"CLARIFYING" LANDMARK V. KESLER: THE KANSAS LEGISLATURE AMENDS THE KANSAS CODE OF CIVIL PROCEDURE AND GIVES COMFORT TO NOMINEES

By Kathleen E. Kraft[i]

In recent years, courts across the country have focused on the role that Mortgage Electronic Registration Systems, Inc. (MERS) plays in the foreclosure process. And now it seems that legislators are entering the fray to answer questions left open by the courts regarding MERS' role and rights in the foreclosure process. In Kansas, both judges and legislators have weighed in on the debate -- the judiciary in the opinions rendered in Landmark National Bank v. Kesler, 40 Kan. App. 2d 325, 192 P.3d 177 (2008), aff'd, 289 Kan. 528, 216 P.3d 158 (2009), and the legislature in House Bill No. 2656.

The Landmark Decisions. In Landmark National Bank v. Kesler, Landmark National Bank, the holder of the senior mortgage on real estate owned by Boyd Kesler, brought suit to foreclose its mortgage. Landmark named Millennia Mortgage Corporation as a defendant. Millennia's second mortgage on the property had been filed of record based on a loan between Millennia and Kesler. Landmark obtained a default judgment of foreclosure when neither Kesler or Millennia responded to the suit.

Subsequent to the entry of the default judgment, Sovereign Bank, the owner of the Millennia loan, moved to set aside the judgment. MERS also filed a motion to set aside the judgment on the basis that MERS held legal title to the mortgage, originally on behalf of Millennia and then on behalf of Sovereign. Both claimed that MERS was a necessary party to the foreclosure suit and that the failure to include MERS as a defendant justified setting aside the judgment. The Court of Appeals disagreed. It determined that MERS was not a contingently necessary party in a mortgage-foreclosure proceeding because MERS, although called the mortgagee in the mortgage, was not the lender, had no right to repayment of the underlying debt, and had no role in handling the mortgage payments. Thus, Landmark's failure to name MERS as a defendant in the foreclosure action and serve MERS with notice of the foreclosure did not affect the foreclosure judgment.

The Kansas Supreme Court affirmed. Without deciding whether MERS was technically entitled to notice and service in the initial foreclosure action, the Supreme Court found no abuse of discretion in the decision to deny Sovereign's and MERS' motions to vacate the default judgment and join Sovereign and MERS as necessary parties to the action.

Landmark's bottom line left MERS and others wondering -- When must foreclosure plaintiffs name and serve a nominee of record? Can MERS lenders no longer rely on the MERS system to obtain notice of actions affecting their collateral? Are MERS lenders in jeopardy of losing their interests absent a recorded assignment?

The Legislature's Response. With encouragement from MERS,[ii] the Kansas legislature responded to Landmark by enacting changes to the Kansas Code of Civil Procedure's provisions on joining "contingently necessary" parties. As amended, K.S.A. 60-219 now requires that nominee of a mortgagee be joined and served with process, even if the nominee does not meet the definition of a "contingently necessary" party.[iii] The amendment provides the certainty that the Landmark decision lacked -- certainty that nominees of record will receive notice of actions potentially affecting the mortgage for which they serve as nominee. The amendment to K.S.A. 60-219 became effective July 1, 2010.

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[ii] See Conference Committee Report Brief for House Bill No. 2656, as agreed to March 25, 2010, at http://skyways.lib.ks.us/ksleg/KLRD/ConfCommBriefs.htm.

[iii] When Landmark was decided, K.S.A. 60-219 read:

> (a) *Persons to be joined if feasible.* Whenever a "contingently necessary" person, as hereafter defined, is subject to service of process, he shall be joined as a party in the action. If he has not been so joined, the court shall order that he be made a party. If he should join as a plaintiff but refuses to do so, he may be made a defendant, or, in a proper case, an involuntary plaintiff. If the joined party objects to venue and his joinder would render the venue of the action improper, he shall be dismissed from the action.
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> A person is contingently necessary if (1) complete relief cannot be accorded in his absence among those already parties, or (2) he claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action in his absence may (i) as a practical matter substantially impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations by reason of his claimed interest.
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> (b) *Determination by court whenever joinder not feasible.* If a contingently necessary person cannot be made a party, the court shall determine whether in equity and good conscience the action ought to proceed among the parties before it or ought to be dismissed. The factors to be considered by the court include: First, to what extent a judgment rendered in the absence of the contingently necessary person might be prejudicial to him or those already parties; second, the extent to which, by protective provisions in the judgment, by the shaping of relief, or other measures, the prejudice can be lessened or avoided; third, whether a judgment rendered in the absence of the contingently necessary person would be adequate; fourth, whether the plaintiff would have an adequate remedy if the action were dismissed for nonjoinder.
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> (c) *Pleading reasons for nonjoinder.* A pleading asserting a claim for relief shall state the names, if known to the pleader, of contingently necessary persons who are not joined, and the reasons why they are not joined.
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> (d) *Exception of class actions.* This section is subject to the provisions of K.S.A. 60-223.

K.S.A. 60-219 now reads:

> (a) Persons required to be joined if feasible. (1) Required party. A person who is subject to service of process must be joined as a party if:
>
> > (A) In that person's absence, the court cannot accord complete relief among existing parties; or

(B) that person claims an interest relating to the subject of the action and is so situated that disposing of the action in the person's absence may:

(i) As a practical matter, impair or impede the person's ability to protect the interest; or

(ii) leave an existing party subject to a substantial risk of incurring double, multiple or otherwise inconsistent obligations because of the interest.

* * *

(e) Nominee. In an action in which any relief sought would determine title or affect a security interest in real property, a person who is subject to service of process must be joined as a party if the person is a nominee of record on behalf of a beneficial owner of a claimed interest in the property that is the subject of the action. The nominee need not be a party required to be joined under subsection (a)(1).

Calling Out From The Grave

By Samuel H. Levine, Arnstein & Lehr LLP[i]

The recent case of ABN AMRO Mortgage Group v. McGahan, 237 Ill. 2d 528 (2010) is an important case regarding the jurisdiction of the court to enter a judgment of foreclosure where the mortgagor is deceased. In McGahan, the Illinois Supreme Court, affirming the trial court, held that a mortgage foreclosure action is a quasi in rem proceeding. The court distinguished between an action quasi in rem, which is brought against a defendant personally with jurisdiction based on an interest in property and an action in rem, in which one is brought against the property. The court held that since a mortgage foreclosure is an action quasi in rem, a mortgagee is required to name a personal representative for a deceased mortgagor in order for the court to obtain subject matter jurisdiction. The case has far reaching implications for lenders, borrowers, third party purchasers and title insurers in Illinois as well as other judicial foreclosure states.

In McGahan, the court found that prior Illinois decisions have inconsistently characterized a foreclosure as both in rem and quasi in rem. In fact, the appellate court in McGahan concluded that a foreclosure proceeding is an in rem action. Further complicating the issue, the court explained that there are two types of quasi in rem actions. In one, the plaintiff is seeking to apply what he concedes to be the property of the defendant to the satisfaction of the claim against him. However, the one relevant to the court was the type where the plaintiff seeks "to secure a pre-existing [sic] claim in the subject property and to extinguish or establish the non existence of similar interests of particular persons." Hanson v. Denckla, 357 U.S. 235, 246 p. 12 (1958).

In arriving at its conclusion, the court relied on an older United States Supreme Court case, Freeman v. Alderson, 119 U.S. 185, 7 S.Ct. 165, where the court characterized a mortgage foreclosure as a quasi in rem proceeding. The case involved an action in trespass. The court discussed in rem and quasi in rem proceedings and their distinguishing characteristics. The court observed that although actions such as enforcement of mortgages and other liens deal with property and seek its sale, they are not strictly in rem because they are against the named parties and actions not personal in nature.

The importance of the McGahan case is the necessity of proper jurisdiction of the court over the deceased mortgagor. The law is well settled in Illinois that the court lacks subject matter jurisdiction where a party files suit against a deceased person. Keller v. Walker, 319 Ill. App. 3d 67 (3rd Dist 2001). In Illinois, as in other judicial foreclosure states, a mortgagor is a necessary party who has a right to defend against the action. 735 ILCS 5/1501(a). The court found that there was nothing in Illinois law to indicate foreclosure actions were exempt from the general rule that a lawsuit against a deceased person is a nullity. Subject matter jurisdiction cannot be waived. Keller v. Walker, supra. Therefore, the court held that because ABN AMRO failed to name a personal representative as a substitute for McGahan, it lacked subject matter jurisdiction and dismissed the complaint.

The decision has far reaching consequences for mortgagees, decedent's estates, third party purchasers and title companies. In Illinois, a judgment of foreclosure in the absence of jurisdiction is void and can be attacked directly or indirectly at any time. Based on McGahan, estates of the decedents may intervene in existing cases or attempt to vacate judgments of foreclosure at any time, even after a subsequent sale to a third party. The validity of sale pursuant to a judgment of foreclosure may be questioned. Ultimately, the title of a third party purchaser may be called into question.

In Illinois, bona fide purchasers may be entitled to protection under the Illinois Code of Civil Procedure which protects bona fide purchasers of property from the effects of an order setting aside a judgment affecting title to property if the purchasers were not parties to the original action and a lack of jurisdiction does not appear from the record. 735 ILCS 5/2-1401(e); Bank of New York v. Hatch, 369 Ill. App. 3d. 472 (1st Dist 2006). In determining whether a lack of jurisdiction is apparent from the record, the reviewing courts look to the whole record, which includes the pleadings, the return of process and the court's judgment. If the record is sufficient to put a prospective purchaser on notice that jurisdiction is improper, a purchaser is not a bona fide purchaser. The Hatch case concerned personal jurisdiction rather than subject matter jurisdiction. The same analysis would apply to subject matter jurisdiction.

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Top Ten Issues in Co-Tenancy Provisions in Retail Leases

By Matthew P. Seeberger[i]

As many real estate professionals know, co-tenancy is one of the more heavily negotiated provisions in a retail lease. A co-tenancy provision permits a tenant to exercise remedies if certain conditions are not met with respect to the shopping center in which it is located. As discussed below, co-tenancy provisions are typically tied to the presence of certain "key" tenants or an occupancy threshold based on a percentage or specified amount of tenants or a square footage in a center being open. Tenants want co-tenancy provisions, which may relieve them from being obligated to open, pay full rent or operate in a shopping center that is not fully occupied, providing remedies in the event that the performance of the center is not want the tenant was anticipating. Landlords dislike co-tenancy provisions because (i) they cannot control the actions of other tenants or occupants in the shopping center, (ii) they feel that a certain amount of vacancy is unavoidable, and (iii) their rent stream from the shopping center can be severely impacted. This article will briefly discuss the top ten issues in co-tenancy provisions in retail leases.

1. **Leverage.** Whether or not a tenant is successful in obtaining a co-tenancy provision is largely dependent on the negotiating leverage that tenant possesses. National and large regional credit tenants are generally highly sought after by landlords because of their name recognition, ability to pay higher rents, and staying power, and "hot" tenants are desirable because they have drawing power and can increase the cachet and prestige of a shopping center. Such tenants usually are in a

better position to obtain co-tenancy protection than smaller regional, lesser credit and shop ("mom and pop") tenants.

2. **Opening Co-Tenancy.** Co-tenancy provisions fall into two categories. The first is an opening co-tenancy, which provides that a tenant need not open its store at full rent unless and until certain other stores, or a certain amount of stores, in the shopping center are open. An opening co-tenancy is usually found in the context of a shopping center in development, which may still be in the entitlement, lease-up or construction phase, particularly in an outlying area where and projections of population growth and income levels have yet to be realized, in which case a tenant will want assurances that the shopping center will be built, occupied and open before it is required to invest its resources in opening a new store. However, an opening co-tenancy may also be found in an existing shopping center that is being renovated or repositioned.

3. **Operating Co-Tenancy.** The second category of co-tenancy provisions is an operating co-tenancy, which provides that once a tenant has opened and is operating, it will be obligated to stay open at full rent only if certain other stores, or a certain amount of stores, are also operating. An operating co-tenancy is not limited to any particular type of shopping center, as no matter where the shopping center is located or how old or new it is, a tenant will not want to be required to stay open in a shopping center where other stores are closing and the synergy of a healthy center is declining.

4. **Key Tenants.** Co-tenancies usually are geared to certain “key” tenants, so-called because they are viewed by the tenant seeking co-tenancy protection as “key” to the success of the shopping center and/or the particular tenant. For example, a tenant generally will not want to be obligated to open or keep operating its store at full rent unless the anchor store in the shopping center, usually a department store in a regional mall or a grocery store in a neighborhood shopping center, is also open and operating. Where there is no true anchor store – *i.e.*, no store is dominantly larger than the other sizable stores (such as in a power shopping center) – a tenant may not want to be open or operate at full rent unless a certain number of mini-major (roughly 15,000 to 30,000 square feet) stores are also open and operating. Another benchmark that is often used is that a certain percentage of or number of stores in the shopping center be open or operating before that tenant has to open or keep operating at full rent. Sometimes, a tenant with significant negotiating power will require that a combination of two or even all three of the above be satisfied before it must open or keep open its store at full rent – *e.g.*, a tenant may require that one of two anchor stores, four of seven mini-major stores, and 75% of the shop spaces, or at least 100,000 square feet of the shop space in the shopping center, be open before that tenant is required to open its store and begin operating, or, if already operating, to keep operating at full rent.

5. **Replacement Tenants.** Tenants seeking co-tenancy protection typically specify the name of the anchor and/or mini-major store(s) that must be open and operating, as landlords usually try to obtain commitments from anchors and mini-majors before committing to develop a shopping center, and the tenant is relying on the existence of that (or those) particular tenant(s). While a landlord may agree to a co-

tenancy provision, it will want to avoid being locked into the specifically listed stores, because landlords are only too aware of the fickleness of the retail sector – a retailer that is “hot” or national or regional in scope and/or with excellent credit might be declining, or even land in bankruptcy court, in a few years. Therefore, landlords will typically require that a co-tenancy provision is satisfied if a “replacement” tenant is open and operating in lieu of a key tenant that is no longer operating. This is usually acceptable to tenants if the replacement tenant is comparable to the named or departing tenant. For example, a landlord may insist that a replacement tenant which occupies most of the vacated space, has a similar (*i.e.*, soft goods or electronics) business, and is comparable in creditworthiness to the departing tenant be deemed to satisfy a co-tenancy provision.

6. **Conditions.** Before a tenant can invoke a remedy under a co-tenancy provision, a landlord will want the tenant to satisfy certain conditions. Foremost is that the tenant is not then in default under the lease, but such conditions may also include that the tenant is itself operating at the time of a violation of the co-tenancy provision, and that the right to invoke the remedy is personal to the original tenant that signed the lease. A landlord may also require that the tenant show a drop in sales during the co-tenancy violation period as compared to the period prior to the violation. Finally, a landlord will want to make sure that if the tenant invokes a co-tenancy provision, the remedy elected by the tenant for such co-tenancy violation is the tenant’s sole remedy for such violation. A landlord does not want to be in a situation where the tenant obtains the benefit of a co-tenancy violation remedy, such as rent abatement or termination, only to have the tenant then sue for other damages.

7. **Cure.** A landlord will also want to have the right to cure a co-tenancy violation before the tenant can invoke any remedies, as the violation might occur with little or no warning, such as a bankruptcy filing. The cure right almost always involves the right to try to obtain replacement tenants for the key tenants, or, in the case of an occupancy threshold, to try to fill the vacant space. Therefore, most landlords will agree to a co-tenancy right only if the violation continues for a significant period of time, with the amount of time depending on the types of remedy that the tenant may elect.

8. **Remedies.** A tenant's remedies for a co-tenancy violation fall into three categories. The first such remedy is rent abatement, where if a co-tenancy violation is not cured within the stated time period, the tenant has the right to pay a lesser rent for so long as the co-tenancy violation exists. The lesser rent is typically based on either a percentage of the fixed annual rent (usually 50%) or percentage rent only during the violation period. The second remedy for a co-tenancy violation is termination of the lease, but as this is an extreme remedy, landlords are loathe to grant it unless the co-tenancy violation continues for an extended period of time – at least six months, often a year, and even longer if the space is particularly large (such as a space occupied by Target, Home Depot or Wal-Mart). An operating co-tenancy provision will usually allow for rent abatement and termination (because rent abatement is not as drastic, a landlord will often permit a tenant to invoke that remedy sooner than the termination remedy, sometimes as soon as the violation occurs, but usually after a relatively short period of time [90 days is typical]) The third remedy for a co-tenancy violation only arises if there is an opening co-tenancy violation, and allows the tenant to delay the opening and/or

rent commencement date (although most tenants will also want to have the right to open but with rent abatement as set forth above).

9. **Return to Full Rent; Recapture.** If a tenant elects rent abatement, the landlord will not want the tenant to be able to take advantage of the substitute rent provision for the remainder of the lease term. In such an instance, a landlord will typically require that if the co-tenancy violation is not cured within a certain period of time (typically one year) and the tenant has not terminated the lease within that time, then the tenant will have to return to paying full rent. The obligation to return to paying full rent is based on the theory that if the tenant is remaining in the shopping center despite the co-tenancy violation it must believe that its store is doing well enough to warrant continuing at full rent. If the tenant does not want to return to full rent, then the landlord will usually insist on the right to recapture the premises.

10. **Reimbursement.** If either party terminates the lease due to a co-tenancy violation, the tenant will want to be reimbursed for its unamortized leasehold improvements (typically amortized on a straight-line basis over the initial term), since the termination was not due to an event within the tenant's control. However, reimbursement should only apply during the initial term of the lease, as that is the length of time on which the tenant based its original decision to enter into the lease.

In summary, while landlords may use whatever bargaining power they possess to avoid granting a co-tenancy provision in a retail lease, the circumstances may dictate that a deal will not get done without one. In such a case, the negotiation of the co-tenancy provision will raise several issues that both the landlord and tenant will need to address to arrive at a compromise that satisfies both parties.

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