordinated to the bank's mortgage. *See id.* The subordination agreement executed by Ranier and the bank recited that the owners would borrow $125,000 from the bank to be secured by the bank's mortgage and that Ranier's mortgage would be junior to that mortgage. *See id.* The bank's mortgage stated that the outstanding indebtedness "shall not exceed the sum of $125,000." *Id.* (ellipsis and internal quotation marks omitted). Without notice to Ranier, however, the bank made an unsecured loan to the owners for an additional $75,000 to complete the repairs. *See id.* And when the owners made payments to the bank, the bank applied the payments to the principal and interest on the unsecured loan. *See id.* The owners defaulted, owing the bank $125,000 principal on the mortgage note plus interest and fees. *See id.*

The state high court held that the bank "breached its implied covenant of good faith and fair dealing when it failed to give notice to [Ranier] of its subsequent loan to the [owners] and when it unilaterally applied the mortgage payments it received from the [owners] first to the unsecured [loan]." *Id.* at 156. Although the court acknowledged that the subordination agreement did not expressly prohibit further loans from the bank to the owners or "provide specifically" that payments from the owners to the bank must be applied first to the mortgage loan, it said that the bank "subverted the [subordination] agreement by applying the payments it received from the [owners], not to the $125,000 debt, but to the unsecured [loan]." *Id.* The court appeared to ground the good-faith requirement in equitable principles, stating: "[W]here a third-party creditor executes a subordination agreement in favor of said creditor, the latter has an implied duty under equitable principles to apply the payment it receives from the debtor in a manner which does not prejudice the third-party creditor's subordinated security interest." *Id.* at 157. It concluded, "Equity requires the Bank to effectuate justice according to the understanding of the parties as represented by the subordination agreement." *Id.*

In both *Ligon* and *Ranier* the bad-faith conduct impaired expectations explicitly referenced in the contract between the parties. In *Ligon* the contract, anticipating that Parr would buy the company stock from the employee, gave Ligon an option right on L & B's stock. There was always the possibility that the purchase could not be accomplished, and that would ordinarily be okay. But when the failure to consummate the purchase was engineered by Parr's bad-faith conduct, and Ligon's option right was thereby terminated, the implied covenant was breached. Likewise, in *Ranier* the subordination agreement recited that the bank's mortgage (to which Ranier's mortgage would be subordinated) would be for a $125,000 loan. The bank's undisclosed arrangement with the borrower in effect also subordinated Ranier's mortgage to the unsecured loan from the bank, thereby impairing Ranier's rights beyond what was bargained for. *See also Maze v. Bd. of Dirs. for Commonwealth Postsecondary Educ. Prepaid Tuition Tr. Fund*, 559 S.W.3d 354, 367 (Ky. 2018) (the implied covenant of good faith and fair dealing imposes on the contracting parties "a duty to do everything necessary to carry . . . out" the contract and is breached when a party "impairs the benefits" of a contract due the other party (internal quotation marks omitted)).

A Sixth Circuit opinion interpreting Kentucky law adopted the same approach. In *Crestwood Farm Bloodstock v. Everest Stables*, 751 F.3d 434 (6th Cir. 2014), a racehorse owner contracted with a thoroughbred horse farm to sell several of the owner's horses. Under the agreement, the horses were to be sold at public auction or in private sales, the seller was prohibited from setting a reserve price on any horse, and the seller was to keep 25% to 50% of the proceeds from each horse's sale as payment for its services. *See id.* at 438–39. When one filly, special in the eyes of the owner, was up for auction, it received two legitimate bids; but the owner was not satisfied and had his agent place a higher bid on his behalf to drive up the selling price, effectively creating a reserve. *See id.* at 439. No legitimate buyer outbid the agent, so the sale failed. *See id.* When the seller learned what the owner had done, it kept a portion of the sales proceeds from the other horses equal to what it would have received if not for the owner's conduct. *See id.* The owner sued, and the seller counterclaimed for breach of contract. *See id.*

The Sixth Circuit affirmed the summary judgment in favor of the seller on the counterclaim. *See id.* at 445–46. Reading the contract as a whole, the court said that its "clear purpose . . . was to *sell* [the] horses," *id.* at 446, and under the implied covenant of good faith and fair dealing, neither party could "act to prevent the creation of the conditions under which payment would be due," *id.* at 445 (brackets, ellipsis, and internal quotation marks omitted). Because the owner had "secretly bid on the filly and effectively set a reserve price that prevented a willing buyer from leaving with the horse," he had kept the seller "from collecting the fruits of its contract, a twenty-five percent cut." *Id.* Again, the good-faith doctrine protected the benefit to the contracting party contemplated by the contract.

But what happens when the alleged bad faith is not tied to the terms of the contract? That is what was addressed in the Kentucky Supreme Court's opinion in *Farmers Bank*, 171 S.W.3d 4. A business owner obtained from a bank a loan-commitment letter specifying a closing date and stating that if the loan did not close by that date, the bank's obligation to make the loan would terminate. *See id.* at 6. A week before the closing date, the bank's vice president sent the business owner an unsigned draft loan agreement saying that the loan "shall occur" on the specified closing date "or at such other time and such other date as the parties shall mutually agree upon." *Id.* at 6–7 (internal quotation marks omitted). The owner was unable to close on the specified date, but the vice president told him that there would be an extension and gave him a handwritten note with a new closing date. *See id.* at 7. A few days later, however, the bank informed the business owner that the loan would not close on that new date, and without the loan the owner was forced to close his business and liquidate his assets. *See id.*

The business owner sued, arguing that that the bank had breached the implied covenant of good faith and fair dealing by "failing to make all reasonable preparations" to ensure that the loan would close. *Id.* at 11. The Kentucky Supreme Court ruled in favor of the bank. After determining that no purported extension of the closing date satisfied the statute of frauds, *see id.* at 9, it said that when the loan did not close on the initially specified date, the bank "had a contractual right to terminate the loan agreement," *id.* at 11. "An implied covenant of good faith and fair dealing," it explained, "does not prevent a party from exercising its contractual rights." *Id.* We understand this opinion to say that the covenant does not grant courts the power to revise a contract to make it "fair." The aggrieved party must point to an expectation created by the contract that was defeated in bad faith by the other party. The contract with the bank created an expectation that the bank would grant the loan only if it could be closed by a certain date; it created no expectation that the bank would grant a loan thereafter.

Following these cases, we conclude that under Kentucky law, to bring a claim for breach of the implied duty of good faith and fair dealing, the party must point to an expectation created by the language of the contract (e.g., that the other party will honor the exercise of an option to buy the company, that the mortgage will be subordinated only to a $125,000 loan, or that the horses will be available for sale) that was defeated by the bad faith of the other party. Because Mr. Kazi cannot make this showing, his claim of breach of the implied covenant is barred as a matter of law.

The Franchise Agreement prohibits KFC from licensing a new franchise within 1.5 miles of Mr. Kazi's present restaurant. The Agreement says nothing to imply that KFC is restricted in granting licenses for new locations outside that circle. On the contrary, to state that Mr. Kazi has exclusive rights within the area is to imply that he has no exclusionary rights outside it. That implication is strengthened by § 19—the contractual provision that he has a right to negotiate for a franchise approved (conditionally) for someone else's restaurant if he has the licensed restaurant closest to the proposed new location. Section 19 shows that the parties considered the issue of new locations outside of the exclusive area and agreed on how to deal with it. The right-to-negotiate provision, and the absence of any other contractual term relating to franchises outside the 1.5-mile radius, eliminates any reasonable expectation of further protections against having a nearby competitor. And we cannot create a freestanding benefit under the rubric of good faith and fair dealing.

The cases in other circuits involving similar franchise arrangements strongly support the proposition that if the franchise agreement addresses encroachment, the franchisee cannot invoke the good-faith covenant to expand its protections against encroachment beyond the contract terms.

In *Clark v. America's Favorite Chicken*, 110 F.3d 295 (5th Cir. 1997), the franchise agreement had the following language regarding encroachment:

> Franchisee understands and agrees that its license under said Proprietary Marks is non-exclusive to the extent that Franchisor has and retains the rights under this Franchise Agreement . . . [t]o develop and establish other franchise systems for the same, similar, or different products or services utilizing Proprietary Marks not now or hereafter designated as part of the system licensed by this Franchise Agreement, and to grant licenses thereto, without providing Franchisee any right therein.

Id. at 297. The Fifth Circuit held that there could be no breach of the implied covenant of good faith and fair dealing for encroachment, explaining that the language of the franchise agreement "unambiguously reserve[d] to [the franchisor] the right to enter [the franchisees'] area and compete against them under a different set of proprietary marks." *Id.*

Similarly, where the franchise agreement stated that "the Licensor shall not grant any other license authorizing the use of the name 'Sheraton' for hotels, motels or inns located within the licensed area described [as being limited to the 'Site

Only'],” the Eleventh Circuit said that “[t]his language makes it clear that [the franchisee] had no contractual right to expect the Sheraton Franchise to refrain from licensing the Sheraton name to additional franchises beyond the site of the [franchisee's] Inn.” *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396, 1404 & n.7 (11th Cir. 1998). It explained that the “great weight of authority on applying the implied covenant of good faith and fair dealing to cases of encroachment” indicates that “when the parties include contract language on the issue of competing franchises the implied covenant will not defeat those terms.” *Id.* at 1403.[4]

The Eleventh Circuit later went further in *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999), when it considered a franchise agreement containing the following language: “this franchise is for the specified location only and does not in any way grant or imply any area, market, or territorial rights proprietary to FRANCHISEE,” *id.* at 1313 (brackets and internal quotation marks omitted). The court rejected a claim by the franchisee that invoked an alleged good-faith covenant that limited incursions, explaining that “right and duty are different sides of the same coin; if one party to a contract has no *right* to exclusive territory, the other party has

[4] *Camp Creek* also addressed whether a franchisee can invoke a good-faith covenant to protect against encroachment when the franchise agreement says nothing on the matter. It held that because the franchise agreement was completely silent on whether the franchisee was protected against incursion by hotels owned by the franchisor itself (rather than by another franchisee), a claim for breach of the implied covenant could be brought against the franchisor for purchasing and operating a nearby hotel; it was a question of fact whether the franchisor had acted in bad faith. *See* 139 F.3d at 1404–05.

no *duty* to limit licensing of new restaurants." *Id.* at 1317. Therefore, if the agreement makes clear that there is no right to exclusive territory, a claim that an encroachment breached the implied duty of good faith and fair dealing cannot be asserted. *See id.*

And in *Cook v. Little Caesar Enterprises,* 210 F.3d 653 (6th Cir. 2000), the Sixth Circuit dismissed the franchisee's argument that the franchise agreement's grant of exclusive territory meant that the franchisor had discretion in licensing beyond that territory and owed the franchisee a duty of fair dealing in exercising that discretion. *See id.* at 657–58 (under Michigan law, "Cook could not employ the implied covenant of good faith and fair dealing to override the express terms of the franchise agreements which allowed [franchisor] to license franchises outside of Cook's one-mile exclusive territories," and franchisor's discretion to place restaurants outside the exclusive territories did not, under the implied covenant, bar franchisor from "plac[ing] other franchises outside this radius even though it did not expressly reserve the right to do so"); *see also Fickling v. Burger King Corp.*, 843 F.2d 1386 (tbl.), 1988 WL 30675, at *1 (4th Cir. 1988) (per curiam) (unpublished) (because the franchise agreements "expressly disavow[ed] any grant of exclusive territory in [the franchisees'] favor," there could be no claim for breach of the implied covenant by encroachment; "[u]nder Florida law, the obligation of good faith will not be implied in derogation of the express terms of a contract").

There is only one circuit opinion that may be contrary to this analysis. In *In re Vylene Enterprises*, 90 F.3d 1472 (9th Cir. 1996), the Ninth Circuit held, applying California law, that although "Vylene [the franchisee] did not have any rights to exclusive territory under the terms of the franchise agreement," the franchisor's "construction of a competing restaurant within a mile and a half of Vylene's restaurant was a breach of the covenant of good faith and fair dealing." *Id.* at 1477. *Vylene*, however, did not provide the relevant contractual language discussing encroachment. If, unlike the Agreement here, the contract in *Vylene* was completely silent on the issue of encroachment, then there would be no conflict with our holding. But on the other hand, if the contract had expressly stated that Vylene would have no exclusive territory, then the *Vylene* decision is without surviving friends in the caselaw. The only supporting case cited by *Vylene* is the Southern District of Florida opinion in *Scheck v. Burger King*, 756 F. Supp. 543 (S.D. Fla. 1991). But four years after *Vylene* the Eleventh Circuit rejected *Scheck* as "logically unsound." *Weaver,* 169 F.3d at 1317. And although *Vylene* was purporting to follow California law, there appears to be no support for its holding in the California appellate courts. On the contrary, an unpublished Court of Appeals opinion expressly rejected *Vylene*'s interpretation of California law, stating that it "disagree[d] with *Vylene*" and "[t]he better reasoned authority defines the parties' commercially reasonable expectations in light of the express language in the franchise agreement with respect to exclusive rights and protected market areas." *Primrose Food Servs., Inc. v. Romacorp, Inc.*, No. G024917, Bus. Franchise Guide (CCH) ¶ 11990, 33781–82, 2000 WL 36695982 (Cal. Ct. App. 2000) (unpublished).

Our view of the caselaw is shared by a discussion of claims for breach of the implied covenant of good faith and fair dealing for franchise encroachment that appears in a chapter on franchising in an ABA Litigation Section's publication. *See* 14 Thomas J. Collin & Matthew D. Ridings, *Business and Commercial Litigation in Federal Courts* § 150:38 (Robert L. Haig, ed., 5th ed. 2022). The discussion states that the holding of *Vylene* "has been criticized and conflicts with California law as applied by state courts" and that the *Scheck* opinion "has long since been repudiated." *Id.* (footnote omitted). It concludes that "[u]nder the weight of authority, an encroachment claim based on breach of the implied covenant of good faith and fair dealing is no longer recognized." *Id.*

Mr. Kazi argues that we should adopt the district court's reasoning that KFC had discretion in licensing new restaurants beyond Mr. Kazi's exclusivity zone and that the implied covenant of good faith and fair dealing required KFC "to exercise that discretion reasonably and with proper motive, and not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties." *Kazi I*, 2020 WL 6680361, at *6 (brackets and internal quotation marks omitted). We are not persuaded.

Neither the district court nor Mr. Kazi has cited any Kentucky caselaw in support.[5] And a previously discussed decision by the Kentucky Supreme Court

[5] The district court relied on a decision by the United States District Court for the Western District of Kentucky, *Time Warner Cable Midwest LLC v. Pennyrile Rural Electric Cooperation Corp.*, 15-cv-0045, 2015 WL 4464105, at *4 (W.D. Ky. July 21, 2015), which in turn relied on an unpublished opinion of the Sixth Circuit applying Illinois law, *Deom v. Walgreen Co.*, 591 F. App'x 313, 317 (6th Cir. 2014). *See Kazi I*, 2020 WL 6680361, at *6. Neither of these opinions concerned franchises, much less encroachment. In any event, *Time Warner* appears to be based on a much narrower notion of what discretion must be channeled by good faith. An example of

cannot be reconciled with the district court's theory. In *Farmers Bank* the court held that the bank had not violated the covenant of good faith and fair dealing when it refused to grant a loan that could not be closed by the date set forth in the agreement between the bank and the prospective borrower. 171 S.W.3d at 11. To be sure, the bank could have extended the time to close; it had full discretion to do so. As the court said:

> After it became apparent that [the business owner] would not be able to close the loan on August 10, 1996, [the bank] continued to discuss the possibility of making the loan to [the owner], although they were under no obligation to do so. It was within [the bank's] discretion to continue discussions, but [the bank] did not waive its right to enforce the express terms of the Commitment Letter by doing so.

Id. at 10. Despite this discretion, the bank had no obligation to act in good faith when deciding whether to extend the date. *See id.* at 11. Similarly, KFC had full discretion to refrain from licensing a new franchise outside the exclusive area (subject to the restrictions in § 19), but no duty of good faith and fair dealing confined that discretion.

Of course, when the covenant of good faith and fair dealing comes into play, it restricts the discretion of the party bound by the covenant. But not every exercise of discretion is so bound. One must look to the considerations discussed above to

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bad faith provided in comment d to the Restatement § 205 is "abuse of a power to specify terms." Thus, when a contract grants a party the power to specify contract terms, that power must be exercised in good faith. In *Time Warner*, for example, the defendant had the power to set the rates paid by Time Warner for attaching equipment to the defendant's utility poles, and therefore setting unreasonable rates in bad faith would be a breach of the covenant.

determine when the covenant applies. When we examine those considerations, we do not think the covenant restricted the actions of KFC of which Mr. Kazi complains.

III. CONCLUSION

We **VACATE** the final judgment of the district court, and **REMAND** for entry of judgment in favor of Defendant KFC US, LLC and against Plaintiffs Zubair Kazi and KFC of Pueblo, Inc.