

**Best Business Practices
For Asserting Ground Lease
Reversionary Rights
At Denton Municipal Airport**

**SAMI Management, Inc.
16051 Addison Road, Suite 220
Addison, Texas 75001
972-392-4856**

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Executive Summary –

Ground leases are unique real estate investments that present sophisticated challenges for both the tenant/investor and landlord. The landlord/tenant relationship is in many regards a long-term business partnership by and between two parties where one depends upon the other to perform as promised. The landlord contractually surrenders the use of its land for an extended period of time in exchange for a steady cash-stream and possibly the use and benefit of the residual improvements. On the other hand, the tenant contractually agrees to pay the ground rent, all construction costs, taxes and insurance, maintenance and operating costs over the lease term in exchange for the opportunity to earn a monetary return sufficient enough to warrant its investment.

One of the key elements found in a ground lease agreement is the provision of a "reversionary clause." This provision sets forth the landlord's right to retake possession and resume the full and sole use and proprietorship of its real property temporarily alienated while the ground lease is in effect.

The "reversionary process" is the progression both the landlord and tenant undergo as they plan, facilitate and administer the eventual and certain retaking of the property and improvements entitled to the landlord. When and how this process unfolds largely depends upon:

- whether the trigger event is voluntary or involuntary;
- the terms and conditions contained in the lease;
- the circumstances surrounding the physical property itself and as it relates to the Airport; and
- the desired or intended objectives and needs expressed by each of the contracting parties.

In most instances, an understanding of these and other factors and their implication must be developed over time through candid landlord/tenant communication and a continual strategic reassessment of the contractual relationship as it relates to the City's long-term objectives for the Airport. Failure to do so may lead to one or the other party being ill-prepared to respond or react to the other's actions, unfortunate misunderstandings, or even costly litigation.

Probably the most difficult component of the reversionary process is determining the disposition of the building improvements. If pursuant to the ground lease the tenant is to construct building improvements on the demised premises, the lease should also clearly state who holds title to these improvements during and after the lease term. Equally important and necessary is a statement detailing the rights, duties and obligations that each of the parties has with respect to the transfer or removal of the building improvements at the end of the lease term.

By definition the reversion of the tenant's property rights is inevitable; however it can be deferred by way of a negotiated lease term extension or lease renewal. The use of a lease extension or renewal must be carefully weighed by the Airport giving regard to the

impact that such an extension may have on the landlord/tenant relationship, the long-term strategic objectives of the Airport and, compliance under state laws and/or Grant Assurances.

When the landlord gives consideration to extending the lease term to a ground lease, there is an opportunity cost for which the Airport ought to be compensated. After the reversion, the Airport has the right and capacity to release the facility at or near market rent, which can be significantly more than the extended ground rental. This compensation most often comes in the form of additional capital investment made by the tenant into the property and/or a modified rental structure. Determining much less agreeing on the appropriate level of capital investment and corresponding lease-term extension (or vice-versa) can be a difficult task.

Ultimately, the Airport must determine whether allowing the property improvements to revert at the end of the lease term or to defer to a later date must be weighed against the Airport's strategic objectives as its real property portfolio matures and the need for redevelopment approaches.

Best Business Practices for Asserting Ground Lease Reversionary Rights at Denton Municipal Airport

Statement of Assignment — The purpose of this assignment is to review and analyze the City of Denton's current business practice of implementing and asserting its reversionary rights pursuant to their existing ground leases at the Airport. In so doing, SAMI provides a brief narrative discussing the unique characteristics of the landlord and ground tenant relationship when structured upon a long-term ground lease arrangement. This analysis is followed by a brief discussion defining the reversionary process and what events typically trigger a reversion. One of the more difficult phases of the ground lease relationship is the reversionary process and determining the eventual disposition of the building improvements. SAMI describes some of the more typical outcomes and what should be planned for. Also provided is a brief description of the FAA's position regarding property reversions and lease terms with respect to the grant assurances and some state statutes regarding airport property and the disposition of public property.

SAMI was also requested to review and provide comment on relevant sections of the Airport's proposed ground lease form and three existing ground lease agreements. In so doing, SAMI also provides a discussion of some alternative considerations relative to each.

Background Information- Denton Municipal Airport is a municipally owned general aviation airport authorized and governed under Section 22 of the Texas Transportation Code. The Airport is classified in the National Plan of Integrated Airports System (NPIAS) as a General Aviation Reliever airport, providing access to the air transportation system for general aviation aircraft. Administratively, Denton Airport is an operating department of the City. As a home-rule municipality with a Council-Manager form of government, the City of Denton administration is the responsibility of the City Manager who is appointed by the City Council. The City Council also appoints an Airport Advisory Board that makes recommendations directly to the City Council regarding all Airport policies. The City Council reviews and approves all Airport operating policies including rate schedules for Airport property leases and services. The day-to-day operation of Airport is the direct responsibility of the Airport Manager.

The City of Denton recently engaged R.A. Wiedemann & Associates, Inc. to draft the Denton Municipal Airport Business Plan, which plan was recently adopted by the City Council. SAMI's report is written with regard to the Business Plan and much of its recommendations.

Overview of the Ground Tenant/Landlord Relationship –

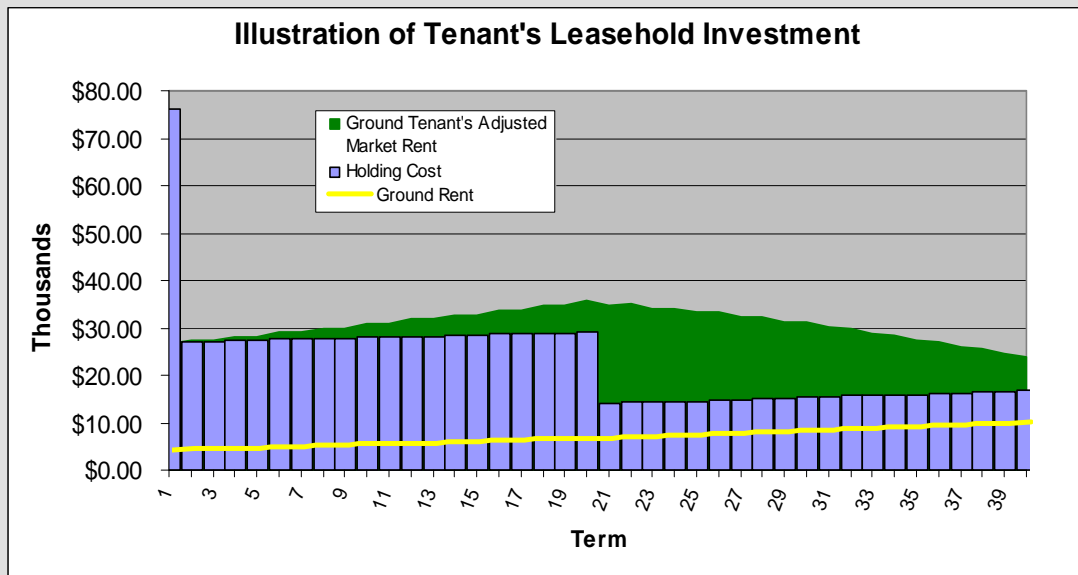
At risk of over simplifying the description of the landlord/tenant relationship; it is a long-term business partnership by and between two parties where one depends upon the other

to perform as promised. The landlord contractually surrenders the use of its land for an extended period of time in exchange for a steady cash-stream over the lease term paid in the form of ground rental and, the use and benefit of the depreciated improvements subsequent to the lease term. The landlord seeks a qualified developer/operator to build and maintain a high quality operation in a first-class facility with the hope that it will contribute to the overall well being of the Airport and local community. The tenant on the other hand contractually agrees to pay ground rent, all construction costs, taxes and insurance, maintenance and operating costs in exchange for the opportunity to earn a sufficient return enough to warrant its investment. During this time the tenant depends on the landlord to efficiently and effectively operate the airport in a manner that sustains a synergetic and thriving tenant base. Both parties need to be sophisticated enough to consider and weigh the myriad of conditions, rights, duties and privileges for which they are obligating themselves to and how these commitments will impact their respective business interests and investments 20 to 40 years into the future.

From a more technical perspective, the creation of the ground lease is the division of property ownership rights into two parts over the term; one part held by the landlord and the other held by the tenant. Theoretically, at anytime over the term the value of the two parts equals the whole, or the fair market value of the “fee interest.” With a typical ground lease the landlord contracts out and surrenders the use of its land over a long period of time with no ownership interest in the building improvements; its interest (the “lease fee”) is limited to the value of the contracted cash flow stream received over the term of the lease plus any reversion value allocated to the remaining improvements. The remainder of the fee interest less the lease fee is the “leasehold” or the tenant's right to use the land during the term as if owned fee simple¹ but without having to commit additional capital to buy the land. After constructing the improvements, the value of the tenant's holdings is increased and reflects not only the leasehold but the added value derived from the improvements² constructed on the premises. When the lease term expires or earlier terminates the two property interests immediately merge back into one with all property rights and interests restored to the landlord.

¹ It is assumed here that the permitted use of the leased premises is the same if it were a fee simple property instead.

² The value of an airport hangar facility is typically determined using the income approach to value rather than the cost or comparable sales approach because of the facility's capacity to generate revenue.



The above graphic illustrates the tenant's investment in a conventional ground lease net of customary operating and holding costs.

The tenant contracts to use the land over a lengthy term and agrees to incur the cost of building and maintaining the improvements and paying ground rent over the term. In this example, the tenant finances 80% of the improvements costs over the first 20 years. Consequently, the first year includes the tenant's equity contribution plus holding costs. The tenant's holding cost over the term includes debt service over the first 20 years plus ground rent, depreciation and market obsolescence (blue shaded area).

Meanwhile, the tenant is able to operate the facility and generate revenue that exceeds all holding costs (green shaded area). Because of the reversionary provision of the ground lease, the tenant does not recognize any residual value from the depreciated building improvements; however the surplus or profit that accrues over the lengthy term is sufficient enough to warrant the tenant's investment.

Landlord's ground rent in proportion to the tenant's holding cost is represented by the yellow trend line.

Describing the Typical Reversionary Process -

One of the key elements found in a ground lease agreement is the provision of a "reversionary clause." A "reversion" is defined as the return of certain property rights to the landlord. The "reversionary right" is the landlord's right to retake possession and resume the full and sole use and proprietorship of the real property that was temporarily alienated while the ground lease was in effect. The reversionary right becomes effective at a stated time or under certain conditions set forth in the lease agreement, such as but

not necessarily the expiration or early termination of the lease. A "reversionary interest" is any interest that reverts back to the landlord after the interest granted to the tenant has ended. If the tenant constructed building improvements on the land that are to remain, the landlord's reversionary interest triggered by the reversionary event includes the full and sole use of the property together with the ownership of the building improvements.

Therefore, what is meant as the "reversionary process" is the progression both the landlord and tenant undergo to plan for, facilitate and administer the eventual and certain retaking of the property and improvements entitled to the landlord. When and how this process unfolds largely depends upon the:

- specific terms and conditions contained in the lease already agreed to by the parties (e.g. options, right of first refusals, events of default giving rise to the termination of the lease, and term expiration);
- circumstances surrounding the physical property itself (e.g. the need for a change in use or some other strategic objective of the landlord's); and
- desired or intended objectives and needs expressed by each of the contracting parties (e.g. state of the relationship and whether there is a desire to continue, tenant's desire to remain or relocate, expansion or contraction requirements, change in business due to industry trends, etc.).

In most instances, an understanding of these and other factors and their implication must be developed over time through candid landlord/tenant communication and a continual strategic reassessment of the contractual relationship as it relates to the City's long-term objectives for the Airport. Failure to do so may lead to one or the other party being ill-prepared to respond or react to the other's actions, unfortunate misunderstandings, or even costly litigation.

Disposition of Building Improvements

Probably the most difficult component of the reversionary process is determining the disposition of the building improvements. If pursuant to the ground lease the tenant is to construct building improvements on the demised premises, the lease should also clearly state who holds title to these improvements during and after the lease term. Equally important and necessary is a statement detailing the rights, duties and obligations that each of the parties has with respect to the transfer or removal of the building improvements at the end of the lease term.

When Title to the Building Improvements Revert to Landlord upon Completion of Construction or prior to the Lease Expiration. In this instance the reversionary trigger may be voluntary or involuntary.

An example of an involuntary trigger would be a default by the tenant for failure to commence or complete construction of the improvements as agreed. The landlord might invoke its right of reentry and terminate the lease, which triggers the full reversion of the property interests to the landlord. Depending upon the circumstances and guidance from legal counsel, the landlord may elect instead to sue for specific performance and seek

completion of the improvements or, possibly the demolition and removal of the partial improvements at the tenant's expense before terminating the lease.

An example of a voluntary trigger is when the parties mutually agree that the tenant will construct the building improvements at its sole cost and expense and then upon completion (as defined in the lease agreement; e.g. upon issuance of a certificate of occupancy) execute and record a conveyance instrument transferring ownership from tenant to landlord. The motivation for such an early conveyance is usually held by the tenant and for reasons that can vary widely. Most often this mechanism is used to mitigate the tenant's property tax liability which in turn improves the tenant's overall return on investment over the term³. This scenario tends to be less problematic for the contracting parties because (i) the condition of the improvements are new and unquestioned, (ii) the rational or motivation for the early transfer of title is also better understood by the contracting parties and was likely a critical negotiating point for the tenant, (iii) it is easier to evaluate the economics of the relationship since there is less need for speculating and making broad assumptions well into the distant future. Although a voluntary reversion such as this is likely to be less contentious, it is critical that the lease agreement clearly articulates whose responsibility it is to maintain and repair the improvements over the term.

When Title to the Building Improvements Revert to Landlord upon the Expiration of the Lease Term. There are generally two basic scenarios when this is the case:

1. Tenant intends or desires to continue its possession of the premises after reversion of the improvements – in this case the tenant will likely impose much less burden on the Airport with regard to repairs and maintenance at the time of reversion because they will likely be motivated to keep the facility in good repair during the term knowing they will continue to receive the use and benefit of the improvements even after they revert to the landlord. However, if the tenant intends to stay beyond the initial term this also implies that the two parties must reach a new lease structure that gives the tenant cause or desire to stay beyond the original lease term. Because the tenant built, maintained and maybe even improved the property over the term, the tenant is likely to have a differing perception of value than the landlord who perceived the property as another added to their owned portfolio and looking forward to a rental stream in line with full commercial rent at the prevailing market rate rather than the much lower ground rent.

Leading up to this critical decision point, the landlord's challenges include:

- Determining whether to allow the current tenant to continue its occupancy under a commercial lease or to use the site for strategic or redevelopment purposes? This is a question that should be vetted during the portfolio's strategic planning and management process well in advance of any reversion. If the landlord has little or

³ In certain circumstances under the Texas Tax Code a tenant's leasehold may be exempt from property tax; however should the tenant be holding title to the improvement the exemption is not available.

- no intention to allow the tenant to remain, this decision should be communicated to the tenant sooner than later as a matter of good business practice;
- Similarly, is the current use compatible with the surrounding uses? Incompatible uses detract value from all properties and frequently lead to discontent among the other tenants. The current tenant use may not be the highest and best use and therefor the tenant can't justify paying a fair market rate for that higher use;
 - Would the proposed lease term be inconsistent with the lease terms of surrounding properties so not to create a "white elephant" situation? Or, if the term is extended does the landlord anticipate extending neighboring property lease terms over time thereby keeping them reasonably coterminous?
 - Weighing the opportunity cost of keeping or possibly losing a creditworthy tenant that is known and proven to be a viable operator at the airport compared to the market risk of a protracted vacancy while attempting to attract an unproven prospect, etc. What would be the acceptable rate and, or term the Airport would be willing to accept in hopes of retaining the tenant?
 - Negotiating a lease agreement that clearly articulates each party's duty to maintain, repair or make improvements to the buildings now owned by the Airport.
2. Tenant intends to depart from the airport – this situation can be and usually is the more complicated process. The reversionary clause should clearly state that upon the expiration or earlier termination of the ground lease, all improvements become the property of the Airport without payment, free and clear of all liens, and in good condition, reasonable wear and tear accepted. The lease should also give the Airport the right to require all or some of the improvements be removed from the premises and restore the land to its original condition at the tenant's sole cost and expense prior to the lease expiration⁴.

When:

- a) All or some of the improvements are to be removed: in the case of lease improvements that are expected to have nominal value at the end of the term, the landlord should require the improvements to be removed. Also, should the results of an environmental audit or some other investigative report identify unfavorable conditions, the Airport want to simply have the land cleared and restored to its original condition without taking title first for liability concerns.
- b) Improvements are to remain: when the landlord anticipates taking possession of the building improvements the Landlord is well served to take certain actions before, during and after the actual reversion event. See task summary below:

⁴ If tenant is permitted to demolish the improvements after the lease expires, the tenant's obligations under the lease, including the obligation to indemnify the landlord and to carry insurance, will not apply during the demolition period unless the lease clearly states those provisions survive the lease expiration.

<u>Ongoing Assessment</u>	
<ul style="list-style-type: none"> Evaluate the tenant's potential need for lease extension, expansion, need for relocation (on or off-airport), business continuity or change due to industry trends. 	Holding annual or semi-annual meetings with tenant to discuss current issues, business trends, needs assessment will begin to reveal the likely reversion scenario. Process should begin early in the tenant/landlord relationship.
<ul style="list-style-type: none"> Is the site needed for redevelopment purposes or other long-term strategic objectives 	Airport staff should annually evaluate the status of the property as it relates to the overall real estate portfolio alignment to the Airport Master Plan, Business Plan and other long-term strategic objectives of the City
<ul style="list-style-type: none"> Periodically review the terms of any options and other terms or rights under the lease that either party is responsible for over the remaining term. 	Periodically reminding the tenant of these matters builds goodwill gives rise to the opportunity to discuss plans and alternatives with the tenant.
Pre Lease Expiration/Termination (3-5 years prior to)	
<ul style="list-style-type: none"> Building condition assessment to determine condition of primary building components (HVAC, plumbing, electrical, office space, hangar door systems, roof, parking, apron, exterior improvements), identify any deferred maintenance and estimate what improvements are desired or necessary to make the property marketable. 	Written notice should be given to tenant of any deferred maintenance items that landlord expects the tenant to cure prior to vacating the premises. Notice should be given well in advance to give the tenant sufficient opportunity to cure without excessive hardship.
<ul style="list-style-type: none"> Lien, UCC, judgment, pending litigation, bankruptcy and tax lien search 	Written notice should be given to tenant to cure any liens encumbering the real property. Notice should be given well in advance to give the tenant sufficient opportunity to cure without excessive hardship.
<ul style="list-style-type: none"> Environmental assessment 	Written notice should be given to tenant of any environmental findings that landlord expects the tenant to cure prior to vacating the premises. Notice should be given well in advance to give the tenant sufficient opportunity to cure without excessive hardship.
<ul style="list-style-type: none"> Capital Improvement reserve analysis 	Based upon building assessment report establish a reserve to cover repairs or modifications and mitigate unexpected takeover costs. Also include an allowance for marketing and vacancy expense based upon prevailing market conditions.
<ul style="list-style-type: none"> Review all subleases and their amendments and modifications for appropriate provisions and to ensure their lease term does not exceed the expiration date of the master lease. 	Tenant should not be allowed to create any sublease arrangement beyond the ground lease expiration date.

At Lease Expiration or Termination (including the 12 months leading upto the date of reversion)	
<ul style="list-style-type: none"> Building condition assessment update. 	<p>Verify what conditions have been resolved from the previous report and what new conditions may have since developed. Subject to the terms of the lease, give tenant written notice of any remedies required prior to the expiration of the lease.</p> <p>Re-evaluate the sufficiency of the Capital Improvement Reserve account</p>
<ul style="list-style-type: none"> Lien, UCC, judgment, pending litigation , bankruptcy and tax lien search update 	<p>Another lien search should be performed after all or most building repairs are complete that are going to be made. Tenant should be required to secure a waiver of lien benefiting both the tenant and the Airport from all contractors and their subs thereafter</p> <p>Written notice should be given to tenant to cure any remaining liens encumbering the real property, including property tax. Notice should be given well in advance to give the tenant sufficient opportunity to cure without excessive hardship.</p>
<ul style="list-style-type: none"> Determine if pro-ration of property tax is required as of reversion date. 	<p>Tenant is liable for property tax assessed for that portion of the year the premises is occupied by tenant. Tenant needs to pay landlord in escrow, otherwise landlord will be obligated to pay balance due</p>
<ul style="list-style-type: none"> Request copies of all building construction documents, files, specifications, warranties, service agreements 	<p>Will need to give notice to service providers of the change of notice.</p>
<ul style="list-style-type: none"> Closing 	<p>Execute memorandum of lease attesting to the expiration or early termination of the agreement. Should be publicly recorded in the County Clerks Official Public Records.</p> <p>Payment of tax escrow and other settlement charges agreed to by the parties.</p>
<ul style="list-style-type: none"> Obtain keys, codes and passwords if building is alarmed 	
<ul style="list-style-type: none"> Commence marketing of facility 	<p>Subject to the terms and conditions of the lease, landlord showed is allowed to show the facility during normal business hours by appointment only.</p>
<u>Post expiration or termination:</u>	
<ul style="list-style-type: none"> Secure property 	<p>Change locks and combinations. Notify security & alarm companies of ownership change</p>
<ul style="list-style-type: none"> Notify Insurance provider/department of added property to owned portfolio 	
<ul style="list-style-type: none"> Perform as-built property survey update if necessary 	<p>Will be needed for new lease.</p>
<ul style="list-style-type: none"> Commence building repairs and modifications necessary to make marketable for reletting 	
<ul style="list-style-type: none"> Notify utility companies of change of service accounts 	
<ul style="list-style-type: none"> Commence marketing plan. 	

Deferment of the Reversion Event.

By definition the reversion of the tenant's property rights is inevitable; however it can be deferred by way of a negotiated lease term extension or lease renewal⁵. A lease term extension is essentially an amendment to the existing agreement that extends the tenant's right of possession for the duration of the extended term. Often a landlord will use this opportunity to include other modifications to the terms and conditions to bring the lease agreement up to their current lease standards. If the lease has been assigned one or more times, and provided the landlord has not released the assignor of its obligations under the lease, the chain of title remains in tact keeping the assignor liable to the landlord.

On the other hand, a lease renewal is literally a new ground lease agreement intended to replace or supersede the original. Since a lease renewal requires either the termination or expiration of the original agreement, the leasehold chain of title is usually severed, extinguishing the assignor's liability to the landlord⁶.

The use of a lease extension or renewal must be carefully weighed by the landlord giving regard to the impact that such an extension may have on the landlord/tenant relationship, the long-term strategic objectives of the Airport and, compliance under state laws and/or Grant Assurances.

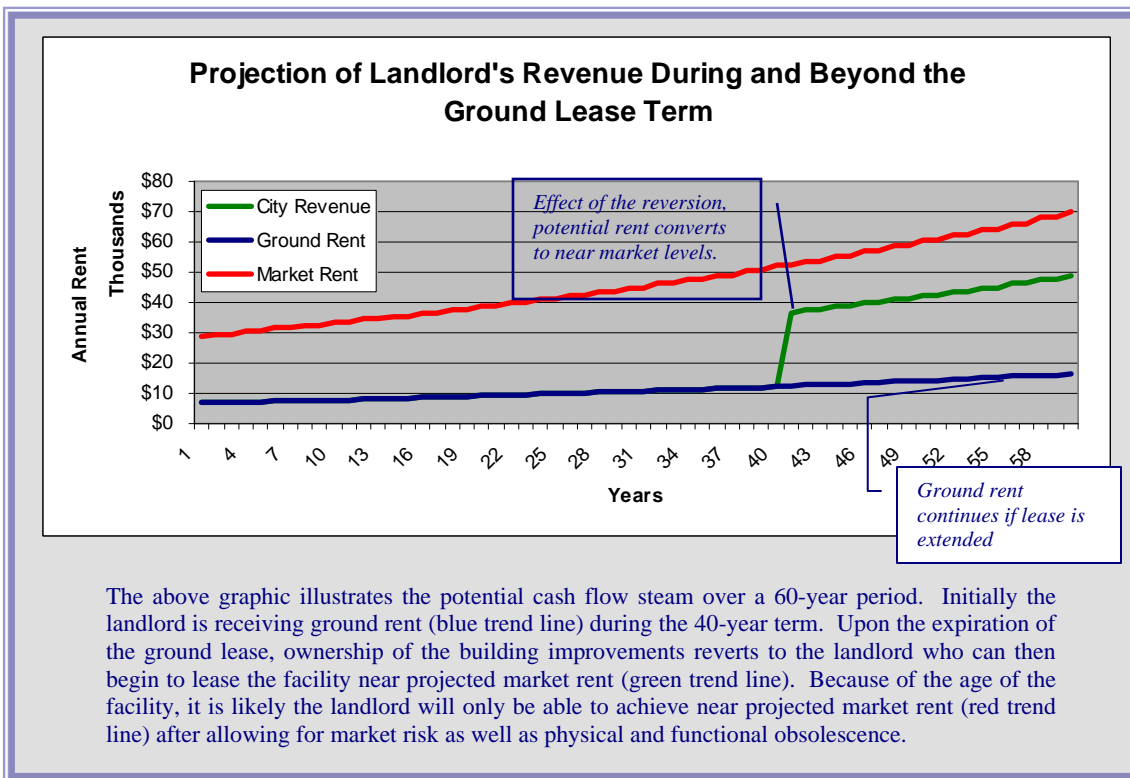
When the landlord gives consideration to extending the lease term to a ground lease, it would be well served to look upon the extension as a form of "equity contribution" granted to the tenant for which the Airport ought to be compensated⁷. This compensation (most often in the form of a capital investment by the tenant that results in an enhanced fair market value of the property or, alternatively, a modified rental structure) offsets the opportunity cost to the Airport when it pre-empt's the property reversion and its ability to earn commercial market rent upon the expiration of the ground lease.

Determining the level of capital investment and the corresponding appropriate lease-term extension (or vice-a-versa) is a difficult task, especially since most extension requests or proposals are made years before the lease expiration, requiring assumptions and projections well into the future. Secondly, if there is significant new investment being proposed often it involves depreciable dollars being expended on an already depreciating asset, which tends to offset or diminish the value of the new investment.

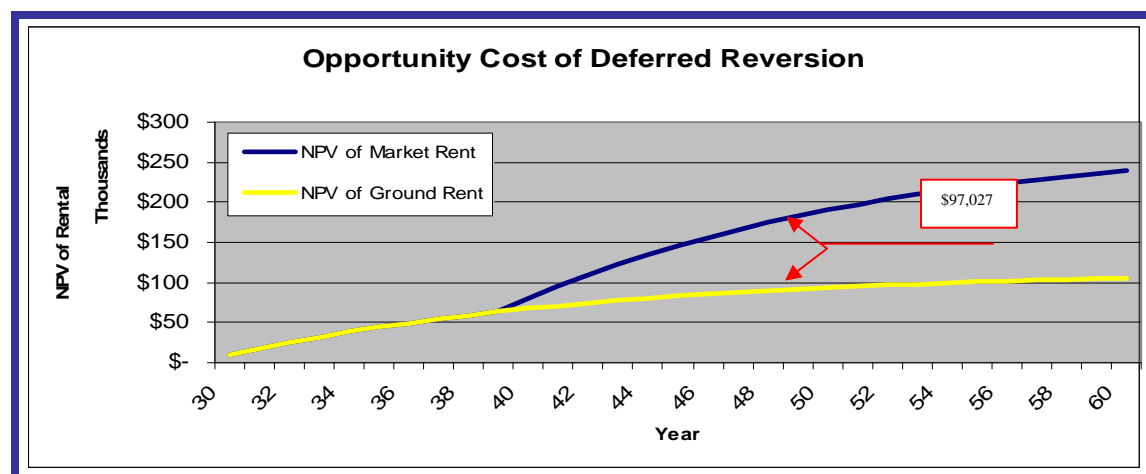
⁵ Options are not regarded as a form of deferment of the reversion event because the option rights are usually unilateral (e.g. provided the tenant is not in default at the time of the option exercise, tenant may at its sole discretion give notice to landlord of it electing to continue the lease for the duration of the option period subject to the terms and conditions of the lease).

⁶ Which of the two vehicles is best depends on a case by case basis. The assignor's liability usually is to the extent of terms and conditions of the lease at the time of the assignment. With most airport properties the value of the improvements will exceed the tenant's contractual liability to the landlord. In the event of a default the landlord will look first to the building improvements for its security. Only if there is a deficiency created where the value of the improvement is less than the remaining contracted ground lease rental would the landlord seek restitution from the tenant and each assignor of record.

⁷ The extended term provides the tenant opportunity to use the leased premises for continued business operations, therefore allowing it to continue making profit.



Nominal credit should be given for those capital expenditures allocated to restoring the existing structure (e.g. roof replacement, parking lot repair, tenant interior finish-out) since these are typically obligations of the tenant to properly maintain the property under the existing agreement. Extensive maintenance enhancements that assure usability beyond the original term of lease and to enhance quality of the facility may allow for a modest extension (say, 3-10 year extension) depending upon the nature and character of the improvements, however extensions for any longer period are generally tied to increased building/hangar capacity, which usually translates to a greater economic impact and value enhancement to the Airport.



The above graphic illustrates the potential opportunity cost to the landlord when the lease term is extended. This is done by comparing the net present value (NPV) of the landlord's projected revenue stream of both, the expected market rent received after the reversion of the building improvements and ground rent received during the extended term.

Net present value is a method to compare to investment alternatives by determining the discounted present value of all anticipated future benefits (or net proceeds). Generally when the NPV is positive or comparatively higher than another alternative, the investment proposal is regarded as acceptable or more acceptable. Where the NPV is equal to zero, the proposal is marginally acceptable; and where the NPV is negative or less than the alternative investment, the proposal is unacceptable.

The above graphic assumes the original ground lease term is 40 years and in Year-30 the tenant requests a 10-year term extension to the ground lease. Given the assumptions used in this analysis, the opportunity cost to the landlord for granting the extension is approximately \$97,027 in today's dollars. If the ground lease is not extended, the landlord would receive near market commercial rent (after allowing for functional and economic obsolescence of the aged facility) and market risk (represented by the blue trend line). The NPV of this cash stream at the end of Year 50 is estimated to be \$190,445. In contrast, if the original ground lease is extended 10 years, the NPV of the continued ground rent (escalating 3% every two years) is estimated to be \$93,418. Therefore, if the ground lease is extended 10 years, the opportunity cost to the landlord is the difference of the two net present values, or \$97,027.

To offset this opportunity cost, the landlord may seek either an adjustment to the ground rental structure beginning as early as Year-30 in a manner that will achieve a comparable NPV as the market rent scenario. Alternatively, the landlord may seek capital improvements to the facility that would provide comparable added value to the facility.

FAA's Perspective Towards Lease Terms and Reversion Interests -

Although the FAA does not specifically approve any lease policy or lease agreement, the FAA maintains the right to periodically review any such policy or lease agreements to ensure they are in compliance with the Airport's federal obligations and that the Airport sponsor's rights and power to operate the airport accordingly are preserved.

Although the FAA does not have a set policy on lease terms or the use of reversionary clauses they:

- Support the use of a standard reversionary clause in the lease in order to maintain a degree of uniformity. It is common for permanent capital improvements made to or on the land to become the property of the landowner at the termination of the lease.
- FAA does not support long term leases beyond the life of the asset – a 50-year term limit is maximum inclusive of all options
- Ideally a new lease should support a new leasehold improvement – not continuous extensions
- Avoid use of Options/Right of First Refusals

- View the enforcement of the reversionary clause is in keeping with the mandate of maintaining a fee and rental structure that makes the Airport as financially self-sustaining as possible;
- Maintain that if the ground lease is renewed without requiring the tenant to make a major capital investment in the structure, the airport sponsor may be in violation of the Grant Assurances because the action could be considered a perpetual lease or the giving or donation of airport property to a private entity.
- Have on occasion indicated:
 - if the airport sponsor were to consider a new ground lease on an existing building in response to a tenant's proposal involving a major reinvestment in the leasehold it would require a rational, equitable approach to determining the threshold level of investment that warrant or justify the strategy;
 - a new ground lease rate would need to be determined inclusive of consideration of all new terms and conditions contained in the agreement.
 - to avoid equity problems, expenditures necessitated by deferred maintenance should not counted as new improvements even if the costs are substantial.
 - the loss of future revenues from reverted properties may have a negative impact on the other users of the airport and may constitute unfair and unequitable treatment among airport users.

Other Legal Considerations:

Title 3, Chapter 22 of the Texas Transportation Code (the "Code") grants county and municipal governments the authority to plan, operate and regulate an airport for the use and benefit of the general public. It should be noted that Section 22.021(a) of the Code limits the terms of any agreement affecting the use of the airport not to exceed 40 years including any options or renewals (excluding those agreements between the local government and the United States government). The significance here is that the Texas statute limits the maximum term to 10 years less than what is generally recognized by the FAA (50 years) as mentioned above.

With respect to the reversionary clause of a lease agreement, Section 22.024(a) of the Code provides that a local government may dispose of an airport or air navigation facility or other property, or a portion of or interest in the property, acquired under this section in any manner, subject to state laws or provisions of the charter of the local government governing the disposition of other property of the local government. Section 22.024(c) states that "[a]n arrangement made under this section is subject to the terms of a grant, loan, or agreement under Section 22.055." This same section goes on to state except for certain circumstances, land that is owned by the local government may be sold or otherwise disposed of by public auction (under Section 253.008 of the Local Government Code) or by a notice and bidding process (Section 272.001, LGC). Should the airport

sponsor fail to enforce its reversion provisions contained in the lease, such failure could be regarded as an unlawful disposition of public property to a private entity.

Review of Excerpt From City of Denton's Commercial Operator Lease Agreement-

SAMI was provided excerpts of the Airport's *proposed* ground lease agreement form including Section VIII – Leasehold Improvements and Section XV.J - Assumption Options for review and comment as follows:

1. The term "Assumption" does not seem to be the proper use of the word. Assumption often means assuming the duties and obligations of another such as assuming the debt or sub-lease of the assignor. The assumption of something typically requires action by one party or another. The more proper term is "Reversion" which means the retaking of something. In this case the lessor is retaking the use of its own land and any improvements thereon free and clear. A reversion can occur automatically without any action by either party. The use of the improper term is misleading and confusing and could possibly have unintended consequences. This should be reviewed by legal counsel.
2. It is unclear to SAMI what benefit the right of first refusal mechanism provides the Airport or the tenant. Because of the magnitude of investment and the tenant's need to know its fate one way or the other, any negotiations for a renewal or extension should take place well before 180 days of the expiration of the lease agreement, as it may be extended. Furthermore, the 180-day right of first refusal period serves as an exclusive period of negotiation benefiting the tenant. At the risk of interfering or being perceived as interfering, the landlord can do little to prepare for the possible reversion until the lease and 180-day right of first refusal period expire.
3. It is not indicated how early the Airport will consider renegotiation of any ground lease agreement. Often tenants will want to begin pursuing such extensions or modifications with 10 to 15 years remaining so they may develop their business plans or secure financing. Lenders will require more than sufficient term to cover the duration of the note and then some. Also lenders will want the tenant to exercise any such options as soon as possible to ensure the extension is secured.
4. Unless particular circumstances warrant the use of Options in a ground lease, SAMI generally recommends not including options in a ground lease. Typically options are unilateral privileges benefiting the tenant and limit the landlord's capability to manage the asset as the situation warrants.
5. Section VIII.C(2). Ownership of Improvements - clearly states that the title to the building improvements constructed on the leased premises is vested in the tenant for the duration of the term or any extension thereto. Upon the expiration of the term as may be extended, title to the improvements are said to automatically revert to the landlord free and clear, subject to the provisions in Section XV.J Assumption Options.

6. Section XV.J Assumption Options - this section provides for three option alternatives available to the tenant provided the tenant gives written notice to the City Manager at least 180 days prior to the end of the current term as it may have been extended.
 - a. Option 1. The tenant is given the right of first refusal to essentially negotiate a ground lease renewal at prevailing market rates, terms and conditions for comparable properties at the Airport. The renewal would effectively defer the reversion of the building improvements provided the improvements meet or exceed prevailing codes, ordinances and building regulations. This option will likely require the tenant to expend considerable capital to keep the improvements within "current standards." It is unclear to SAMI if the standards are for existing occupancies and uses or for new construction and new occupancy and enforced in the same manner elsewhere in the city other than the Airport. This option would potentially require a depreciated building to be brought into new-building condition from a code compliance standpoint. This could require an expenditure that does not provide the tenant with any added operational or functional benefit.
 - b. Option 2. This option essentially gives the tenant the opportunity to negotiate a new ground lease agreement before the expiration of the current lease term as it may have been extended. If the ground lease has been previously assigned, the Airport might be better served to negotiate an amendment to the existing lease agreement to preserve the landlord's rights against the assignors. (See above discussion regarding **Deferment of the Reversion Event**.)
 - c. Option 3. If the tenant elects not to exercise either Option 1 or Option 2, then the tenant has the right to negotiate a conventional commercial lease at prevailing market rates and terms.
7. It is unclear to SAMI whether the tenant must declare which option they intend to pursue at the onset of their right of first refusal period. The three options actually provide a logical progression the tenant will likely go through. First they will likely want to pursue Option 1 until they learn how much they will be required to spend on the facility to satisfy the Airport's requirements. Consequently, the tenant will then opt for Option 2. If they are unable to negotiate an extended agreement under Option 1 or Option 2, the lease will expire and either they will be required to surrender the lease premises or accept a conventional commercial lease agreement for the same facility.

ADDENDUM

SAMI was provided three existing ground lease agreements to review and to provide comment where appropriate in regard to the terms and conditions directly or indirectly influencing the reversionary process. These reviews should in no way be regarded as a legal opinion or counsel. All legal questions should be considered and addressed by a licensed attorney and/or the City Attorney.

The three leases are commonly referred as: (i) First Financial Resources, Inc, (ii) US Aviation Group, and (iii) Jet Works Aviation, Inc..

Review of First Financial Resources, Inc., a Delaware corporation

Term	Description	First Defined & Comments
Effective Date:	September 15, 1987	Preamble
Land Area	23,915 SFL (.508 acres), Tract II on Attachment "A"	Section II.A.
Lease Term (primary term)	23 years commencing September 15, 1987 and continuing through September 15, 2010 unless earlier terminated	Section III (page 4)
Right of First Refusal	For three addl. 5-year periods. <ul style="list-style-type: none"> w/o regard to COL index written notice required of intent to renegotiate 180 days prior to expiration of pending term 	Section III (page 4) <ul style="list-style-type: none"> Last sentence of paragraph appears to conflict with notice requirement
Land Rental	\$1,675.05/yr (\$133.50/mo.) To be offset \$.07565/sf of public easement granted, if any	Section IV (page 5)
Rental Adjustment	Yearly rental for land <u>and</u> improvements (emphasis added) herein leased shall be readjusted at the end of each 5 yr. period during the term. Adjustment capped at 50% preceding rental.	Section IV C. (page 5) Base Yr is said to be indexed to March 1985, two years prior to commencement date. However first adjustment is said to take place 9/15/90, or end of Yr. 3.
Construction Period	None specified	No commencement or completion date specified. Appears to rely on the permitted use clause to enforce requirement to construct the improvements.

First Financial Resources, Inc. (FFR) is headquartered in Denton, TX, and is the parent company of Hulcher Services, Inc., a full-service environmental specialty company providing emergency response services to railroads, general industry and governments

with over 600 employees throughout the continental United States. FFR is the original tenant to the subject ground lease. The leased premises are used as the corporate flight department for FFR where they currently keep a multi-engine fixed wing Cessna 560XL registered to FFR. It is understood that FFR constructed and has maintained the improvements on the leased premises throughout the primary term. In late 2009 or early 2010, FFR expended a reported \$175,000 on capital improvements to the leased premises including approximately 1,600 square feet of additional shop/office space attached to the main hangar. As indicated above, the primary term of the lease was scheduled to expire September 15, 2010. The primary term has been mutually extended until June 15, 2011.

The following are comments offered based upon SAMI's review of the described lease:

1. The agreement is entitled "Commercial Operator Lease Agreement between the City of Denton and First Financial Resources, Inc." However, the agreement contains many of the characteristics of a conventional ground lease agreement (e.g. the leaseholder has the right to use the land, rental payable is referred to as "Land Rental," the tenant is required to build, own and maintain the improvements made to the leased premises at its sole cost and expense and the agreement is long-term in nature).
2. The agreement does not stipulate if or when the tenant is required to begin or complete construction of the building improvements. Similarly, the agreement does not specifically state that tenant's failure to construct the improvements would constitute a default of the agreement. Possibly it could be maintained by the lessor that the permitted use required the improvements, but this is vague and ambiguous.
3. Section III. Term. The primary term expires after 23 years. The tenant has three consecutive first-right-of-refusal options subsequent to the primary term. In order for the tenant to invoke this right, the tenant must deliver written notice delivered to the City Manager 180 days prior to the expiration of the primary term or any renegotiated terms.
 - a. Tenant's failure to deliver such written notice as required would give cause for the lease to automatically expire at the end of the operating term.
 - b. If tenant delivers such notice, it gives the tenant the right to "renegotiate" the terms, which terms shall be "reasonable and consistent with the then values, rentals and terms of similar properties on the Airport."
 - i. However, it is not clear whether "similar properties" is meant to be other ground-leased properties such as the subject property or commercially operated city-owned properties that command higher rentals.
 - ii. In this regard, Section VII.B(2) Assumption states that only after the primary term or any extension thereof shall the improvements automatically become the property of Lessor free and clear. If the reversion trigger has not occurred it is likely then "similar properties" would imply other ground-leased properties similar to the subject property. This should be reviewed by legal counsel.

- iii. Lessor does not have any duty or obligation to agree to or accept tenant's proposed terms and conditions for any extended period unless such terms and conditions are found to be reasonable and consistent with similar properties. It appears that it is the burden of the lessor to prove tenant's terms and conditions are not reasonable and consistent (which in itself is vague and ambiguous). This should be reviewed by legal counsel.
 - iv. The condition "without regard for or considering the then cost of living index" is believed to mean the new terms would be consistent with the prevailing market, which could be greater or less than the current contract rate.
 - v. Lessor does not have any duty to agree to or accept the tenant's proposed terms and conditions unless what tenant proposed is regarded to be reasonably consistent with comparable properties at the Airport.
 - vi. Tenant's exclusive right to renegotiate expires at the end of the primary term or any extended term. If an extended agreement cannot be reached, the lease agreement automatically expires and the building improvements revert to the Airport.
 - 1. The Airport probably needs to exercise caution and carefully document all negotiations in the event an agreement between the parties cannot be reached by the deadline and the tenant alleges the Airport did not negotiate in good faith.
 - c. The Airport should exercise caution not to hold any negotiations whatsoever with any third party about leasing the subject property while the tenant's exclusive right to renegotiate is in effect. Guidance on this matter should be sought from legal counsel.
 - d. It is understood that the parties have mutually agreed to extend the primary term until June 15, 2011. It is also presumed that tenant has delivered the required written notice to the City Manager of its desire to exercise its right of first refusal option since, or that the Airport has waived this requirement; otherwise, this agreement would have already expired. As such, the tenant's right to renegotiate expires June 15, 2011.
4. Section V.B. Standards:
- a. Sub-paragraph 6 & 9. As stipulated under these sub-paragraphs, the standard of maintenance required of the tenant includes keeping the premises neat, clean and in respectable condition, free from any objectionable matter or thing. Sub-paragraph 9 also requires the tenant to deliver the leased premises in "as good condition as existed when possession was taken by lessee, reasonable wear and tear expected." The Airport should be careful not to require anything greater than these standards in anticipation of the eventual reversion of the improvements.

- b. Sub-paragraph 9 appears to conflict with Section VII.B(1). Sub-paragraph 9 states that tenant should deliver the leased premises in similar condition as when the lease first commenced; however, the lease fails to describe what condition that was. Short of other documentation, it is presumed the premises were unimproved at the time the lease commenced; therefore, this sub-paragraph implies all improvements should be removed at lease expiration. However, Section VII.B(1) clearly states no building or permanent fixture is to be removed from the premises.
 - c. Sub-paragraph 10 Hold Harmless. This should be reviewed by legal counsel in the event the agreement is to be renegotiated.
5. Section VII.B. Ownership of Improvements
- a. Leading paragraph clearly states that the improvements remain the property of the lessee unless the property becomes the property of the lessor under the conditions listed.
 - b. Subsection B.1 stipulates that no building or permanent fixtures may be removed from the premises. This limitation requires the landlord to take title of the improvements without the option to require the tenant to remove any inferior or unsafe improvements before taking possession. This may be especially problematic if there are any environmental conditions the tenant had not remediated for which the Airport would rather not be held liable. The lease agreement needs to have a clearly stated reversionary clause indicating that upon the expiration or earlier termination of the ground lease, all improvements become the property of the landlord without payment, free and clear of all liens, and in good condition, reasonable wear and tear expected. The lease should also give the landlord the right to require all or some of the improvements be removed from the premises and the land restored to its original condition at the tenant's sole cost and expense upon to the lease expiration.
 - c. Subsection B.2. The term "Assumption" does not seem to be the proper use of the word. Assumption often means assuming the duties and obligations of another such as assuming the debt of an assignor. The assumption of something typically requires action by one party or another. The proper term is "Reversion" which means the retaking of something. In this case, the lessor is retaking the use of its own land and any improvements thereon free and clear. A reversion can occur automatically without any action by either party. The use of the improper term is misleading and confusing. This should be reviewed by legal counsel.
 - d. Sub-paragraph 4. This sub-paragraph states that should this lease be cancelled for any reason during the primary term, the Airport has the right to purchase the building improvements at their depreciated value. Cancellation is defined in Sections XII and XIII. It is unclear under what circumstances the Airport would want to consider purchasing the improvements if the lease is cancelled

by the tenant or in the event the tenant defaults. It should be noted the agreement does not have any provisions for condemnation or eminent domain or in the event of partial or complete destruction or the duties and obligations of the parties under such circumstances. This should be discussed further with legal counsel.

6. Section XII. Cancellation By Lessor. This section states "In the event of default, Lessor has the right to purchase any or all structures on the leased premises under the provisions of Section VII.B(4). It is unclear under what circumstances the Airport would want to acquire any of the building improvements when the tenant defaults the lease. If the tenant defaults, the landlord should reserve the right to exercise all rights and remedies available to it pursuant to the contract and by law, including terminating the lease. If the lease is terminated, all leasehold interest reverts to the Airport. A provision of this nature almost implies the Airport has a duty to purchase the improvements. This should be reviewed by legal counsel.

On rare occasion, the Airport and tenant might negotiate a buy-out provision of the improvements at the end of the lease term if for some reason the Airport prefers to see a level of improvement greater in value than the extended term desired by the tenant. For example, the tenant needs to make certain structural improvements to the existing hangar in order to keep its government contract but with only 10-years remaining in the contract and lease term. The Airport recognizes that there could be considerable long-term cost savings and economic benefit to the Airport if the tenant also raised the hangar roof and put on a new thirty-year warranted roof. The tenant might be amenable to make the added improvements if assured of getting a fair market value of the added improvements at the end of the lease term. Under this scenario, the tenant was able to keep its government contract for the duration of its term without having to relocate, the Airport retained a good tenant, will receive an upgraded hangar with a good roof upon reversion at likely a considerable over all cost savings.

Reversionary Process Considerations:

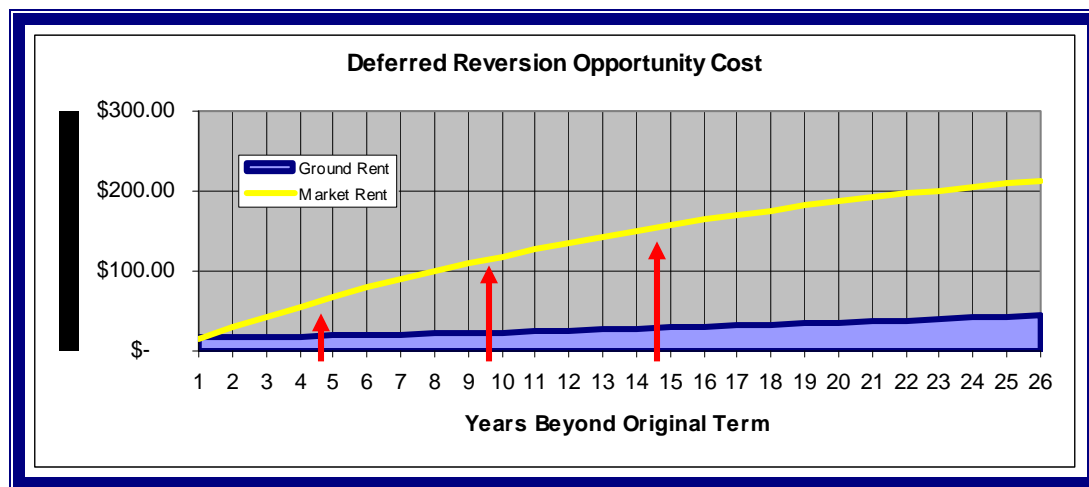
As previously stated, the primary term of FFR's lease was scheduled to expire September 15, 2010. Due to extenuating circumstances the parties mutually agreed to extend the primary lease term to June 15, 2011. It is also understood that the tenant has delivered its required written notice pursuant to the lease agreement to exercise its right of first refusal to renegotiate a five-year extended term (or the Airport has waived this requirement) and the parties are within the tenant's exclusive renegotiating period, which has also been extended to June 15, 2011. Unless something to the contrary occurs, should the parties fail to come to terms on a new extended agreement, the lease agreement will expire and the tenant will be required to surrender possession of the leased premises and all reversionary interests, including all building improvements, revert to the Airport.

In developing the following alternatives, SAMI understands the following statements are accurate:

- The tenant is in good standing with the Airport and is regarded a valued tenant at the airport.
- The current use of the leased premises is its highest and best use and not needed for redevelopment purposes anytime in the foreseeable future.
- In 2009/2010 the tenant reportedly spent \$175,000 in capital improvements which included additional office and shop space currently used to store proprietary equipment in connection with the tenant's core business.
- Prior to the tenant making the improvements, it is estimated the depreciated value of the original improvements was \$110,000 to \$117,000.⁸

Estimating the Opportunity Cost of Deferring the Reversion.

As previously explained, when considering whether to extend or renew a ground lease instead of allowing the lease to expire and the improvements revert back to the Airport, it is often beneficial to weigh the potential opportunity cost of such a decision.



- Assuming FFR's ground rental in 2010 is \$3,066 and is subject to adjustment every five years (approx 20%) just as before, all other terms and conditions remain the same, and
- Assume the current market rent is \$4/BSF and escalating 4% per annum, but because of the age of the building and its physical and functional obsolescence without significant capital investment and, market risk, the building is marketable today at \$2.50/BSF without any major capital improvement required.

Determining the NPV of the projected cash streams for the two alternatives, the opportunity cost increases but at a diminishing rate as the number of years increases. Thus, the opportunity cost for a 5-year extension is approximately \$47,450, a 10-year

⁸ According to Marshall & Swift SwiftEstimator® for Commercial Property Type 329 Hangar, Maintenance & Office of Class S, Quality 2 buildings of 6,000 square feet, the cost new is \$265,740 (\$44.29/SF). The 23 year old building is 58% depreciated or valued at \$117,000.

extension is \$97,644 and, 15-year term \$135,762. The goal then is to consider those alternatives that best mitigate this opportunity cost while giving regard to other (non-economic) strategic needs and objectives.

Alternative 1: Do Nothing and Allow the Lease to Expire. Under this alternative it is assumed that FFR and the Airport were unable to come to an agreement to extend the lease agreement. Unless something occurs to the contrary, the lease will automatically expire June 15, 2011. Upon the agreement's expiration, the tenant would be required to peaceably surrender the leased premises without removing or taking any building improvements and all building improvements will automatically revert to the Airport's ownership. The Airport will be free to make any repairs or modifications prior to reletting the property as a commercial property with the intent of getting close to current market rent. This will likely be an unfavorable result for the tenant for they have expressed an interest in extending the lease agreement. The tenant may also contend the Airport is unfairly taking property, especially considering that they recently expended considerable dollars in capital improvements valued in excess of the depreciated improvements. Because of this, the Airport is likely to harm a valued tenant relationship. This action will also be unfavorably viewed by other current and prospective ground tenants, developers and operators at the airport.

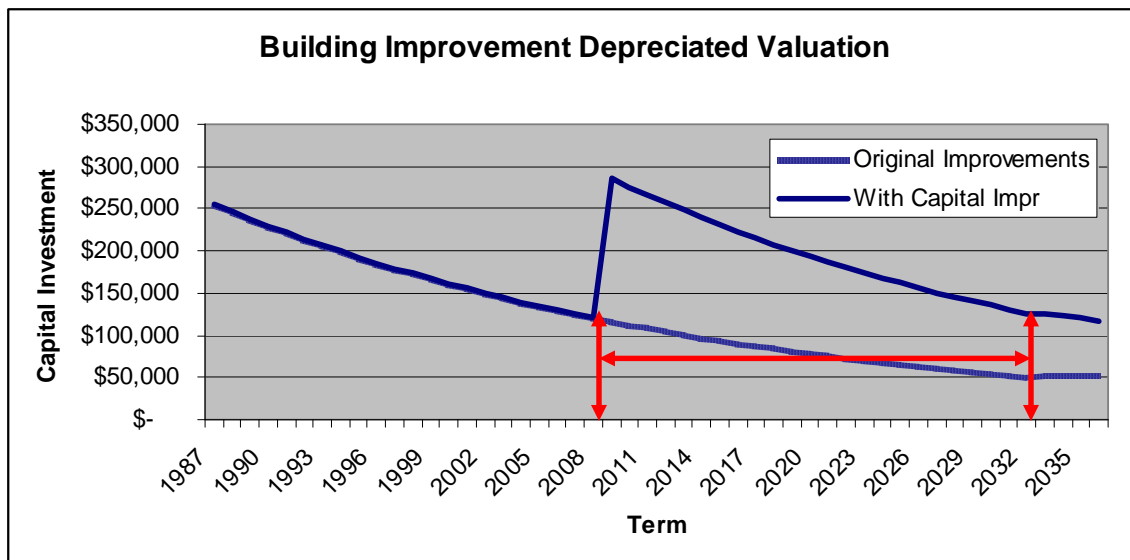
Alternative 2: Renegotiate the Existing Lease Agreement with the 5-Year Option Period. This alternative assumes the two parties can come to agreement on new terms and conditions at a rental structure acceptable to both parties. The rental structure would be reasonable and consistent with other ground-leased properties of similar type, size, age and use. The difficulty will be agreeing on what one or two properties might be available to serve as viable comparables. If the parties cannot agree, perhaps engaging a third-party appraiser mutually acceptable to both parties should be considered for determining an appropriate rate and term; recognizing the valued-added improvements made to the leased premises.

Alternative 3: Negotiate an Amendment to the Existing Ground Lease. This alternative assumes that the two parties agree to amend the existing lease agreement by extending the primary term a sufficient number of years, giving FFR reasonable credit for the improvements they made to the leased premises. The Airport can take this opportunity to also update the lease agreement to bring it into current lease standards and to clean up deficiencies found in the existing agreement. The agreement should allow the rental to continue to adjust periodically as with the current agreement. The amendment should also remove, if possible, any future rights of first refusal or option periods. These usually become points of contention and misunderstandings and really do not provide the Airport any added benefit.

Determining the appropriate number of years of added term due to the improvements made is not a simple task. Basically, the tenant is spending depreciable dollars on a depreciating asset so the tenant doesn't receive full credit; but this is the nature of capital improvements. Alternatively, a tenant could "buy down" added years by paying a lump sum at one or more intervals over the modified term instead of improving the facility, the

Airport risks having lease terms extended well beyond the useful life of the building. When this occurs, the tenant's leasehold position becomes so upside down, the tenant may be better off to turn the keys in and walk away.

The following graph shows FFR expended approximately \$250,000 in 1987 when the lease first commenced. The building improvements depreciate over the original term. By 2009, and before FFR completed the capital improvements, the building's depreciated value is estimated to be \$117,000. After FFR completed their improvements, the restated building value is estimated range from \$285,000 to \$292,000, which continues to depreciate at the same rate as before the improvements were made. In this analysis, the capital improvements pushed out the curve by 23 years, implying the lease could be extended as much as 23 years in order for FFR to receive full credit for their improvements.



The FFR scenario described above is somewhat unusual because the value of the capital improvements are greater than the depreciated asset, which caused the estimated added term to nearly exceed the original term. This scenario also suggests that perhaps the original term was not in balance with the original investment made to the property. Nonetheless, the original term was negotiated and agreed to by both parties together with all other terms and conditions contemplated.

For the FFR case, using the above depreciation curve, the following matrix gives a range of investments and suggested lease terms accordingly:

Level of Investment	Added Term Years
\$50,000	8 years
\$75,000	12 years
\$100,000	15 years
\$125,000	18 years
\$150,000	21 years

This alternative will hopefully enable the Airport to retain a valued tenant and give it the opportunity to improve upon its current lease agreement. It gives FFR plenty of time to plan for its future needs and purposes before the amended lease agreement expires. This alternative will defer the Airport from taking possession of the improvements and collecting market rents; however, the overall value of the Airport's aeronautical facilities has been significantly improved by FFR which, arguably, may be of greater value and benefit to the Airport over the long term.

Review of US Aviation Group Lease Agreement

The following are comments offered based upon SAMI's review of the described lease with regard to primarily the reversionary process:

Term	Description	First Defined & Comments
Effective Date:	<i>Date Not Given, 2007</i>	Preamble
Land Area	64,861 SFL (1.49 acres)	Section II.A. Attachment "A" & "B" not available
Leased Premises: Land Area	23,915 SFL (.508 acres), Tract II on Attachment "A"	Section II.A.
Lease Premises: Lessee Improvements	<ul style="list-style-type: none"> • Certain Drainage improvements • Apron approached "to the north and south" • 20' x 40' parking area • Lessee must enter "Development Contract" Must comply with local codes, standards and processes	Section II.C (page 4) No description provided re any vertical structures. Preamble references two 14K SFOffice/hangars structures (See Section VIII.B.) <ul style="list-style-type: none"> • Development Contract is not defined or described.
Construction Period	<ul style="list-style-type: none"> • Design plans due to landlord no later than 45 days from date of execution of lease (Effective Date); • Cost estimate due to landlord within 60 days of 	Section II.C. (page 4) Construction regarded commenced upon issuance of permit "and construction of any portion of the proposed

	<p>the Effective Date;</p> <ul style="list-style-type: none"> Construction must commence no later than 270 days (not specific, assumed to be from Effective Date); Construction must be completed no later than 720 days after the effective date. 	<p>improvements" believed to mean when mobilized.</p> <p>It is unclear if landlord's delay in issuing permit, if any, would be regarded as force majeure</p> <p>Construction completion is defined to be when CO is issued.</p>
Lease Term (primary term)	<p>30 years commencing ____ June, 2007 and continuing through June ____ 2037 unless earlier terminated (the "Lease Term").</p>	<p>Section III (page 5)</p> <p>See Section II.C regarding condition precedents must be fulfilled prior to taking possession of premises (w/in first 60 days cost estimate, construction schedule and loan commitment must be submitted and accepted by landlord.)</p>
Option	<p>To "renew" for one (1) ten (10) year term.</p> <ul style="list-style-type: none"> written notice of intent to exercise option due no later than 180 days before expiration of primary term. Terms of renewal shall be reasonable and consistent with the value, rentals and other terms consistent with similar properties on the Airport. 	<p>Section III (page 6)</p> <p>It is unclear if "similar properties" are ground lease or commercial facilities.</p> <p>How are rentals & terms of similar properties to be determined and by whom?</p> <p>How soon can the tenant exercise its option?</p>
Land Rental	<p>\$11,026.3/yr (\$.17/SF) with first year due in advance and non-refundable. Thereafter, payable in 12 equal monthly installments. Tenant may pay rental one year in advance.</p> <p>To be offset \$.07565/sf of public easement granted, if any</p>	<p>Section IV (page 5)</p>
Rental Adjustment	<p>Annually each 11/1 during the primary term. Base year is March 2006, or 188.4. Adjustment is capped at 20% for any two year period compared to prior CPI adjustment.</p>	<p>Section IV C. (page 6)</p> <p>Adjustment cap provision is somewhat unclear.</p>
Permitted Use	<p>Non-exclusive right to rent hangar and office space (and/or other aeronautical activities subject to the landlord's prior consent, not unreasonably</p>	<p>Section V.A (page 8)</p>

	withheld.	
Special Conditions	Lessee not to conduct aeronautical activity in excess of 30K lbs until such time the runway and taxilane have been improved to handle greater weight.	Section VII (page 13)
Leasehold Improvements	<p>Before commencing construction, all construction documents and cost estimates are to be approved by lessor. Design to conform to airport standards;</p> <p>Documentary evidence of actual cost of construction on public areas only (such as taxiway) shall be delivered to City Manager</p> <p>As-builts plans are required upon completion</p>	<p>Section VIII.A. (page 13) No further description of improvements provided</p> <p>Paragraph makes reference to public improvements and "said contract shall be conclusive" is unclear.</p> <p>Should probably be part of Section II.C</p>
Additional Improvements	Lessee may construct at its sole cost and expense all other building improvements necessary in connection with Permitted Use. Must comply with Section VIII.A	Section VIII.B.
Ownership of Improvements	<p>Title to improvements is held by lessee during the Lease Term or any extension thereof.</p> <p>Improvements remain with the land and are not to be removed</p> <p>Assumption: the improvements revert to the Airport upon the expiration of the Lease Term or any extension thereof, free and clear to the Airport</p> <p>If lessee fails to complete construction, the partial improvements revert to the Airport</p>	<p>Section VIII.C (page 14) Definition of Leased term does not appear to include Option term.</p>
Cancellation or Termination	The Airport has the right to purchase all of the Lease Improvements if the lease is canceled or terminated before the lease term and not for cause of default	<p>Section VIII.C.4 Purchase price is determined based upon the % of unamortized portion of building useful life times the Appraisal Districts assessment of value for tax purposes.</p>

The following are comments offered based upon SAMI's review of the described lease with respect to the reversionary process:

1. The heading of this lease agreement is "Airport Lease Agreement – Flight School and Aircraft Maintenance Facility," which would imply these two aeronautical activities would be included among the permitted uses of the Leased Premises, however they do not appear to be included under Section V of the Agreement.
2. Section II.C, page 5 in bold print is certain language that states "the lease shall automatically terminate without notice and Lessee shall remove itself from the premises. It further states that the lessee's improvements, if any, shall immediately become the property of lessor at no cost, expense or other compensation paid by lessor to lessee. The Airport might reconsider incorporating such absolute terminations. In some instances, the automatic termination of a lease may have unintended consequences that the Airport might find difficult to reverse. The Airport might rather reserve all its rights and remedies available to it by contract and law, including the right to retake possession of its property or, to terminate the lease. Also the Airport might rather reserve the use of other legal remedies to resolve such disputes including making demand for the tenant to remove all their improvements to the property at the tenant's sole cost and expense.
3. The primary lease term is for thirty (30) years. Provided the tenant gives proper written notice (at least 180 days prior to the lease term expiration) of its intent to exercise its option provided for in Section III of the Lease Agreement, the tenant may enter into a renewal agreement for an additional ten (10) year term. The terms and condition of the renewal agreement are to be "consistent with the then value, rentals and terms of similar property at the Airport."
 - a. It is uncertain the terms and conditions are to be of a comparable ground lease property or Airport-owned commercial hangar.
 - b. Section VIII.C clearly states the title to the building improvements are vested with the tenant during the Lease Term or any extension thereof. Section III defines Lease Term to consist of the primary term. It is not clear whether the option term(s) is to be regarded as an extension of the primary term. If the option years are regarded as an extension of the primary term, then the reversion of the improvements is deferred to the end of the option term. This would imply the renewal terms would be in relation of other ground leased properties. On the other hand, if the option years are not an extension of the primary term, then the improvements automatically revert at the ends of the primary term. Consequently, the terms of the renewal terms would then be in relation to other commercial Airport-owned properties.
4. The Lease stipulates the rental and terms for the option terms shall be consistent with the then value, rentals, and terms of similar property on the Denton Airport." The agreement does not indicate who determines the properties to be used as the comparables. If this is to be determined at the sole discretion of the Airport, the

- Airport should be diligent to document the basis for selection. It is possible to use a third-party such as a real estate appraiser or licensed broker to assist in this process; however the lease does not clarify who will bear the cost for such services.
5. In most instances, the Airport should avoid including options or right of first refusals as part of a long-term arrangement. First, it essentially creates an exclusive right to negotiate with the Airport once the option has been exercised. Secondly, after so many years circumstances affecting the property, tenant or Airport often change. The Airport may find the option provision to be more of an encumbrance than benefit. The Airport is better served to either grant the additional years as part of the primary term or, not to offer them at all.
 6. Once the tenant exercises its option rights, it creates effectively creates an exclusive right to renegotiate, an exclusive right that does not appear to expire until the end of the primary term.
 - a. The Airport probably needs to exercise caution and carefully document all negotiations in the event an agreement between the parties cannot be reached by the deadline in case the tenant alleges the Airport did not negotiate in good faith; and
 - b. The Airport should exercise caution not to hold any negotiations whatsoever with any third party once the option has been exercised, so not to be found interfering with the tenant's contract rights. Guidance on this matter should be sought from Airport's legal counsel.
 7. The agreement does not stipulate how early in the primary lease term the tenant can exercise its option right. As written, it appears the tenant can exercise its option the same day but subsequent to executing the Lease. This may not be the Airport's intent, but by doing so, the tenant has effectively protected its option right and its exclusive position to negotiate with the Airport. Most lenders will require the tenant to exercise its option right earlier rather than later.
 8. It has been noted the Airport tends to incorporate in its agreements "shall not unreasonably withhold" its consent or approval. Often such language becomes disputed because there isn't a standard readily available to serve as the basis for reasonableness. For example, in Section V.A. the Airport reserves the right to authorize the tenant the right to conduct other commercial, retail or industrial activity. The tenant may desire to conduct helicopter operations in a portion of the airport that may not be ideal or preferable in the opinion of the Airport. Is it reasonable for the Airport to deny such use when, after all, it is an airport? It is recommended Airport Management discuss this with its legal counsel.
 9. Section XI contains language where by the tenant cannot sublease any portion of its facility for a rental in excess of the rental or fees paid by the Lessee to the Airport. This language is not uncommon to conventional commercial leases, however the permitted use of the subject ground lease is specifically for the subletting of hangar and office space and it is understood this is the tenant's

primary business. This paragraph also provides the Airport is to be paid a \$500 administrative fee for each and every assignment of rights. It is recommended the Airport discuss this further with its legal counsel.

10. Use of the term Assumption may not be correct section VIII.C.2

11. Section VIII.C.4. This sub-paragraph states that should this lease be cancelled or terminated during the primary term, the Airport has the right to purchase the building improvements at their depreciated value. Cancellation is defined in Sections XIII and XIV. It is unclear under what circumstances the Airport would want to consider purchasing the improvements if the lease is cancelled by the tenant or in the event the tenant defaults. It should be noted the agreement does not have any provisions for condemnation or eminent domain or in the event of partial or complete destruction or the duties and obligations of the parties under such circumstances. This should be discussed further with legal counsel.

Review of Jet Works Aviation, Inc., a Texas corporation Lease Agreement

Term	Description	First Defined & Comments
Effective Date:	December 1, 2004	Preamble
Leased Premises: Land Area	59,398 SFL (1.3636 acres), Parcel on Attachment "A"	Section II.A.
Leased Premises:	Defined to include the land and all leasehold improvements made to the land less any easements or property owned or control by the Airport.	Section II.
Right of First Refusal for additional land.	Effective for the first three years from the Effective Date (Option Period), provided tenant is not in default and in good standing tenant can lease Parcel 2 at the same terms and conditions as any bona fide offer received by the Airport. Tenant has 45 days to exercise its option after receipt of the other offer.	Section II.B
Lessor Improvements	Airport is to continue planning and construction efforts with TxDOT on the expansion of the north terminal apron. Improvements are to be completed prior to Lessee's completion of its improvements. If state funding is delayed or denied, the Airport is obligated to build a portion of the planned apron adjacent to the tenant's hangar providing access to Taxiway Alpha. Airport is also to complete @	Section II.C, page 4

	1,000 of water main before tenant's improvements are complete.	
Lessee's Improvements	To construct 26,000 sf of office/hangar complex, dedicated apron, drainage infrastructure. Construction to commence within 270 days from the Effective Date and be completed by no later than 720 days. Completion is defined as upon issuance of CO	<p>Section II.D., page 4</p> <p>Failure to complete construction as obligated, Airport may at its sole discretion terminate the lease upon 30 days written notice of cancellation to lease.</p> <p>This paragraph may conflict or be inconsistent with the notice requirements of Section XIII, page 17</p> <p>Airport might rather retain right to require tenant to remove improvements at tenant's expense before terminating the lease.</p>
Term	Primary term is 30 years commencing December 1, 2004 through November 30, 2034.	Section III, Page 5
Option to Renew	<ul style="list-style-type: none"> Tenant has option to "renew" for two additional 10 year periods. Tenant must give notice of intent to renew no later than 180 days prior to the expiration of the lease term or extended lease term. Terms of renewal shall be reasonable and consistent with the value, rentals and other terms consistent with similar properties on the Airport 	<p>Section III, Page 5</p> <p>It is unclear if "similar properties" are ground lease or commercial facilities.</p> <p>How are rentals & terms of similar properties to be determined and by whom?</p> <p>How soon can the tenant exercise its option? Bank may require the option to be exercised soon than later.</p>
Rental	<ul style="list-style-type: none"> For the period between 12/1/04 thru 11/30/07 the tenant may qualify for the Reduced Rent (\$.05). For the period between 12/1/07 thru 11/30/34 or if in default during the earlier period tenant pays the Original Rent (\$.20) subject to adjustment as provided for in the agreement. 	Section IV, Page 5
Permitted Use	<ul style="list-style-type: none"> General aircraft maintenance Avionics 	Section V., Page 7

	<ul style="list-style-type: none"> • Hangar & Office leasing • Aircraft interior shop • rental 	
Special Conditions	<ul style="list-style-type: none"> • Lessee not to conduct aeronautical activity in excess of 60K lbs until such time the runway and taxilane have been improved to handle greater weight. 	
Leasehold Improvements	<p>Before commencing construction, all construction documents and cost estimates are to be approved by lessor. Design to conform to airport standards;</p> <p>As-builts plans are required upon completion</p>	<p>Section VIII.A. (page 13) No further description of improvements provided</p> <p>Should probably be part of Section II.C</p>
Ownership of Improvements	<p>Title to improvements is held by lessee during the Lease Term or any extension thereof.</p> <p>Improvements remain with the land and are not to be removed</p> <p>Assumption: the improvements revert to the Airport upon the expiration of the Lease Term or any extension thereof, free and clear to the Airport</p> <ul style="list-style-type: none"> • If lessee fails to complete construction, the partial improvements revert to the Airport 	<p>Section VIII.C (page 13) Definition of Leased term does not appear to include Option term.</p>
Cancellation or Termination	<p>The Airport has the right to purchase all of the Lease Improvements if the lease is canceled or terminated before the lease term and not for cause of default</p>	<p>Section VIII.C.4 Purchase price is determined based upon the % of unamortized portion of building useful life times the Appraisal Districts assessment of value for tax purposes.</p>

1. Section II.D, page 4 & 5 in bold print is certain language that states the lease shall immediately terminate with notice of cancellation should tenant fail to commence or complete construction of the improvements during the Construction Period. After given 30 days written notice of cancellation, the lessee's rights under the lease immediately ceases and are forfeited. Also the lessee's improvements, if

- any, shall immediately become the property of lessor at no cost, expense or other compensation paid by lessor to lessee.
- a. The provisions of Section III.D may be inconsistent with Section XIII. This should be reviewed by legal counsel.
 - b. The Airport might reconsider incorporating such absolute terminations. In some instances, the immediate termination of a lease may have unintended consequences that the Airport might find difficult to reverse. The Airport might rather reserve all its rights and remedies available to it by contract and law, including the right to retake possession of its property or, to terminate the lease. Also the Airport might rather reserve the use of other legal remedies to resolve such disputes including making demand for the tenant to remove all their improvements to the property at the tenant's sole cost and expense.
2. The primary lease term is for thirty (30) years. The tenant also has the option to renew for two consecutive 10-year periods. The terms and condition of the renewals are to be "consistent with the then value, rentals and terms of similar property at the Airport."
- a. It is uncertain the terms and conditions are to be of a comparable ground lease property or Airport-owned commercial hangar.
 - b. Section VIII.C clearly states the title to the building improvements are vested with the tenant during the Lease Term or any extension thereof. Section III defines Lease Term to consist of the primary term. It is not clear whether the option periods are to be regarded as an extension of the primary term. If the option years are regarded as an extension of the primary term, then the reversion of the improvements appear to be deferred to the end of the option term. This would then imply that the renewal terms would be in relation to other ground leased properties at the Airport. On the other hand, if the option years are not an extension of the primary term, then the improvements automatically revert at the ends of the primary term. Consequently, the terms of any renewal would be in relation to other Airport-owned commercial properties.
3. The Lease stipulates the rental and terms for the option terms shall be consistent with the then value, rentals, and terms of similar property on the Denton Airport." The agreement does not indicate who determines the properties to be used as the comparables. If this is to be determined at the sole discretion of the Airport, the Airport should be diligent to document the basis for selection. It is possible to use a third-party such as a real estate appraiser or licensed broker to assist in this process; however the lease does not clarify who will bear the cost for such services.
4. In most instances, the Airport should avoid including options or right of first refusals as part of a long-term arrangement. First, it essentially creates an

- exclusive right to negotiate with the Airport once the option has been exercised. Secondly, after so many years circumstances affecting the property, tenant or Airport often change. The Airport may find the option provision to be more of an encumbrance than benefit. The Airport is better served to either grant the additional years as part of the primary term or, not to offer them at all.
5. Once the tenant exercises its option rights, it creates effectively creates an exclusive right to renegotiate, an exclusive right that does not appear to expire until the end of the primary term.
 - a. The Airport probably needs to exercise caution and carefully document all negotiations in the event an agreement between the parties cannot be reached by the deadline in case the tenant alleges the Airport did not negotiate in good faith; and
 - b. The Airport should exercise caution not to hold any negotiations whatsoever with any third party once the option has been exercised, so not to be found interfering with the tenant's contract rights. Guidance on this matter should be sought from Airport's legal counsel.
 6. The agreement does not stipulate how early in the primary lease term the tenant can exercise its option right. As written, it appears the tenant can exercise its option the same day but subsequent to executing the Lease. This may not be the Airport's intent, but by doing so, the tenant has effectively protected its option right and its exclusive position to negotiate with the Airport. Most lenders will require the tenant to exercise its option right earlier rather than later.
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SAMI Management, Inc.

SAMI Management, Inc. (SAMI) is a local, privately held real estate company specializing in the leasing, management and advisory of real estate assets within the aviation industry. SAMI Management, Inc. is currently under contract with the Town of Addison, TX to provide lease administration, property-level accounting, asset management and strategic planning for Addison Airport. The airport's portfolio consists of 90 properties, 300+ leases and over 1.5 million square feet of building space.

Management Team Credentials

Larry B. Kimbler - President

Larry has over 35 years of experience in the real estate industry. He joined The Staubach Company in 1991 and retired as Executive Vice President in 2002. Prior to joining Staubach, Larry was Vice President, Corporate Real Estate for GTE Corp. and President of GTE Realty Corp. from 1981 to 1989; Vice President, Land Utilization with International Paper Company and President from 1974 to 1981. Larry began his career as a certified public accountant with KPMG after earning a Bachelor of Business Administration degree from The University of Cincinnati. He was awarded the Master Professional designation from the International Development Research Council and was twice awarded the Distinguished Service Award for "combining economic developments with sound conservation principles." Currently Larry serves on the investment committees of Staubach Capital Funds I and II; the Board of Trustees of the American Foundation for the Blind (AFB) and as Chairman for the AFB Center on Vision Loss located in Dallas, Texas.

William M. Dyer - Vice President

Since 2002, Bill has been directing all real estate-related activities at Addison Airport including the leasing, marketing and managing of the Airport's real estate portfolio in support of the its aeronautical operations. Additionally, he is responsible for recommending and implementing targeted strategies necessary to align or realign the portfolio with the client's stated objectives and provides daily oversight and management of the property-level accounting and reporting functions for the Airport.

A graduate from the University of Texas at Austin earning a Bachelor of Business Administration in Real Estate, Bill's diverse real estate background spans 30 years with expertise in corporate real estate, portfolio and facility management, distressed asset

resolution, commercial brokerage (acquisitions and dispositions), leasing, development, construction and project management. His accomplishments are as varied as his diverse expertise ranging from directing the critical due diligence and takeover of 37 government and private sector loan and real estate owned (REO) portfolios valued in excess of \$8 billion to providing turnkey real estate management solutions for prominent financial institutions for compliance with impending federal regulations. As the Director of Operations for BEI/Amresco between 1991 and 1997, Bill directed all support operations for the company as it grew to 65 locations nationwide and 1,600 employees including facility management, LAN/WAN administration, vendor and service contract administration, records management, database administration and general administrative support services. As a licensed real estate professional in the State of Texas since 1980, Bill has successfully closed an array of commercial brokerage and lease transactions now valued in excess of \$250 million. He is currently a candidate for the Master of Commercial Real Estate (MCR) designation through Corenet Global, the world's leading professional association for corporate real estate and workplace executives.

John Shuffler, Accounting Manager

John is responsible for managing all accounting and reporting activities in support of the Airport's overall objectives. His primary duties include the control and maintenance of the corporate-level and property-level accounting systems. He is responsible for overseeing the Airport's real estate portfolio tracking and reporting systems. Routine tasks include general ledger entries and allocations, reconciliation of records, ensuring timely deposits of all cash receipts, monthly tenant statements and invoices, monitoring collections, verifying invoices and expense reimbursements, monthly financial statements, oversight and preparation of annual operating budgets and audits, and producing and filing vendor 1099 forms and other tax-related forms as required.

Melissa Newman, Leasing Manager

Melissa is the first point of contact for facilitating rentals and leasing solutions for Airport tenants. This includes showing prospective tenants available hangars, discussing lease terms and airport requirements and minimum standards, preparing lease agreements and renewals, processing lease changes and terminations, and requesting work orders as needed. Routine duties include monitoring key and critical dates, tenants' compliance with lease requirements, portfolio occupancy levels by type and location, and accurately updating and maintaining the Airport's tenant data base, prospect lists and all property and lease files. She assists Airport Management with producing monthly and annual management reports, various presentations and tenant communiqué, and acts as the back-up for the office manager in her absence. Melissa has 15 years of experience in the real estate field and is a licensed real estate professional in the State of Texas.