



Defining Capital Expense Is a Dilemma

A landlord repaves his entire parking lot one spring and charges it to CAM. Another landlord repaves his parking lot one pothole at a time, until at the end of five years he's repaved the entire parking lot.

One landlord decides he's had enough with his tired-looking bathrooms and spends \$20,000 for a remodel. Another landlord has his maintenance personnel fix the bathrooms one sink at a time. The end results may be the same, but the question is, which of these expenses can be charged to CAM and which can't?

Landlords and tenants have long disputed whether expenses are capital, and thus not billable to the tenants, or maintenance and repair, and thus billable to CAM. The subject of these disputes can range from expenses for landscaping, painting and repaving of parking lots, to roof repairs, decorations, and bathroom or tile renovations.

Moreover, these disputes are likely to become more heated, and the stakes higher, as the inventory of larger malls continues to age and as landlords improve properties to make them more attractive to retailers and investors.

Frequently, the focus of the controversy is the typical CAM clause, which requires most tenants to pay their share of the cost of maintaining and repairing the shopping center and/or the common area. Unfortunately, few leases provide clues as to the meaning of these important provisions.

Landlords often take the position that any investment they make in the center, whether a remodel or a repair, makes it more attractive to shoppers and therefore beneficial to their tenants. Tenants may agree that these improvements make the center more attractive, but they argue that expenditures for anything beyond ordinary wear and tear are more likely to benefit the land-

lord and should not be paid by the tenants.

Solutions to this problem aren't easy to find. Part of the difficulty is that hard-and-fast rules of accounting don't work very well. If looked at from a tax accounting viewpoint, almost any improvement that lasts more than a year and whose cost is "material" (for which there's a very low threshold from the IRS' point of view), is a capital item.

On the other hand, most corporate bookkeepers place a higher threshold on such expenses and are unlikely to use the IRS' standards in deciding whether an expense is "capital," especially for purposes of billing to CAM.

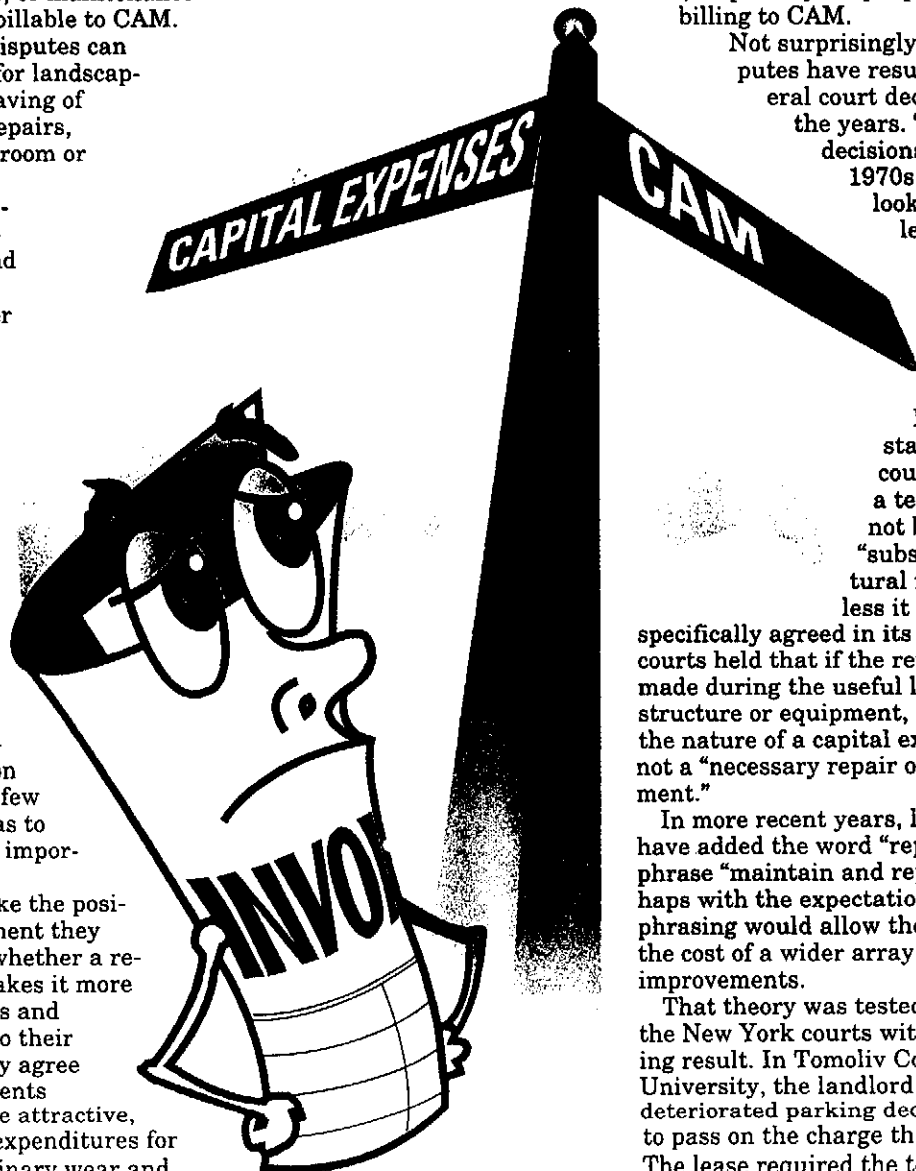
Not surprisingly, these disputes have resulted in several court decisions over the years. The earlier decisions, from the 1970s and 1980s, looked at older lease forms that merely required the landlord to "maintain and repair."

In those instances, several courts held that a tenant could not be liable for "substantial structural repairs," unless it had so

specifically agreed in its lease. Other courts held that if the repair was made during the useful life of the structure or equipment, it was more the nature of a capital expense and not a "necessary repair or replacement."

In more recent years, landlords have added the word "replace" to the phrase "maintain and repair," perhaps with the expectation that such phrasing would allow them to pass on the cost of a wider array of structural improvements.

That theory was tested recently in the New York courts with a surprising result. In *Tomoliv Corp. v. Yale University*, the landlord replaced a deteriorated parking deck and sought to pass on the charge through CAM. The lease required the tenant to pay for "repair, replacement and mainte-



nance" of the common areas, including the parking deck, so the landlord argued that it was entitled to pass on the cost of such "replacement."

The court disagreed. It held that this now-common phrase, "repair, replace and maintain," meant only "ordinary maintenance and repair and did not contemplate ... a complete replacement of a common area structure which had deteriorated so extensively as to render repair ... impractical."

Notwithstanding these varying rules and court decisions, there should be some common ground. A landlord shouldn't have to make basic repairs one step at a time, such as replacing one leaky sink a year, or paving one pothole at a time. This piecemeal approach is inefficient. Similarly, the landlord shouldn't be permitted to improve the center at the tenant's expense.

A simple solution might be to establish a rigid rule — for example, prohibiting any costs in excess of a certain amount, say \$10,000, from being passed on through CAM. Unfortunately, that kind of limitation might prevent landlords from making needed repairs that would immediately benefit tenants.

A far better approach to the problem is to establish some general principles regarding allocation of these expenses. Here are some suggestions:

Expenses connected to the original construction of a center, or the repair or replacement of a structure or facility during its useful life, should not be paid by tenants. This includes charges for the repair or replacement of poorly constructed or badly designed facilities.

Tenants should not be required to pay for expenses that upgrade or improve the building, as opposed to ordinary maintenance and repair.

For example, the landlord's reinstallation of new tiles as part of a renovation or ex-

pansion (as opposed to repairing old tiles), remodeling of bathrooms, or replanting of trees as part of a new landscape design — these actions fall more in the category of upgrad-

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ing and improving the value of the center and should not be passed on to CAM.

However, judgment and good faith must prevail; if the landlord is replacing dead or dying trees with fresh landscaping or replacing 20-year-old toilets with new toilets, the expense may be billable to CAM.

On the other hand, capital costs that reduce operating expenses, such as replacement of elevators or escalators, or installation of an energy management system, might properly be charged to CAM so long as the expense is amortized over the useful life of such equipment or replacement.

The bottom line is that landlords and tenants each have a stake in the appearance and maintenance of their centers. To avoid disputes, each should decide before they sign their lease how those expenses will be paid.

Robert A. Machson is the principal of Robert A. Machson & Associates, a New York-based law firm specializing in retail real estate. He can be reached via e-mail at rm@retailaw.com. The firm's website is retailaw.com.