REAL ESTATE DEVELOPMENT COMPANY FORMATION HANDBOOK

A Guide to Forming and Structuring a Real Estate Development & Sponsor Company

Jason M. Powell

CORPORATE, M&A AND SECURITIES ATTORNEY

Dickinson Wright PLLC

Austin, Texas • Seattle, Washington

Real Estate Development Company Formation Handbook

Table of Contents

PREFACE

What This Handbook Covers v

Who This Book Is For — and Who It Is Not For vi

How to Use This Handbook vii

A Word About What This Book Does Not Do vii

About the Author viii

Legal Disclaimer ix

A Final Word ix

PART I — THRESHOLD QUESTIONS & STRATEGIC FOUNDATIONS

1 **Before You Build: Strategic Alignment & Partner Fit** 11
What the founding partners must agree on before a single document is drafted — and why skipping these conversations is the most expensive mistake a founding team can make.

2 **Defining the Business: What Kind of Company Are You Building?** 26
Choosing between a balance-sheet company, a sponsor platform, and a fund manager — and the regulatory, tax, and governance consequences of each choice.

PART II — ENTITY STRUCTURE & FORMATION ARCHITECTURE

3 **Choosing the Right Entity Structure** 40
The three-layer entity architecture; state-by-state formation considerations; why the GP entity and the management company must be separate.

4 **The Operating Agreement: The Company's Foundational Document** 54
The eleven provisions every development company operating agreement must address; why templates fail; what the founding team must decide before counsel can draft.

5 **Partner Equity Allocation: Dividing the Company** 71
Evidence-based equity allocation using the Contribution Matrix; vesting schedules and cliff provisions; the Section 83(b) election and its absolute 30-day deadline.

PART III — ECONOMICS, COMPENSATION & GOVERNANCE

6 **Profits Interests, Promoted Interests & Carried Interest** 86
How the GP's performance-based compensation is structured, allocated among founding partners, and protected from clawback risk.

7 **Partner Compensation, Distributions & Financial Arrangements** 101
Guaranteed payments, mandatory tax distributions, discretionary distributions, and the compensation framework that prevents phantom income surprises.

8 **Governance Structure & Decision-Making Authority** 115
Manager-managed vs. member-managed; the Decision Authority Matrix; approval thresholds from unilateral Managing Partner authority through unanimous consent.

PART IV — OPERATIONS, FEES & HUMAN CAPITAL

9 **The Annual Business Plan & Budget Process** 129
The six required components of a professionally structured business plan; how the approved plan authorizes the Managing Partner's operational mandate for the year.

10 **The Fee Architecture of a Development & Sponsor Company** 142
Every fee a development company earns — acquisition, development management, asset management, disposition — and the disclosure obligations each fee creates.

11 **Development Profits & the Project Promote Structure** 157
How the promoted interest waterfall works at the deal level; preferred returns, catch-ups, and the mechanics of distributing project profits.

12 **Human Capital: Employees, Compensation & Equity Participation** 169
When to hire vs. contract; how to compensate key employees with profits interests; the governance of an emerging team.

PART V — FIDUCIARY DUTIES, RISK MANAGEMENT & PARTNER PROTECTION

13 **Fiduciary Duties & Conflict-of-Interest Management** 185
The duty of loyalty, the duty of care, the corporate opportunity doctrine, and the related-party transaction approval process.

14 **Restrictive Covenants: Non-Compete, Non-Solicitation & Confidentiality** 199
How to draft enforceable restrictive covenants; the enforceability landscape by state; the specific obligations that survive a founding partner's departure.

15 **Insurance and Liability Management** 213
Every insurance policy a development company must carry — D&O, EPLI, E&O, CGL, Cyber, Builder's Risk, key-person life — and what each one actually covers.

16 **Transfer Restrictions & Partner Exit Mechanics** 226

Lock-up periods, rights of first refusal, drag-along and tag-along rights, and the complete framework for good leaver and bad leaver departures.

PART VI — DISPUTES, SUCCESSION & LONG-TERM PLANNING

17 **Dispute Resolution and Deadlock Mechanisms** 239
The escalation framework from negotiation through arbitration; deadlock resolution mechanisms including the shotgun buy-sell and appraisal-based buyout.

18 **Succession Planning and Dissolution** 251
The three destination visions; transition planning for each founding partner; the wind-down process for a company that has completed its purpose.

PART VII — SECURITIES LAW, INVESTMENT ADVISER COMPLIANCE & TAX

19 **Securities Law Compliance: Raising Capital Legally** 264
The Howey test; Regulation D from Rule 506(b) through 506(c); Form D; blue sky laws; the PPM and the anti-fraud rules that govern every investor communication.

20 **Investment Adviser Obligations & Regulatory Registration** 277
Whether the GP entity is an investment adviser; the ERA exemption and its conditions; the Investment Company Act exclusions; the registration threshold analysis.

21 **Financial Controls, Tax Planning & Reporting Standards** 289
Multi-entity accounting architecture; pass-through taxation; cost segregation; Section 1031 exchanges; K-1 preparation; the mandatory tax distribution.

PART VIII — THE FORMATION ROADMAP

22 **The Formation Roadmap: From First Conversation to Open for Business** 304
The complete phase-by-phase formation process; every document, filing, and decision in sequence; how the advisors, documents, and governance structures fit together.

APPENDICES — OPERATIONAL TOOLS & REFERENCE DOCUMENTS

A **Partners' Term Sheet Template & Completion Guide** 320
The non-binding written record of the founding partners' agreed terms — the primary instruction document for legal counsel in the operating agreement drafting process.

B **Entity Structure Comparison** 336
Side-by-side analysis of every entity type across the three-layer architecture; state-by-state LLC formation comparison; ICA exclusion by entity layer.

C **Contribution Matrix & Equity Allocation Worksheet** 344

The nine-category scoring rubric and synthesis worksheet for evidence-based equity allocation; signed by all founding partners as the documented basis for the equity grant.

D **Decision Authority Matrix** 357
The complete catalogue of management decisions mapped to their required approval level — Managing Partner, majority, supermajority, or unanimous consent.

E **Partner Exit Scenarios Table** 364
Every departure scenario with its leaver classification, economic treatment, buyout pricing, payment timeline, and governance consequences — with worked calculations.

F **Securities Law Compliance Checklist** 372
A staged checklist from pre-offering assessment through ongoing post-closing investor reporting obligations — organized by lifecycle stage with deadlines and risk ratings.

G **Regulatory Compliance Calendar** 380
Month-by-month filing, reporting, and governance obligations across securities, tax, investment adviser, insurance, and employment compliance categories.

H **Formation Documents Checklist** 390
Every document required from Phase 1 partner alignment through the first investor closing — organized by phase with CRITICAL and REQUIRED ratings and absolute deadlines flagged.

I **Insurance Coverage Checklist** 406
Structured coverage cards for every policy a development company must carry — what each policy covers, what it excludes, when to bind, recommended limits, and annual review questions.

Page numbers reflect the complete handbook and may vary by version. All chapter cross-references in the appendices refer to chapters by number.

Preface

Every year, real estate developers who have spent years mastering the craft of building, finding sites, understanding markets, managing contractors, reading plans, and closing deals, sit across a conference table from their first outside investor and realize they have built something that is not yet a company.

They have a track record, a pipeline, and a vision for what they intend to build over the next decade. What they do not always have is the legal, regulatory, tax, and governance infrastructure that turns a capable individual practitioner into a professionally organized real estate investment platform, the kind of platform that institutional investors trust with their capital, that lenders treat as a counterparty rather than a principal, and that can survive the departure of a founding partner without collapsing into litigation.

That gap, the distance between the competence to execute deals and the infrastructure to manage a company that executes deals at scale, is what this handbook exists to close.

> *The aim is not to turn developers into lawyers. It is to turn them into the kind of clients who understand what their lawyers are building and why, so that the documents governing their most important professional relationships reflect their actual intentions rather than a template's defaults.*

WHAT THIS HANDBOOK COVERS

This handbook walks through every dimension of forming and operating a real estate development company, from the earliest partner alignment conversations through the first investor closing and into the ongoing governance, compliance, and operational disciplines that a professional platform requires. It is organized in twenty-two chapters and ten appendices.

	Part / Section	What It Addresses
Chapters 1-2	Foundation: Vision & Strategy	The destination vision for the company; the partner alignment process; and the Partners' Term Sheet as the pre-legal agreement document
Chapters 3-5	Entity Structure & Equity	Three-layer entity architecture; the operating agreement's eleven essential provisions; and equity allocation, vesting, and the Section 83(b) election
Chapters 6-8	Economics & Governance	The promoted interest and carried interest structure; the compensation framework for founding partners; and the decision authority framework
Chapters 9-12	Operations, Fees & Human Capital	The annual business plan and budget process; the fee architecture of a development and sponsor company; the project promote structure; and the human capital framework for employees and key hires
Chapters 13-16	Risk Management	Conflict of interest governance; restrictive covenants; insurance program design; and partner departure mechanics for every scenario

	Part / Section	What It Addresses
Chapters 17-18	Disputes & Succession	Deadlock resolution mechanisms; succession planning; and the destination vision's three pathways
Chapters 19-21	Securities & Tax	Federal securities law from the Howey test through Regulation D; investment adviser registration; and the tax framework for pass-through entities and real estate investors
Chapter 22	Bringing It Together	The complete formation roadmap, and how the documents, advisors, and process fit together
Appendices A-J	Practical Tools	Ten operational documents, including the Partners' Term Sheet template, the Decision Authority Matrix, the partner exit scenarios table, the regulatory compliance calendar, the insurance coverage checklist, and a glossary of key terms

WHO THIS BOOK IS FOR AND WHO IT IS NOT FOR

A book that tries to speak to everyone tends to serve no one well. This one was written for a specific audience, and being honest about that audience, and about who falls outside it, helps every reader decide how to engage with it.

This Book IS For You If…	This Book Is NOT For You If…
■ You are an active real estate developer, or a team of two to four developers, preparing to raise outside investor capital for the first time or to formalize a partnership that has been operating on a handshake	■ You are looking for a substitute for legal counsel. This handbook is an educational resource, not a legal service. No amount of reading it will produce the same result as retaining qualified securities and corporate counsel who know your specific facts, your state's specific law, and the regulatory environment in which your company will operate
■ You have completed at least one development deal and understand how real estate development works at the project level, but you want to understand the legal, regulatory, and governance infrastructure around the business	■ You are a passive real estate investor who wants to understand how to evaluate a development company's offering. This book is written for operators and sponsors, not for investors deciding whether to commit capital
■ You are a founding partner who wants to understand what you are signing before you sign it, rather than assuming the documents are fine because your attorney prepared them	■ You are looking for a how-to guide for managing a development project. This book addresses the company that manages projects, not the projects themselves. There is no guidance here on construction management, permitting, design, or leasing
■ You are an experienced developer who has been operating informally and wants to build a platform that institutional capital, sophisticated lenders, and co-investment partners will take seriously	■ You are an institutional real estate investment manager with a fully staffed compliance department, a registered investment adviser, and an existing fund platform. The material here is foundational. It addresses the formation challenges of emerging and mid-market development companies, not the operational complexities of established institutions
■ You are a real estate attorney, CPA, or other advisor who works with development company clients and wants a structured framework for the conversations you have at client formation engagements	■ You are looking for specific legal advice about your situation. This book provides education
■ You are engaging legal counsel to form your company and want to arrive at that engagement with your business decisions already made, so that your attorney is documenting agreements	

This Book IS For You If…	This Book Is NOT For You If…
rather than facilitating negotiations at billable rates	about how development company formation generally works. It cannot and does not account for the specific facts, circumstances, state laws, or regulatory requirements that apply to your particular company

The developers this handbook was written for are competent at the deal level but have not yet built the company-level infrastructure around that competence. Many have had the uncomfortable experience of realizing, mid-negotiation with a sophisticated investor, that their operating agreement was a template they signed in year one and have not thought about since. Others have watched a partner leave and discovered, only then, that the operating agreement's departure mechanics were either missing or impossible to apply.

They already know they need to build that infrastructure. This handbook is the map for doing it.

HOW TO USE THIS HANDBOOK

This handbook is not designed to be read once, cover to cover, and set aside. It is a working reference, the kind that should sit on the desk or stay bookmarked on the screen throughout the formation process and be returned to whenever a specific issue arises in the company's life.

For a founding team preparing to form a company, the recommended reading sequence is Chapter 1 (the destination vision and partner alignment), then Chapter 22 (the complete formation roadmap), and then the specific chapters relevant to the decisions the team is currently working through. The appendices are operational tools. Complete the Partners' Term Sheet (Appendix A), work through the Contribution Matrix (Appendix C), and bring both to the first meeting with legal counsel rather than asking counsel to facilitate from scratch.

For a company that is already operating but whose governance infrastructure has grown stale, such as the operating agreement that was drafted in year one and never revisited, or the insurance program that was bound at formation and never reviewed against the company's current AUM, the handbook functions as an audit framework. Chapter 22 contains the formation checklist, Appendix H provides the documents checklist, and Appendix G, the regulatory compliance calendar, provides the recurring obligation framework.

For advisors, the attorneys, CPAs, and insurance brokers who work with development company clients, the handbook provides the structured vocabulary and framework for the formation engagement conversations that are most commonly underprepared. A client who arrives at the operating agreement drafting engagement having completed the Partners' Term Sheet (Appendix A) and the Decision Authority Matrix (Appendix D) enables a drafting process that takes days instead of weeks.

A WORD ABOUT WHAT THIS BOOK DOES NOT DO

This handbook covers a substantial amount of legal, regulatory, tax, securities, and governance ground. It does so in enough depth to give a founding team a real working understanding of the framework they are operating in. It does not go deep enough to replace the professional advisors who apply that framework to specific facts.

The securities law chapters explain Regulation D, the Howey test, the accredited investor standard, the Investment Company Act exclusions, and the investment adviser registration framework in terms that any sophisticated businessperson can understand and work with. They do not replace securities counsel who know the current state of SEC interpretive guidance, the specific requirements of the states where your investors are located, and the factual nuances that determine whether your specific offering qualifies for the exemption you intend to rely on.

The tax chapters explain pass-through taxation, cost segregation, bonus depreciation, Section 1031 exchanges, and the passive activity loss rules in terms that allow a developer to understand their tax position and ask informed questions. They do not replace a real estate CPA who knows your specific income profile, your specific deal structures, and the interplay between those facts and the tax provisions that most advantageously apply to them.

The operating agreement chapter explains the eleven provisions every development company agreement must address, the state law defaults that apply if those provisions are absent, and the specific questions every founding team must answer before counsel can draft a provision that actually serves their interests. It does not replace experienced corporate counsel who will draft the document, negotiate its provisions, and ensure that it complies with the law of the applicable state.

> *Understanding what your advisors are building is not the same as building it yourself. This handbook is meant to make you a better client, not to replace the professionals you hire.*

ABOUT THE AUTHOR

Jason Powell is a corporate and securities attorney whose practice is focused exclusively on the formation, structuring, and regulatory compliance needs of real estate investment companies. The practice concentrates on four transaction types that sit at the intersection of real estate and securities law: real estate joint ventures, real estate syndications, real estate funds, and real estate tokenization projects. The clients Jason represents are the operators and sponsors on the left side of the capital stack, the developers, development managers, and real estate investment managers who originate deals, manage the development process, and are responsible for the returns their investors receive. The practice is built around the documents, structures, and regulatory frameworks those clients need to operate professionally: operating agreements, subscription agreements, private placement memoranda, GP entity structures, investment adviser registration analysis, and the securities law compliance programs that a professionally organized real estate investment platform requires. This handbook grew out of the formation engagements the practice handles regularly, and out of a recurring observation: the most expensive problems development company clients face are not the ones that arise from bad deals. They are the ones that arise from governance documents drafted without enough specificity to govern a real situation, from regulatory obligations that were not discovered until an investor complained or a regulator asked, and from partnership structures that reflected what the partners assumed without ever confirming what they had agreed. The handbook is an attempt to address those problems before they occur rather than after they become expensive. Real estate tokenization, the fourth area of the practice, sits at the intersection of the traditional real estate investment company structure with digital asset technology and the evolving regulatory framework around blockchain-based securities. Jason's work in this area is addressed in a separate tokenization practice handbook.

LEGAL DISCLAIMER

IMPORTANT. PLEASE READ BEFORE PROCEEDING

This handbook is an educational resource only. It is not legal advice, tax advice, investment advice, or securities advice. Nothing in this handbook creates an attorney-client relationship between the reader and Jason Powell or Dickinson Wright PLLC. Nothing in this handbook should be relied upon as a substitute for the advice of qualified legal counsel, a licensed CPA, a registered investment adviser, or other applicable professional advisor.

The materials in this handbook are provided for general informational and educational purposes only. They reflect the state of law, regulation, and common practice as understood by the author at the time of writing. Laws change. Regulations are amended. SEC interpretive guidance evolves. Court decisions modify how statutory provisions are applied. The specific facts of any particular company's situation may produce different conclusions than the general principles described here. The author makes no representation that the information in this handbook is current, complete, or applicable to any particular reader's circumstances.

The securities law, investment adviser, Investment Company Act, and tax materials in this handbook are particularly fact-specific in their application. Whether a specific offering qualifies for a particular Regulation D exemption, whether a specific entity qualifies for a specific Investment Company Act exclusion, whether a specific GP entity is an investment adviser and what registration or exemption applies, and whether specific tax elections or strategies are appropriate for a specific taxpayer, are all questions that require the analysis of qualified professionals applying the applicable law to the specific facts. The general framework described in this handbook provides the vocabulary and context for those conversations; it does not answer those specific questions.

Real estate development is a regulated industry. Securities laws apply to capital raises from outside investors. Investment adviser laws apply to those who provide investment advisory services. Tax laws govern the treatment of income, gain, loss, and deduction. Building codes, zoning regulations, environmental laws, and contractor licensing requirements govern the construction activities that development companies undertake. Failure to comply with any of these regulatory frameworks can result in civil liability, regulatory enforcement, and, in serious cases, criminal consequences. This handbook does not and cannot provide compliance assurance for any specific company's operations.

By reading and using this handbook, the reader acknowledges that they have read this disclaimer, understand its scope, and agree that the materials herein are educational only and do not constitute legal, tax, securities, or investment advice of any kind.

A FINAL WORD

Real estate development is a business that creates things. It produces neighborhoods, housing, workplaces, and infrastructure that did not previously exist. The developers who do this work well, who find the sites, understand the markets, manage the process, and deliver what they promised to the people who trusted them with their capital, create real value that extends well beyond the return figures on an investor's K-1.

The infrastructure this handbook describes exists in service of that work. Operating agreements and compliance calendars are not themselves the point. They are the scaffolding that lets the real work, the buildings, the investments, and the partnerships, proceed without collapsing under its own organizational weight.

A company that is properly formed, properly governed, and properly documented does not spend its founders' energy on procedural disputes about what was agreed, regulatory problems that proper compliance would have prevented, or investor relationships damaged by inadequate disclosure. It spends that energy on finding the next deal, building the platform, and delivering the returns that justify the investors' trust.

That is the point, and this handbook is written in service of it.

Jason Powell
Dickinson Wright PLLC

End of Preface

CH. 1

PART I: THRESHOLD QUESTIONS & STRATEGIC FOUNDATIONS

Before You Build:

Strategic Alignment & Partner Fit

What the founding partners must agree on before a single document is drafted, and why skipping these conversations is the most expensive mistake a founding team can make.

Every real estate partnership reaches a moment that most founding teams would rather rush past. In their heads the leases are already signed. In conversation the projects are already underway. The pitch deck is partly written. Wanting to skip straight to building the company is understandable, because this is the point of highest energy and lowest patience for the unglamorous work of figuring out what each partner actually wants and whether the partners agree on the fundamentals.

That impulse has ended more real estate partnerships than any failed deal or market downturn. The companies that fracture two years in, generating expensive litigation, damaged investor relationships, and years of professional fallout, can almost always trace the trouble back to conversations that were skipped at the start. This chapter is about those conversations.

Why These Conversations Are Harder Than They Look

Ask an experienced real estate attorney to name the most common source of partnership failure and you will hear roughly the same answer: not bad deals, not bad markets, and not bad legal documents. The culprit is unresolved assumptions, the things each partner believed were understood and settled but that were never actually discussed. Those assumptions tend to collide under the pressure of a real business decision, when something is genuinely at stake, and the collision is ugly.

The difficulty does not come from technical complexity, because these conversations are not technically complex. They are hard because they ask the founding partners to be honest with one another about matters they would often prefer to leave vague: what each person expects to earn, who holds more leverage, who is carrying more of the work, what happens if things go wrong, and what each partner ultimately wants out of the business. The questions feel divisive at the very moment everyone wants to feel unified.

Timing makes it worse. These conversations happen before the company has earned a dollar, before any deal has closed, and before anyone knows who will actually perform as promised. The partners are dividing the value of something that does not yet exist, based on projected contributions that have not yet been made. Staying vague and sorting it out later is the tempting path. The problem is that later is precisely when the vagueness turns expensive.

This chapter offers a framework for having those conversations productively and in specific terms. It covers five domains where founding partners need real, documented alignment: business vision and strategy; revenue model and financial sustainability; partner contributions and role clarity; cultural values and operating style; and long-term exit ambitions. None of the five is optional, and all of them belong before legal counsel is engaged and before any formation document is signed.

How to Use This Chapter

This chapter is a discussion guide, not a legal document. It maps the conversations that should happen before any legal documents are prepared. The founding team should work through each section, ideally in a structured session away from the office with enough time to reach an actual resolution rather than a polite deferral, and record their answers in a Partners' Term Sheet before any attorney is engaged. The Partners' Term Sheet template appears in Appendix A.

A completed Term Sheet is the single most valuable thing a founding team can bring to its first meeting with counsel. It lowers legal fees by giving the attorney a clear brief instead of forcing the attorney to discover the partners' intentions through rounds of questions and revisions. More than that, it pushes each conversation toward a real conclusion. If the partners cannot finish the Term Sheet without substantial unresolved disagreement on fundamentals, that tells them something important about the foundation they are building on.

Domain One: Business Vision, Strategy & Investment Focus

The founding partners need to be able to state a shared investment thesis, a specific and defensible view of where they can create value in real estate and why their particular team is positioned to do it. Shared enthusiasm for development is only a starting point. The conversation has to become far more concrete before anyone commits to building a company together.

What Type of Development Company Are You Building?

Real estate development is not one business. It spans ground-up construction and adaptive reuse, horizontal land development and vertical building, residential and commercial product, partnerships between public and private parties and entirely private ventures. The founding partners need to establish with real precision what kind of company they are building. Settling this early does not limit future flexibility; it gives every operational, financial, and legal decision that follows a foundation to rest on.

The questions the founding team must answer:

- **What asset class or classes will the company focus on?** Multifamily residential, single-family for-sale, commercial office, industrial and logistics, retail, hospitality, mixed-use, life sciences, or something else. The answer drives what personnel the company needs, which market relationships it must cultivate, which capital sources fit, and which regulatory environment it will operate in.
- **What is the development strategy?** Ground-up construction from raw land through entitlement, permitting, and construction; repositioning and renovation of existing assets; or acquisition of stabilized properties that already produce income. These are distinct businesses with distinct risk profiles, timelines, and skill requirements.
- **Where will the company operate?** A single metropolitan market, a regional footprint, or a national platform. Geographic scope is a competitive question as much as a preference. A team with real broker, contractor, and municipal relationships in a specific market is a different animal from a team claiming a national mandate it cannot yet support with local knowledge.

- **What is the intended deal size,** and is that size realistic given the team's current capitalization, capital raising capacity, and operational bandwidth? A founding team with $3 million in committed capital should not premise its first two years on $50 million projects.
- **What is the entitlement strategy?** Will the company take raw land through entitlement itself, accepting high risk, high reward, and a long timeline, or will it work mainly with already entitled or shovel-ready sites, accepting lower risk and a faster timeline in exchange for more competition?

The Competitive Moat Question

Every founding team believes its company will succeed. What sophisticated investors, lenders, and partners actually want to understand is not whether the team is talented but what makes it better positioned than everyone else chasing the same sites, the same capital, and the same markets.

The answer, which some call the competitive moat, should be concrete. It is not that the team works harder than other developers or has great relationships. Those are table stakes. A real moat in development tends to look like one of the following:

- Proprietary deal flow from a source competitors cannot easily copy, such as a municipal relationship that produces off-market sites, a homebuilder relationship that delivers land positions ahead of the market, or a longstanding tie to a specific type of property owner
- Sector expertise in a product type where the team has a documented track record and operational knowledge that generic developers lack, such as affordable housing tax credits, historic preservation credit deals, or modular construction
- Cost advantages from construction relationships, labor arrangements, or technology-enabled project management that let the team build more efficiently than its peers
- Capital access that most developers at the company's scale cannot match, such as a committed equity partner or family office that supplies preferred equity or shared general partner capital on favorable terms

The founding partners should be able to state their competitive advantage in two or three sentences before they form the company. If they cannot, that is not a reason to delay formation. It is a reason to have a more honest conversation about what the company is really competing on and whether that edge will hold.

Geographic Focus and the Danger of Premature Expansion

Few things predict early stage failure as reliably as premature geographic expansion. A founding team with real expertise in Dallas, meaning established contractor relationships, municipal contacts, submarket knowledge, and credibility with local capital, decides to pursue Austin, Phoenix, and Nashville at the same time because those markets are growing. The result is diluted attention, unfamiliar competitive dynamics, relationships that do not travel, and execution risk the team cannot manage.

Geographic focus in the early years is a discipline the partners impose on themselves. They should commit to a single primary market, with expansion to follow demonstrated success rather than optimism. The triggers for expansion ought to be defined in advance: a set number of completed projects in the primary market, a specific revenue or assets under management threshold, and the addition of local personnel in any target market before capital is committed there.

The partners should discuss:

- What is the primary launch market, and what is the team's specific advantage in it?
- What counts as success in the primary market before expansion begins, measured in projects completed, dollar volume delivered, or returns achieved?

- What triggers the first expansion, and does that trigger require local relationships and possibly local personnel before any capital is committed?
- How will the company manage the operational complexity of running in more than one market once expansion starts?

Domain Two: Revenue Model and Financial Sustainability

A development company that loses money serves no one, not its partners, not its investors, not the projects it hopes to build. Yet the revenue model is more layered than most founding partners appreciate at formation, and almost everyone underestimates the gap between the day the company opens and the day it earns meaningful revenue.

The Three Revenue Streams of a Development Company

A development and sponsor company typically earns revenue from three sources. Understanding all three, and how each matures over time, is essential to a realistic financial plan.

- **Fee income from services rendered.** Development management fees, commonly 3 to 5 percent of total project costs, plus construction oversight fees, asset management fees on stabilized holdings, property management fees on owned or managed properties, and acquisition fees on closed transactions. Fee income is the most predictable stream, and also the one that requires the most deal volume to keep the company running.
- **Development profits from equity ownership.** When the company holds an ownership stake in a project, whether as sole owner, as an investor alongside joint venture partners, or as the holder of a promoted interest beside outside investors, it shares in the profit once the project is built, stabilized, and sold or refinanced. For most companies this becomes the largest stream over time, and also the most delayed. A ground-up project can take three to seven years from land acquisition through construction, stabilization, and disposition.
- **Promoted interest from managing outside capital.** When the company manages equity from outside investors, whether high-net-worth individuals, family offices, or institutions, it generally earns a promoted interest, also called carried interest, above a preferred return. This stream depends on performance and is realized at disposition, so it can be sizable but only arrives when investments perform and are sold.

The partners must be clear about which streams the company will pursue and in what order. A pure fee-for-service business carries different capital needs, governance implications, and risk than a business that takes meaningful equity in its own projects. A business that raises outside capital takes on securities law obligations that a balance sheet developer does not.

The Revenue Timeline Problem

Nearly every development company underestimates how long it takes to reach positive operating cash flow on fee income alone. The sequence is simple and slow:

- **Months 1 to 6.** The company is formed, partners are installed, the office is set up, the website goes live, and deal pursuit begins. Revenue is zero while operating expenses, including legal and accounting fees, technology, insurance, and any salaries, accumulate.
- **Months 6 to 18.** The first project enters due diligence or goes under contract. Transaction legal fees, earnest money, and pursuit costs accelerate. Development management fees are not earned until construction starts, so revenue stays minimal or zero.

- **Months 18 to 36.** The first project closes, construction begins, and development management fees start to accrue. Because the fee is typically paid in installments tied to construction milestones, the cash flow spreads across the build.
- **Years 3 to 7.** Development profits from the first project begin to materialize, but only once the project has been completed, stabilized, and sold or refinanced. These are the profits that make a development company a real source of wealth for its founders, and they arrive late.

This timeline opens a funding gap of anywhere from 12 to 36 months, during which operating expenses may run well above fee income. The founding partners need a plan for that gap before they form the company.

Funding the Gap: The Operating Budget Conversation

Before any entity is formed, the partners should build an operating budget for the management company that covers a full 24 months. It should reflect the company's real anticipated expenses, not optimistic projections that assume immediate deal flow, and it should name the funding source for each item:

- **Legal and accounting:** formation fees, ongoing compliance, deal-level legal fees, annual tax preparation, and annual accounting or audit if required
- **Insurance:** general liability, professional liability (errors and omissions), management liability, workers' compensation, and cyber liability
- **Technology:** an investor portal if applicable, project management software, financial modeling tools, a CRM, and cybersecurity
- **Personnel:** whether partners will draw a salary or guaranteed payment, any early hires and their compensation, and payroll taxes and benefits
- **Occupancy:** office rent, even for a shared workspace, plus utilities and equipment
- **Marketing and business development:** deal pursuit costs, travel, due diligence expenses on transactions that do not close, and investor relations materials

With the budget in hand, the partners must decide how those costs will be covered through the ramp-up. The usual sources are initial partner capital contributions, in which each partner puts in an agreed amount at formation to fund operations; the pursuit of fee-generating work as early as possible; and in some cases a working capital line of credit. What does not hold up is the assumption that deals will close fast enough to cover operating costs before the partners' personal resources run out.

Partner Compensation During the Ramp-Up Period

Compensation during the early years is one of the most tension generating parts of the founding conversation, because it sits where financial reality meets personal obligation. Some partners have the resources and risk tolerance to work for 12 to 24 months without meaningful pay while the company earns its first fees. Others carry mortgages, families, and prior commitments that require income from day one.

There is no single correct answer. A team where every partner has substantial reserves and is equally willing to defer pay has options that a team with one partner who needs income simply does not. What matters is that the answer is explicit, honest, and written down before anyone signs an operating agreement that creates compensation obligations. Common approaches worth weighing:

- No guaranteed payments for the first 12 to 24 months, with partners covering personal obligations from reserves and a date set in advance for revisiting the question as fees materialize. This fits when all partners have real financial runway and the company is conserving capital.

- Below market guaranteed payments from day one, funded by initial capital contributions, with a defined path to raise compensation as revenue allows. This gives everyone a shared stake in the ramp-up without imposing full market salaries before the company has earned them.
- Market rate compensation for the partner or partners who will be full-time from day one, funded by initial contributions, with a clear understanding of how long that capital lasts and what happens when it is gone. This approach needs careful modeling to confirm the initial capital is sufficient.
- Deferred compensation, where partners accrue a salary the company pays once it has the cash flow, with or without interest on the deferred amounts. This requires careful documentation to avoid creating unintended tax consequences.

Whatever the arrangement, it belongs in the operating agreement. An operating agreement that says nothing about partner compensation during the startup phase is an operating agreement waiting for a dispute.

Domain Three: Partner Contributions and Role Clarity

Development companies rise or fall on the quality and fit of the people who run them. The founding partners should assess their collective capabilities with the same rigor they would bring to underwriting a project, naming strengths, admitting gaps, and being candid about who is actually going to do what.

The Contribution Inventory

Before the equity conversation starts, the partners should run a structured assessment of what each one truly brings. The aim is to replace vague impressions, the I bring a ton to this sort of claim, with documented and mutually understood facts about each partner's contribution profile. The exercise is not meant to diminish anyone. It builds the shared factual basis for the conversations about equity, compensation, and role that would otherwise run on each partner's private sense of their own importance.

The contribution categories that matter in a development company:

- **Capital.** How much cash is each partner prepared to invest at formation? How much can each co-invest alongside the company on individual projects? Does any partner provide credit or guaranty capacity the others cannot replicate?
- **Track record.** What has each partner actually built, managed, and delivered, in which asset classes, in which markets, over what periods, with what outcomes? A track record that can be documented, with project names, dates, costs, and returns, is worth far more than one that lives mainly in the partner's description of it.
- **Deal flow.** Who holds the relationships that generate opportunities, with landowners, brokers, municipalities, and owners of developable sites? And what evidence is there that those relationships will actually produce deals in the next 12 to 24 months?
- **Capital relationships.** Who has active relationships with equity sources, including joint venture partners, family offices, and private investors? There is a real difference between knowing people who have money and having invested capital for five investors who are ready to commit to the next project.
- **Construction and project management.** Who has the operational experience to run a build, from contractor selection through draw management, scheduling, and quality control? Ground up work without someone who can actually run construction is a high-risk proposition.

- **Entitlement and municipal relationships.** Who has navigated entitlement in the target market, and who has standing with planning departments, councils, community groups, and other stakeholders whose support a project needs?
- **Platform development.** Has any partner already done substantial pre-formation work, building underwriting models, cultivating investors, identifying sites, lining up contractors, in ways the others have not yet matched?
- **Professional and technical skills.** Does any partner bring legal, accounting, engineering, architectural, or financial modeling expertise the company would otherwise outsource, and what is the market value of those skills applied to its operations?

The Role Definition Imperative

Equity allocation and role definition are related but separate questions. A partner can hold 40 percent of the equity and carry 80 percent of the daily operational load. Another can hold 60 percent and spend most of their time on capital relationships and strategy. Neither arrangement is inherently wrong, but both need to be written down to stay fair and durable.

The partners should define, in writing, the primary operational responsibility of each one. These definitions need not be rigid job descriptions, since the best development partnerships keep real flexibility about who handles what as projects and markets shift, but they should be specific enough to create mutual accountability. At a minimum:

- **Deal origination and site control.** Who identifies sites, builds landowner relationships, executes letters of intent, and runs the acquisition process?
- **Project development and entitlement.** Who manages entitlement, coordinates the design team, navigates municipal approvals, and oversees pre-development through permit issuance?
- **Construction management.** Who manages the general contractor relationship, monitors progress, approves pay applications, manages the development budget, and handles schedule and cost issues during construction?
- **Capital and financing.** Who runs the debt financing process, coordinates with lenders, manages equity partner relationships, and owns project financial reporting?
- **Asset management and disposition.** Who manages stabilized assets, oversees property management whether internal or third-party, and runs the sale or refinancing at the end of the hold?
- **Finance and administration.** Who manages the company's own finances, keeps its books, handles payroll and compliance, and owns investor reporting and regulatory filings?

Time Commitment: The Fault Line That Hides in Plain Sight

Of every contribution a partner can make, time is the most immediately felt and the most often misrepresented, usually not through dishonesty but through optimism about how fast prior obligations can be wound down and uncertainty about how demanding the new venture will be from the start.

Asymmetry in time commitment is one of the most common causes of partnership breakdown. The pattern is familiar. One partner is full-time from inception, working long hours on deal pursuit, lender relationships, contractor negotiations, and the thousand operational details that keep a development company running. Another is in transition, winding down a prior employer, finishing projects at a former company, or carrying a board seat or advisory role. The full-time partner starts to bear a disproportionate load, and the resentment that follows is real and compounds. The partners should address the following directly and document the answers:

- Is each partner committing full-time from formation, or is there a transition period? If there is, what is its maximum length, and what does the commitment look like during it in measurable terms?
- Does any partner have ongoing obligations, such as employment agreements, board seats, fund management duties, or personal business interests, that will compete for their time? What is the plan and timeline for winding them down?
- Are there non-compete provisions in any existing employment or advisory relationship that must be cleared before the company can pursue its intended strategy?
- What happens if a partner's time commitment falls materially below the agreed level? Does the operating agreement provide a way to raise and address it, whether a formal remediation process, an adjustment to economic rights, or a buyout triggered by sustained failure to meet the commitment?
- Are there circumstances where a partner's part-time involvement is expected and economically accommodated? If a partner's primary contribution is capital and strategic relationships rather than daily operations, is that reflected in their economic rights, guaranteed payment, and equity?

The Conflicts Disclosure

Before the operating agreement is signed, each partner should disclose in writing every existing business activity, investment, employment relationship, fiduciary duty, and contractual restriction that could create a conflict or limit available time. This is standard professional practice, and it protects all partners equally rather than singling anyone out. The disclosure should include:

- **Existing real estate investments and ownership interests.** Which properties, funds, or projects does each partner own or manage, and how do those positions interact with the new company's strategy? Does any existing position compete for the same opportunities?
- **Noncompete and non-solicitation agreements.** Is any partner subject to a restriction from a prior employer, fund, or relationship that limits what they can do here? Counsel must evaluate this before the company pursues anything that might fall within the restricted scope.
- **Investor relationship conflicts.** Does any partner currently manage or advise capital from investors who would also suit the new company's projects, and how will those relationships be handled to avoid even the appearance of a conflict?
- **Board memberships and advisory roles.** Does any partner sit on a board or advise another company in a way that creates duties potentially in tension with this one?

Domain Four: Risk Tolerance, Operating Style & Cultural Alignment

Development is a business of constant judgment under real uncertainty. The partners will face calls about when to push a project and when to kill it, how much leverage to carry, whether to self-fund a hard entitlement or bring in an equity partner to share the risk, and how to respond when a project hits trouble, as every project eventually does. How they make those calls together, and whether they can actually agree when it counts, depends on alignment about risk tolerance, operating style, and values that often go unexamined until a crisis forces the question.

Risk Tolerance

Collective risk tolerance shapes every major investment decision the company makes. A partner comfortable with construction financing at 75 percent of cost and lease-up periods of 18 months is running a different business than one who insists on 50 percent equity cushions and pre-sold or pre-leased projects. These are not small differences of preference. They are differences in business

model that will produce conflict when specific deals come up for decision. The conversation should be explicit:

- What is the construction debt philosophy? Which loan-to-cost ratios are acceptable, which lender structures are preferred, and what is the policy on recourse guarantees? Will all partners provide personal guarantees, and is there a cap on each partner's exposure?
- What is the entitlement risk tolerance? Will the company take land under control before entitlements are secured, after zoning is in place, or only once a building permit is in hand? Each position carries a different risk profile and different economics.
- What are the pre-leasing or pre-sale requirements before breaking ground, and what happens if those thresholds are not met? Does the company proceed on full speculative risk or wait for committed tenants or buyers?
- How will the company handle a project that has gone sideways, with cost overruns, entitlement delays, or a softening market during construction? Is the culture one of doubling down on conviction or cutting losses early?

Decision-Making Style

How the partners decide together, not in the formal governance sense of who holds voting authority over what, which Chapter 8 addresses, but in the everyday sense of how the company moves, is a cultural reality that has to match the governance the operating agreement creates.

Some companies run on a designated lead partner whose judgment the others generally defer to on deal decisions, with broader input reserved for major strategic choices. Others run on consensus, where every material decision is discussed and agreed before action. Both models work. What fails is the mismatch, a consensus minded partnership that has handed one partner unilateral authority on paper, or a lead partner model where the others keep relitigating closed decisions. The partners should talk honestly about:

- Is there a lead or managing partner with primary authority over deal decisions? If so, what are the explicit limits of that authority, and how are they enforced without creating paralysis?
- How fast does the company need to decide to stay competitive in its market? Some opportunities demand an answer in days. If every decision needs full consensus, what is the mechanism for reaching it quickly when speed matters?
- How does the company handle a genuine disagreement about a deal or a strategic direction? Who breaks the tie, and under what circumstances does a deadlock provision come into play?
- What level of transparency is expected about the pipeline, investor relationships, and operational issues? Do all partners have equal access to information, or are some more operationally connected than others?

The Ethics of Investor and Partner Management

A development company holds a real position of trust. Investors have committed capital on the strength of the company's representations, contractors and subcontractors have extended credit on its reliability, and employees have staked their careers on its soundness. The partners should have a frank conversation about the ethical standards they will apply to all of these relationships. Worth discussing before formation:

- How will the company communicate with investors when a project underperforms? Will it disclose problems promptly, as soon as they are material, or wait until the situation resolves or the outcome looks more certain?
- How will it treat contractors and subcontractors when cash is tight? Will timely payment be a non-negotiable obligation, or will payables be stretched as a cash management tool?

- What is the standard for disclosure in investor materials and project presentations? Will risks appear as prominently as opportunities, or will the upside be emphasized and the downside minimized?
- How will a related-party transaction be handled, for example when a construction firm a partner has an interest in wants to bid on a company project? Will independent competitive bidding be required regardless?

These questions can feel abstract before the first deal. They are not. The standards a company sets in its first year, through actual decisions rather than stated values, become its culture, and culture is very hard to change once it sets.

Domain Five: Long-Term Vision and Exit Ambitions

The conversation founding teams skip most often is the one about what they ultimately want to do with the business they are building. It feels premature, since there is no business yet, but the answer drives core decisions about governance, vesting, transfer restrictions, and the whole economic architecture of the operating agreement. Partners with different answers are building different companies, whether they know it or not.

The Three Destination Models

In practice, development companies tend toward one of three long-term destinations, and each carries different implications for how the company should be structured from day one.

- **The permanent institution.** The team intends to build a company that outlives its founders, with a strong brand, a repeatable investment process, and a culture able to survive leadership transitions. It may grow to dozens of employees, run several projects at once, and raise from institutions. This vision implies longer vesting, more formal governance, a succession framework, and equity structures that can admit new partners over time.
- **The professionally managed exit.** The team intends to build to a scale where the company becomes an attractive acquisition target for a larger operator, a private equity sponsor, or a financial institution, perhaps over 5 to 10 years. The economic design, including fee structure, growth in assets under management, and investor relationships, should be oriented toward enterprise value an acquirer will pay for. This implies faster scaling, clean governance an acquirer can step into, and transfer provisions that allow an exit when a qualified buyer appears.
- **The boutique platform.** The team has no intention of building a large organization. It wants to develop high-quality projects, keep close investor relationships, and earn strong returns without the complexity of scale. This is a legitimate and viable vision, and it implies a different capital structure, hiring strategy, and governance framework than either of the others.

The partners should be candid about which model, or which variation, reflects their shared ambition. A team where one partner is building toward a $500 million institutional platform while another is content to run six to eight projects a year as a tight boutique is not aligned on the most basic question of what they are building. That gap will surface in every capital allocation decision, every hiring discussion, and every conversation about whether to chase an opportunity that requires growth.

The Timeline Question

The destination question cannot be separated from the timeline question. How long do the partners intend to work together in this specific venture? Are all of them assuming a ten-year commitment, or are some viewing it as a three-to-five-year project before a sale or restructuring?

This is not about loyalty. It is about structuring governance and economics to match reality. A partner who plans to stay five years should have a vesting schedule that reflects five years, not a ten-year schedule that creates perverse incentives. A partner who anticipates an earlier exit should have clear, documented rights about what their interest is worth on departure and how it can be transferred. The partners should discuss:

- Does each partner have a real long-term commitment to this venture, or is one of them treating it as a bridge to something else?
- What is the minimum operating period before a partner can exit voluntarily with full economic rights?
- If the partners' circumstances or ambitions diverge over time, with one wanting to keep building while another wants to sell, what governance mechanism lets the company evolve without requiring unanimous consent for every strategic shift?

What Can Go Wrong: Three Partnership Failure Patterns

The scenarios below are drawn from recurring patterns in real estate development partnerships. They are not exotic cautionary tales. They are the most common failure modes, the ones experienced attorneys see regularly, the ones the legal system is asked to untangle, and the ones that leave lasting damage to businesses, careers, and investor relationships. Each could have been prevented by the conversations this chapter describes.

The Exit Horizon Conflict

Two experienced developers form a company. Partner A, who brings the capital relationships and institutional connections, has always seen this as a platform to build over 15 to 20 years, the kind of company that could eventually raise institutional fund capital and build a lasting brand. Partner B, whose development expertise and deal flow form the operational core, sees it as a vehicle to build a strong track record and then sell to a larger platform within five to seven years, take liquidity, and move on to the next challenge.

Neither partner ever asked the other about the long-term plan. Each assumed the other shared their vision. They collaborated well on projects, hiring, and strategy, and the company performed. Then, in year six, an inbound acquisition inquiry from a regional private equity firm landed in Partner B's inbox.

The next 18 months were consumed by a dispute that generated hundreds of thousands of dollars in legal fees, damaged several investor relationships once the uncertainty became known in the market, and ultimately required a partial buyout of Partner B's interest on terms neither partner considered fair. The company survived, but the internal conflict set it back years.

The prevention is an explicit, documented discussion of the long-term exit vision at formation, with operating agreement provisions that address what happens when visions diverge, including a right of first refusal process for acquisition inquiries, a defined threshold for approving a company sale, and a buyout mechanism for a partner who wants out when the others do not.

The Time Commitment Drift

Three partners form a development company. Partner A is the operating partner, handling deal sourcing, project management, lender relationships, and construction oversight. Partners B and C are the capital and investor partners, each owning one third of the company. At formation, both B and C represented that they would move to full-time involvement within six months as their prior obligations wound down.

Eighteen months in, Partner A is running the company full-time, managing two active construction projects, pursuing three more deals at various stages, and handling investor relationships. Partners B and C are still part-time, each available a few hours a week, nominally engaged on investor relationships but closing no capital commitments. Each still holds one third of the equity and receives one third of every distribution.

Partner A raises the issue. B and C each offer a reasonable explanation for the delay. The operating agreement says nothing about a minimum time commitment or the consequences of falling short. The dispute takes years to resolve and costs the company its early lead in a market where competitors, who had no internal governance problems, moved quickly.

The prevention is explicit time commitment representations in the operating agreement, a defined and documented process for raising and addressing shortfalls, and either an economic adjustment mechanism, such as reduced guaranteed payments for below-threshold contribution, or a buyout trigger for sustained material non-performance.

The Undisclosed Non-Compete

A founding partner joins a new development company without disclosing a 24-month non-compete and non-solicitation agreement from a prior employer, a restriction that specifically bars soliciting any client, investor, or employee of that employer for two years after departure. The new company's capital raising strategy rests substantially on that partner's prior investor relationships, many of whom overlap with the former employer's client base.

The former employer discovers the overlap within six months of the new company's first capital raise and sues both the individual and the company for tortious interference and breach of contract. The litigation is expensive, disruptive, and public. Two investors who had committed capital withdraw pending resolution. The company's first project, which depended on that capital, is delayed by more than a year.

The prevention is mandatory written disclosure at formation of all existing contractual restrictions, reviewed by the company's counsel before the operating agreement is executed and before any investor outreach begins.

Documenting Alignment: The Partners' Term Sheet

Once the conversations in this chapter are complete, the founding team should not run straight to engaging counsel. The next step is to capture what was agreed in a written Partners' Term Sheet.

The Term Sheet does not bind anyone, and it does not replace the operating agreement counsel will draft. It records the positions the partners have settled, captured before lawyers are involved, in language that reflects the partners' actual understanding rather than legal drafting conventions. It does several things at once:

- It confirms that each conversation actually reached a conclusion. Partners willing to discuss a topic but unwilling to write down what they agreed often reveal, intentionally or not, that the underlying agreement is shakier than it looks. If a position cannot be stated in a sentence or two, it has probably not been fully agreed.
- It gives counsel a precise brief. Drafting the operating agreement goes faster, cheaper, and more accurately from a completed Term Sheet than from a process where counsel has to discover the partners' intentions through rounds of questions and revisions. Every dollar spent in the Term Sheet conversation saves several in legal fees.
- It creates a reference document. If a dispute later arises about what was agreed at formation, and in complex partnerships such disputes are common, the Term Sheet is

contemporaneous evidence of what the parties agreed before any legal language entered the picture.

- It surfaces unresolved disagreements while they are still cheap to resolve. A disagreement caught during the Term Sheet conversation costs only time and candor. The same disagreement caught during operating agreement drafting, with fees accruing and relationships more formalized, costs far more. Caught after formation, after investor capital is committed and employees are hired, it can cost the company its existence.

The Partner Alignment Checklist

Before engaging counsel and beginning entity formation, the founding partners should be able to answer each of the following with a specific, agreed, and documented response. Any question that remains genuinely unresolved after the Chapter 1 conversations should be resolved before formation proceeds.

- What asset class or classes, what development strategy, and what geographic market will the company focus on at launch?
- What is the company's specific competitive advantage, and can each partner state it concisely and consistently?
- What are the three primary revenue streams the company will pursue, and in what sequence?
- What is the operating budget covering the first 24 months, and how will the gap between formation and meaningful fee revenue be funded?
- What are each partner's compensation arrangements during the ramp-up period?
- What are each partner's specific contributions, across capital, track record, deal flow, investor relationships, and operating expertise, documented closely enough to support the equity allocation?
- What are each partner's primary operational responsibilities, and are they consistent with the anticipated equity allocation?
- Is each partner committing full-time from formation? If not, what is the precise arrangement for the transition period?
- Has each partner disclosed all existing business activities, contractual restrictions, and potential conflicts of interest?
- What are the partners' positions on construction debt, entitlement risk, and leverage, and are those positions consistent with one another?
- What is the long-term destination model, whether permanent institution, professionally managed exit, or boutique platform, and is that vision shared?
- Has a completed Partners' Term Sheet been prepared and reviewed by all founding partners?

Engaging Legal Counsel: What to Bring and What to Expect

With the Chapter 1 conversations complete and the Partners' Term Sheet drafted, the founding team is ready to engage counsel. This marks the transition from the strategic alignment phase to the documentation phase, not the start of formation. The partners have done the work; the attorney's job is to translate the agreed positions into enforceable agreements and to flag any legal issues the partners did not address in their strategic conversations.

Selecting the Right Counsel

Forming a development company calls for a specific combination of disciplines that not every firm or attorney commands equally: real estate corporate law and LLC governance; securities law if the company will raise outside capital; tax law as it applies to entities taxed as partnerships, profits interests, and real estate investment structures; and employment law for the company's personnel arrangements. The team should engage counsel with real depth in each relevant area, whether a single firm that covers all of them or, in some cases, separate specialists for entity formation and securities matters. The marks of counsel well-matched to this work:

- **Experience forming real estate operating companies,** not just generic LLCs. The governance a development company needs, including the decision authority matrix, the provisions around project approvals, and the fee approval mechanisms for related-party transactions, requires an attorney who understands how these companies actually function.
- **Securities law expertise,** even if the company has no immediate plan to raise outside capital. The line between a private development that does not implicate securities law and one that does is not always obvious, and crossing it without guidance carries severe consequences.
- **Tax counsel coordination.** The operating agreement's economic provisions, including the allocation of profits and losses, the treatment of guaranteed payments, and the structure of profits interests, carry direct tax consequences and require the attorney to work with the company's CPA. An attorney who drafts economic provisions without involving tax counsel is creating tax problems the CPA will later have to fix.

What to Bring to the First Legal Engagement

The founding team should arrive at the first engagement with:

- The completed Partners' Term Sheet, covering the agreed positions on all material economic and governance terms
- An entity structure diagram showing the proposed ownership hierarchy from the founding partners through the operating company and any affiliated entities
- The operating budget covering the management company's first 24 months
- Copies of any existing contractual restrictions, including non-competes, confidentiality agreements, and prior employment agreements, that may affect the company's activities or any partner's ability to participate fully
- A brief description of the first intended deal or project, if one has been identified, so counsel can assess whether any transaction specific issue belongs in the formation documents

The Cost of Formation Done Right Versus Done Wrong

A comprehensive operating agreement for a development company, drafted by experienced counsel from a detailed Partners' Term Sheet, typically costs between $15,000 and $40,000 in legal fees. The additional formation work, including articles of organization, equity grant agreements, intellectual property assignments, and confidentiality agreements, usually adds another $5,000 to $15,000. For a company that may manage hundreds of millions of dollars in projects over its life, these are not large numbers.

The cost of litigating a partnership dispute that a properly drafted operating agreement would have prevented runs an order of magnitude higher. Arbitration of a significant partnership dispute routinely costs $250,000 to $750,000 in legal fees per side, and often far more when the dispute involves allegations of fraud, breach of fiduciary duty, or

misappropriation of business opportunities. The management distraction, the damage to investor relationships, and the reputational cost cannot be tallied. Done right, formation is an investment with among the highest expected returns of any expenditure the company will make. Treat it accordingly.

CHAPTER 1: KEY TAKEAWAYS

1. The most expensive legal problems in development partnerships grow out of misalignments that should have surfaced before formation. Skipping the Chapter 1 conversations is the single most common and most costly mistake founding teams make.
2. Five domains require real, documented alignment before counsel is engaged: business vision and investment strategy; revenue model and financial sustainability; partner contributions and role clarity; risk tolerance, operating style, and cultural alignment; and long-term exit ambitions.
3. The revenue timeline problem is almost always underestimated. Development companies typically take 18 to 36 months to earn meaningful fee income, and the development profits that make the business a real source of wealth for founders may take three to seven years to arrive. The 24-month operating budget and the funding plan for the ramp-up gap must be completed before formation.
4. Asymmetry in time commitment is among the most common causes of partnership breakdown. Explicit time commitment representations, documented in the operating agreement with consequences for falling short, are essential.
5. The three most common failure patterns, the exit horizon conflict, the time commitment drift, and the undisclosed non-compete, are entirely preventable through the conversations and documentation this chapter describes.
6. The Partners' Term Sheet is the most valuable document the founding team can produce before counsel is engaged. It confirms real agreement, gives counsel a precise brief, surfaces unresolved disagreements while they are still cheap to resolve, and creates a contemporaneous record of the parties' original intent.
7. Done right, formation is an investment. Done wrong, it becomes an expense that compounds for years, in legal fees, management distraction, investor damage, and reputational cost.

WHAT COMES NEXT

Chapter 2 takes up the second foundational question: what kind of company, specifically, are you building? Before any entity is selected or formed, the founding team needs to define the company's business model, revenue architecture, and organizational design with enough precision to make the structural decisions of Part II, namely entity type, state of formation, and entity hierarchy, clearly and correctly. Chapter 2 bridges the strategic alignment work of Chapter 1 and the formation architecture decisions of Chapters 3 and 4.

See also: *Appendix A (Partners' Term Sheet Template) • Appendix C (Contribution Matrix & Equity Allocation Worksheet) • Appendix J (Glossary)*

CH. 2

PART I: THRESHOLD QUESTIONS & STRATEGIC FOUNDATIONS

Defining the Business:

What Kind of Company Are You Building?

The structural decision that shapes every choice that follows: how to define the company's business model, revenue architecture, and competitive identity before any entity is formed.

Ask a founding team what kind of company they are forming and the answer is almost always the same: a real estate development company. That is true in the way that calling a place a restaurant is true, whether the place is a corner sandwich shop or a fine dining room. The label names the category and tells you nothing about the specific business, its model, its economics, its organizational needs, or what it has to get right to survive.

This chapter closes that gap. Before any entity is formed, before any operating agreement is drafted, and before any attorney is engaged on formation work, the founding partners need to define the specific business they are building in enough detail to drive the structural, financial, and legal decisions that follow. A company that develops on its own balance sheet runs on a different model than one that raises equity from outside investors. A company that earns fees for managing other people's projects is a different business than one that takes promoted interests in the deals it sponsors. Getting the model right, and agreeing on it, before formation begins is the work of this chapter.

The Three Business Models of a Real Estate Development Company

Real estate development companies are not all the same business. They share one activity, developing real property, but they earn revenue through different mechanisms, carry different levels of risk, require different capital structures, and attract different partners and investors. Before making any structural decision, the founding team needs to assess honestly which of three business models they are actually building, because that choice drives nearly everything that follows.

The Three Models

The Balance Sheet Developer *Capital at risk; profits from ownership*	The Sponsor or Manager *Fees plus promoted interest on others' capital*	The Integrated Platform *Owns some deals; sponsors others*
Invests its own capital in every project	Raises equity from outside investors per deal	Balance sheet deals, co-investment, and sponsored deals
Revenue from development profits and appreciation	Revenue from fees plus carried interest or promote	Multiple revenue streams at once
No outside investor capital, or very limited JV partners	Minimal or no company capital in deals	Most complex governance and capital structure
Partners personally at risk for development outcomes	Securities law compliance required	Partial securities law exposure on sponsored deals
No securities law exposure in most cases	Lower personal capital requirement	Deepest talent and infrastructure requirements
	Depends on investor relationships and track record	A transition model for maturing companies
	Scalable; carry realized at exit, years out	Highest revenue ceiling; most complexity

Requires substantial committed partner capital Highest upside and highest personal financial risk		

Most founding teams sit in one of the first two models at launch and aspire to the third as the business matures. The common mistake is designing governance, compensation, and capital structure around the aspiration rather than the reality. A company that will operate as a pure sponsor, raising outside investor capital for every deal, needs a different operating agreement, different securities compliance infrastructure, and a different partner compensation framework than one that will develop on its own balance sheet. The integrated platform needs elements of each.

The founding team should choose a primary model for launch and be specific about what would trigger a move to a more complex one. The model choice drives the structural decisions in the parts of this handbook that follow.

The Balance Sheet Developer: Building With Your Own Capital

The balance sheet developer is the easiest model to understand and, paradoxically, the hardest to sustain at scale without outside capital. The company finds development opportunities, controls sites through purchase or option, funds entitlement, design, and pre-development costs from its own resources, secures construction financing from lenders, builds the project, and captures the development profit at completion and sale. The partners' capital is at risk the entire time.

Revenue Characteristics

A balance sheet developer earns project by project, and it earns when a project is completed or sold. There is no ongoing fee income from third-party management, no carried interest from investor capital, and no asset management revenue from a standing portfolio. The company makes money when it sells or refinances a finished project, and the amount depends entirely on how the project performed against its original pro forma.

That produces a lumpy, cyclical revenue pattern with real consequences for how the company manages its own overhead. In the months or years between one project's completion and the next, the company may have no meaningful revenue at all. It is still paying salaries, carrying overhead, pursuing future deals, and waiting on closing proceeds that will not arrive until the next disposition. The working capital implications are concrete:

- The company must hold enough operating capital to cover overhead between completions, which often means leaving a meaningful share of prior project profits inside the business rather than distributing them.
- Construction financing is the main source of project-level leverage, and because lenders typically require personal recourse guarantees, the partners' personal exposure tracks the project pipeline directly. A company running three projects at once may carry three active personal guarantees.
- The cost of chasing deals that do not close, including earnest money, due diligence, and design and entitlement work that becomes worthless when a deal is abandoned, falls entirely on the company's balance sheet when there are no outside investors to share it.

Capital Requirements and Partner Financial Exposure

The balance sheet model requires founding partners with real financial resources to commit, not only sweat equity and deal flow but actual capital that can fund pre-development work, cover overhead during the ramp-up, and supply the equity cushion construction lenders demand. The Chapter 1 conversations about each partner's capital contribution matter even more here, because the company's ability to pursue any deals at all is gated by the capital the partners can put up. The founding team should address head on:

- What is the minimum equity the company needs to carry its first project from site control through construction completion? The figure depends heavily on deal size, the lender's loan-to-cost requirements, and the projected pre-development spend before a construction loan closes.
- How much of that equity can the company afford to lose if the first project disappoints, and what is the backup plan if it does?
- Are the partners prepared to give personal guarantees on construction loans, and if so, what is the cap on each partner's individual guarantee exposure? A guarantee one partner can absorb might be ruinous for another.
- Does the company intend to bring joint venture equity partners into some deals, whether institutional capital, family office equity, or preferred equity, and if so, what securities law obligations does that create? Chapter 19 treats this question in full.

When the Balance Sheet Model Is the Right Starting Point

For all its capital intensity, the balance sheet model is the right place to start for some teams. It fits best when:

- The partners collectively have meaningful capital to deploy and the financial resilience to absorb early-stage development risk without outside support.
- The deal size targets are modest enough that partner capital plus construction financing can fund the whole capital stack without third-party equity.
- The team does not yet have the investor relationships or the auditable track record that outside investors will require. Building the first project or two on balance sheet, generating a documented return history, then moving to a sponsor model is a well-worn path.
- The partners want to avoid the securities law compliance obligations that come with raising outside capital, at least in the early years.

The Sponsor or Manager Model: Building With Other People's Capital

The sponsor model is the most common structure for development companies that intend to scale beyond what their own balance sheet can support. The company finds the opportunity, secures the site, leads the entitlement and development process, and raises the equity the project needs from outside investors, whether high-net-worth individuals, family offices, or institutional sources, in exchange for a fee structure and a promoted interest in the deal's profits above a preferred return.

This is a different business from balance sheet development. The company is no longer only a developer. It is also a capital markets business, a compliance-sensitive enterprise under securities law oversight, and a fiduciary manager with obligations to the investors whose capital it deploys.

How the Sponsor Model Actually Works

In the simplest sponsor structure, the company assembles the capital to execute a project as follows:

- As the sponsor and general partner entity, the company controls the development site, often through a short-term option or purchase agreement.
- The company raises equity from accredited investors. This is a securities offering governed by federal and state securities law, typically conducted under an exemption from registration such as Rule 506(b) or Rule 506(c) of Regulation D.
- The equity is pooled in a deal-level LLC or limited partnership, with the company as managing member or general partner and the outside investors as non-managing members or limited partners.
- The project entity deploys that equity alongside construction debt to fund the development. The company earns fees, including development management fees, acquisition fees, and sometimes property management fees, during the development and operating period.
- At disposition, proceeds run through the waterfall: investors first receive a return of their capital and a preferred return, and the company then earns its promoted interest on profits above the threshold.

This model produces several revenue streams at once, ongoing fee income during development and a back-end promoted interest at disposition, which makes it more durable over time than the pure balance sheet model. But it demands capital-raising capability, investor relationship infrastructure, and securities compliance systems that add real complexity and cost.

The Securities Law Consequence

When a real estate company raises equity from outside investors, it is offering and selling securities. That is true no matter what the interests are called, whether LLC membership interests, limited partnership interests, or co-investment interests. Whether an investment is a security turns on economic substance, not on the label in the documents.

The securities framework that governs private real estate offerings is covered in detail in Chapter 19. At the business model level, the founding team needs to understand that operating as a sponsor subjects the company to a compliance infrastructure, including offering documents, investor qualification procedures, Form D filings, state blue sky compliance, and anti-fraud obligations, that does not apply to a pure balance sheet developer. Those obligations add cost, create ongoing responsibilities, and expose the company and its principals to regulatory liability if they are not met.

The partners should decide, before formation, whether the company will raise outside capital from the start, in which case securities compliance has to be built into the company's infrastructure from day one, or whether it will operate as a balance sheet developer first and move to sponsoring outside capital once it has a track record. The regulatory infrastructure for the sponsor model cannot be switched on retroactively after the first investor relationship has already begun.

Track Record as a Prerequisite

The sponsor model has one prerequisite that no amount of planning or legal structure can replace: a demonstrable, auditable track record of development performance. Outside investors, whether high-net-worth individuals or institutional sources, commit capital to a sponsor on documented evidence that the sponsor has done what it proposes to do, has delivered the returns it promised, and has the organizational capacity to manage their money responsibly.

Teams without a documented individual track record, meaning projects completed, costs managed, and returns delivered, face a real challenge in the sponsor model. Approaches that have worked for emerging sponsors include:

- Starting with a small first deal funded by partner capital plus a small group of high-trust investors who are making a relationship investment rather than a purely track-record-based one, sized to be manageable given the team's experience.
- Partnering with an experienced developer on the first deal or two as a co-general partner or project manager, gaining transaction experience under an established platform before launching independently.
- Representing track record built through employment, even where no independent deals have closed. A partner who managed $200 million of development at a prior employer has a track record even if it was not under the new company's name, and that history can be presented accurately in investor materials with appropriate disclosure.

What does not work is claiming a track record that overstates what was actually accomplished. The securities anti-fraud rules reach every representation made in connection with the offer and sale of securities, including statements about prior performance. Misrepresenting track record is among the most common triggers for regulatory action against real estate sponsors.

Deal-by-Deal Syndications vs. Discretionary Funds

Within the sponsor model sits a second foundational choice: will the company raise capital deal by deal for each specific project, or will it eventually raise a discretionary blind pool fund in which investors commit capital for deployment across a portfolio the company identifies after the fund closes?

This does not have to be resolved for good at formation. Most development companies begin with deal-by-deal syndications and graduate to funds as the track record and investor base mature. But the distinction shapes how the company is structured and what infrastructure it has to build.

Deal-by-Deal Syndications

In a deal-by-deal syndication, the company identifies a specific project, prepares deal-specific investor materials, including a private placement memorandum, an operating agreement, and a subscription agreement, and raises equity for that project from accredited investors who evaluate and commit to the individual opportunity before any capital is deployed. This model has practical advantages for an emerging company:

- Investors see the specific project before committing. That makes the ask more concrete and often easier for investors who are not yet comfortable backing a blind pool run by an unproven team.
- Each deal's legal documents are specific to that deal, so the company's compliance obligations stay isolated to the offering at hand rather than the heavier ongoing compliance of a fund.
- Risk is deal-specific. A disappointing outcome on one project does not directly affect investors in another, which limits the contagion risk of underperformance.

The disadvantages are just as real:

- Capital has to be raised for every deal, which creates timing risk. If a deal is ready to close before the equity is fully committed, the company faces a gap it must fund from its own resources or a bridge lender.
- Investors in each deal can exercise their deal-selection rights to pass on specific projects, leaving the company short of its target on individual transactions even when its overall relationships are strong.

- The administrative burden of separate offering documents, investor accounts, K-1 preparation, and reporting for each deal compounds quickly as volume grows.

Discretionary Funds

A discretionary fund is a pooled vehicle in which investors commit capital at fund formation, before specific projects are identified. The manager, the company acting as general partner or managing member, then has a defined investment period in which to identify and deploy that capital across a portfolio according to the strategy disclosed in the fund's offering documents. The fund model offers structural advantages that grow more valuable as the platform matures:

- Committed capital removes deal-level timing risk. The company can move quickly on an opportunity because the equity is already in hand, rather than racing to close a capital raise alongside the transaction.
- The fund model scales more efficiently than deal-by-deal syndication because the legal, compliance, and administrative infrastructure is built once for the fund rather than rebuilt for every transaction.
- Institutional investors, including pension funds, endowments, and family offices, strongly prefer the fund model, because it lets them commit a meaningful allocation to a manager and trust that manager to deploy it across a portfolio rather than underwriting each deal.

The fund model's prerequisites are more demanding:

- Investors are making a blind commitment to the manager's judgment, without reviewing individual deals first. That requires a level of trust in the manager's track record, process, and organizational capability that most emerging sponsors have not yet earned.
- The regulatory complexity of a discretionary fund runs meaningfully higher than a deal-by-deal syndication, potentially including Investment Advisers Act registration obligations that do not attach to the deal-by-deal model. Chapter 20 covers this.
- The fund's strategy must be disclosed precisely in the private placement memorandum, and the manager's ability to stray from it is legally constrained. Deal-by-deal sponsors keep more freedom to pursue opportunities as they arise.

The Practical Starting Point for Most Founding Teams

For most emerging companies the realistic path through these two models is sequential, not simultaneous. Start with deal-by-deal syndications on the first two or three projects, and use those transactions to build an auditable track record, develop investor relationships grounded in actual performance, and show a wider investor base that the team executes on what it promises. Once the company has two or three completed projects with documented returns, an active investor base that understands the team's work, and the infrastructure to handle a fund's compliance and reporting, the move to a discretionary fund becomes both viable and attractive. Trying to raise a blind pool fund before those prerequisites are in place is a strategy that most investors, and all institutional investors, will decline.

Branding, Market Positioning & Investor Identity

The company's brand, meaning its name, visual identity, market positioning, and the professional reputation it projects to deal sources, investors, lenders, and the wider real estate community, is an asset that starts accruing from the first day the company opens. Most founding teams badly

underinvest in it in the early years, treating it as an aesthetic concern rather than a business development tool. That is a mistake.

The Brand as a Deal Flow and Capital Attraction Tool

In development, the company's reputation arrives in every important room ahead of its principals: the seller deciding which developer gets an exclusive negotiating window; the lender's underwriting team weighing a construction loan; the investor deciding whether to commit $500,000 to a first deal; the general contractor whose bid reflects a judgment about whether the company is a reliable client. Each of these decision makers forms an impression before sitting down with the principals, and that impression is shaped by the company's visible presence in the market.

A professional website that accurately represents the team, strategy, and track record is table stakes for any company that expects sophisticated counterparties to take it seriously. A company with no web presence, a generic email address, and no visible market identity is sending a message about its professionalism and its commitment that its partners probably do not intend. The founding team should address:

- What is the company's name, and does it represent what the company does accurately and memorably? A generic name that sounds like every other development firm is a disadvantage, not a neutral choice.
- What is the positioning statement, the sentence or two that captures what makes the company different from the others competing for the same deals and the same investor capital?
- What does the website need to accomplish? For a balance sheet developer the primary audience is deal sources and lenders. For a sponsor it is investors, and the content is subject to securities marketing review under the applicable advertising rules.
- Who owns the brand assets, the name, logo, domain, and social accounts, and what happens to them if a founding partner leaves? The operating agreement should address intellectual property ownership explicitly, the brand included.

The Investor Identity

For companies that intend to raise outside capital, the founding team should define its investor identity with as much precision as its development strategy: who are the investors the company is building for, how does it intend to reach them, and what investor experience does it intend to provide?

This question carries direct legal and regulatory weight. Under Rule 506(b) of Regulation D, the exemption most private real estate offerings rely on, the company may not use general solicitation or advertising to attract investors. It has to rely on pre-existing, substantive relationships with each investor. Under Rule 506(c), the company may advertise and generally solicit, but only to accredited investors whose status has been independently verified. The choice of exemption shapes the permissible outreach strategy, and the intended outreach strategy shapes the choice of exemption.

A company whose founders have deep, active relationships with a defined group of high-net-worth investors who backed their prior deals has a different investor identity than one whose founders are building those relationships from scratch. Both are viable, but they imply different capital-raising timelines and different regulatory approaches. Chapter 19 takes up the choice between Rule 506(b) and Rule 506(c) in full.

The 24-Month Operating Budget: A Reality Check

Every model, whether balance sheet developer, sponsor, or integrated platform, needs operating capital to sustain the management company between formation and meaningful revenue. For a development company that period is almost always longer than the founding team expects, and the costs are almost always higher.

The 24-month operating budget is not a projection for the development projects the company intends to pursue. It is a budget for the management company itself, the overhead of running the business while deals are sourced, underwritten, financed, and built. Building it honestly, before formation, is one of the most important analytical exercises the founding team can undertake.

The Budget Categories

The budget should account for every category of operating expense the management company will carry. The table below sets out realistic Year 1 ranges for each category. The founding team should then project Year 2 on the same lines, usually higher as the company adds headcount and deal activity, to complete the full 24-month picture:

Expense category	Year 1 low	Year 1 high	Notes
Legal: formation and ongoing compliance	$18,000	$55,000	Entity formation, operating agreement, annual compliance
Legal: deal-level transaction work	$12,000	$40,000	Per deal; varies with transaction complexity
Accounting and tax preparation	$8,000	$20,000	Tax returns, bookkeeping, financial statement preparation
Insurance (all lines)	$12,000	$30,000	GL, D&O, E&O, cyber; lower end before employees
Technology and software	$6,000	$18,000	Project management, financial modeling, CRM, office tools
Office or workspace	$0	$36,000	Zero if home office; $3,000 per month for shared or dedicated space
Marketing and business development	$8,000	$25,000	Website, branding, deal pursuit travel, due diligence costs
Partner compensation (if any in Year 1)	$0	$300,000	Highly variable; zero to below-market draws common in Year 1
Contingency and miscellaneous	$10,000	$20,000	Equipment, subscriptions, unforeseen formation costs
Total Year 1 operating budget	**$74,000**	**$544,000**	**Wide range driven mainly by compensation and office choices**

A few points about these ranges deserve emphasis. First, partner compensation is the single largest variable, and the founding team's decision about pay during the ramp-up, taken up in Chapter 1, will determine whether the budget is manageable or unsustainable. A company that pays two partners a combined $300,000 in Year 1 has to be capitalized to cover that cost before a single dollar of fee income arrives.

Second, the deal-level legal line deserves a note on how to treat it. Legal fees on a deal that closes are properly project costs rather than standing management-company overhead, and they are usually charged to the project entity at closing or drawn from a due diligence reserve, so they should not be carried twice. The line appears here because the company generally fronts these fees before a closing reimburses them, and because pursuit costs on deals that never close, such

as forfeited earnest money and abortive feasibility and legal work, fall on the company and are never recovered. Budget for both.

Third, the technology line covers the tools a professional development company actually runs on: project management software that tracks design, entitlement, and construction milestones; financial modeling tools sophisticated enough to produce the returns analysis investors and lenders expect; a CRM to manage deal flow and investor relationships; and the cybersecurity that protects sensitive investor data. None of these is a luxury for a company that means to be taken seriously by professional counterparties.

Funding the Budget: The Capitalization Conversation

Once the budget is built, the founding team has to identify the source of every dollar. The funding sources for the management company's operating budget are usually some combination of the following:

- **Initial partner capital contributions.** Each founding partner contributes a defined amount to the operating company at formation, creating a cash reserve that covers operating expenses through the ramp-up. This is the most reliable source and the one that creates the clearest shared stake in the company's early success.
- **Fee income from early deals.** If the company can close one or more transactions in its first year, generating development management, acquisition, or construction management fees, that income begins to offset the operating budget. The reliability of this source depends entirely on deal pipeline and deal velocity, neither of which can be guaranteed.
- **Outside working capital financing.** Some companies secure a working capital line of credit from a commercial bank to bridge the gap between expenses and fee income. This requires bankable assets, typically the partners' personal guarantees, and it creates a debt obligation that must be serviced whether or not deals are closing.
- **Project-level cost recovery.** Some management company overhead can legitimately be charged to deal-level project entities as development expenses, shifting cost from the management company's budget to the project's. This is appropriate only where the costs are truly project-related and are properly disclosed to investors when outside capital is involved.

The capitalization conversation has to be honest about the minimum the company needs at formation to survive until fee income can sustain operations. That figure belongs in the Partners' Term Sheet before any attorney is engaged, because it sets the required initial capital contribution from each founding partner and the governance provisions for capital calls if the initial contribution runs out before the company reaches operating cash flow.

Build vs. Buy: Hiring vs. Outsourcing Core Functions

One of the most consequential early decisions a development company makes is how to staff its core functions. The choice between an internal team and specialist outside providers bears directly on cost structure, quality control, scalability, and the regulatory obligations that come with employing people. Most founding teams get this wrong in one direction or the other, either staffing up faster than revenue supports or outsourcing functions so critical that handing them off undermines the company's ability to operate.

Functions That Should Generally Be Internal

Some functions are so central to the company's competitive advantage and quality of execution that outsourcing them creates unacceptable risk or simply does not work. The test is straightforward:

what does the company do better than outside providers, and what does it need to do consistently and confidentially? Functions usually better handled internally:

- **Deal origination and site control.** The relationships and local market knowledge that generate opportunities are the company's most proprietary asset. Outsourcing this to a broker or consultant means the company does not own its deal flow; it is buying it from a third party who is working for its competitors at the same time.
- **Project management and construction oversight.** Cost and quality control on a development project depend on consistent, expert supervision of construction. A company that hands this to a third-party project manager with no financial stake in the outcome is accepting execution risk that experienced investors and lenders will notice.
- **Investor relations and capital management.** The company's relationships with its capital sources are among its most valuable assets. Outsourcing investor communications and capital management is impractical from a relationship standpoint and can be problematic from a regulatory one, since it may amount to broker-dealer activity that requires registration.
- **Financial reporting and accounting oversight.** The company may use an outside CPA firm for tax, audit, and complex accounting, but internal oversight of financial reporting, including approval of draw requests, review of project budgets, and management of the operating company's accounts, should sit with someone who has fiduciary accountability to the company.

Functions That Can Productively Be Outsourced

Other functions are better handled by specialist outside providers, at least in the early years before the company has the volume to justify dedicated internal staff. Outsourcing them lets the founding team reach expert capacity without the fixed cost and management burden of employment. Functions often outsourced effectively by early-stage companies:

- **Legal services.** Outside counsel handles deal-level transactional work, securities compliance, employment matters, and regulatory filings on an as-needed basis, usually more efficiently and at higher quality than an early-stage company could manage in house. Most development companies reach $100 million or more in deal volume before in-house counsel becomes cost-effective.
- **Accounting and tax preparation.** A qualified CPA firm with real estate and private fund experience is typically more effective than an in-house accountant in the early years, providing tax preparation, financial statement compilation or audit, and tax planning across both the management company and the project entities.
- **Property management.** Unless the business model specifically includes a property management operation, with its own licensing, staffing, and operational requirements, outsourcing management of completed projects to a qualified third party lets the company focus on development without building a separate property operations group.
- **Architecture and engineering.** Retaining architects, engineers, and other design professionals project by project is standard practice for development companies of every size. Building these capabilities in house makes sense only for very large platforms with enough volume to keep design teams consistently busy.
- **General contracting.** Unless the team has specific general contracting expertise and the company intends to serve as its own contractor, a model that requires contractor licensing in most states along with insurance, bonding capacity, and a workforce, hiring an independent contractor for each project is standard and lets the company match the right contractor to each project type and market.

The Employment Obligation

When the company does hire employees, which most founding teams will need to do within the first 12 to 24 months as deal volume grows, it takes on legal and financial obligations that require planning and infrastructure before the first employee starts. Employment is more than paying someone to do work. It creates obligations under federal and state employment law, tax withholding and reporting requirements, workers' compensation insurance requirements, and, in many jurisdictions, a range of benefit and leave obligations. Before the first hire, the founding team should make sure of the following:

- The company has a payroll system that can withhold and remit federal and state payroll taxes on schedule. Failure to remit payroll taxes is one of the most serious compliance violations a small business can commit, and it carries personal liability for the owners who control the company's finances.
- The company has obtained workers' compensation coverage, which is mandatory in virtually every state for any employer with even one employee.
- The company has documented its employment practices in a basic handbook covering at least hours and attendance expectations, compensation and payroll schedule, expense reimbursement, anti-harassment and anti-discrimination policy, and confidentiality and intellectual property ownership.
- Every new employee has signed the company's confidentiality and non-solicitation agreement and, where applicable, an intellectual property assignment confirming that work product developed during employment belongs to the company.

The Independent Contractor Trap

One of the most common employment law mistakes early-stage development companies make is classifying employees as independent contractors to avoid payroll taxes, benefits, and the administrative burden of employment. This is not a gray area. It is a defined legal violation when it is applied to workers who, under the governing standard, are actually employees.

The IRS and most state labor agencies use a multi-factor test built around economic reality and behavioral control. The key questions: does the company control when, where, and how the worker does the job? Does the company supply the worker's tools and equipment? Is the work integral to the company's regular business? Does the worker provide services exclusively or mainly to the company? Workers who fail these tests are likely employees regardless of what the contract calls them.

The consequences of misclassification include back payroll taxes plus interest and penalties, workers' compensation claims from injured workers who were not covered, benefit claims from workers who were entitled to benefits as employees, and personal liability for the principals who controlled the decision to misclassify. The cost of correction almost always exceeds the cost of proper classification from the start. When in doubt, consult employment counsel before classifying a regular worker as a contractor.

Proprietary Deal Flow: The Company's Most Important Asset

In real estate development, the company that consistently finds better deals earlier than its competition wins over time. There is nothing subtle about this. It is the central competitive reality of the business. And yet most founding teams spend far more time planning governance and compensation than they spend on how they will generate a consistent, proprietary pipeline of opportunities.

Deal flow is the company's most important operational asset, and it is also the most fragile. If the primary source is one founding partner's relationships and that partner departs, the deal flow may depart with them. If deal flow depends entirely on brokers who are working with a dozen competitors at the same time, the company has no proprietary advantage at all.

Sources of Proprietary Deal Flow

The founding team should map its current deal flow sources honestly rather than aspirationally, and weigh the reliability, exclusivity, and replicability of each:

- **Direct landowner relationships.** Long-standing personal ties to land and property owners who will call the company first when they are ready to sell or develop. These are real advantages, but they are relationship-specific rather than institutional. If the relationship belongs to a partner personally, it may not transfer to the company when that partner leaves.
- **Municipal and community relationships.** Deep connections with planning departments, city councils, redevelopment agencies, and community stakeholders that position the company to learn about opportunities, such as surplus public property, urban renewal areas, and tax increment financing districts, before they are widely marketed.
- **Industry network relationships.** Connections with homebuilders, commercial operators, retailers, and institutional owners that generate opportunities, including build-to-suit deals, sale-leaseback development, and ground lease structures, which never reach standard brokerage channels.
- **Off-market sourcing systems.** Proprietary methods for identifying opportunities before they are listed, such as direct mail to specific owner categories, targeted outreach to owners of underutilized property in target markets, and data-driven identification of sites with development potential the market has not yet recognized.

The founding team should discuss not only where current deal flow comes from but how the company will institutionalize and protect those sources, through documented relationship management, through the organization's CRM rather than a partner's personal contacts, and through the restrictive covenants discussed in Chapter 14 that keep a departing partner from taking the deal flow with them.

The CRM as an Institutional Asset

One of the most important early infrastructure decisions a development company makes is how it manages its relationship data. A company that keeps its deal contacts, landowner relationships, investor relationships, broker relationships, and municipal contacts in a partner's personal address book or individual email account is not building an institutional asset. It is building a personal asset for that partner, one that walks out the door when the partner leaves.

A company-managed customer relationship management system, accessible to all principals and staff, that tracks every significant relationship the company maintains is an infrastructure investment that pays back far more than it costs. It ensures the company's relationships survive personnel changes, lets several team members develop important relationships at once, and lets the company show investors and capital partners the real depth and breadth of its network.

The operating agreement should address the CRM directly: all contact information, relationship history, and deal pipeline data held in the company's systems is the company's property, not any individual partner's. A departing partner's access should end promptly on departure, and the operating agreement's non-solicitation provisions should name the company's investor and deal source data as confidential company information.

Bridging to Entity Structure: What the Model Choice Drives

The decisions in this chapter, about business model, revenue architecture, deal flow, branding, capitalization, and hiring, are not preliminary to the structural and legal decisions in the parts of the handbook that follow. They are the inputs that drive those decisions. Before moving to Chapter 3 and its treatment of entity selection and formation architecture, the founding team should be able to answer the following definitively, because the answers determine the right structural approach:

Business model decision	What it drives downstream
Balance sheet only (no outside investors)	Simpler entity structure; no securities compliance infrastructure required; operating agreement focuses on partner governance; no separate GP entity needed
Sponsor model (outside investors from the start)	A separate GP or sponsor entity; securities compliance built into the infrastructure from day one; PPM and offering document templates prepared before the first raise; ERA and RIA analysis required
Deal-by-deal syndications only	Deal-level single-purpose entities for each transaction; simpler ongoing compliance than a blind pool; Form D filing per offering; deal-specific offering documents
Discretionary fund (now or near-term)	Fund entity formation; limited partnership agreement or fund operating agreement; investment adviser registration analysis; more complex investor reporting infrastructure
Co-GP or joint venture with other developers	Joint venture governance provisions; co-GP fee and promote allocation; conflict-of-interest policies for deals involving JV partners
Employing staff from formation	Payroll infrastructure; workers' compensation; employee handbook; non-solicitation and IP assignment agreements before the first hire
Outsourcing most functions initially	Contractor classification analysis; contractor IP assignment and confidentiality obligations; a contractor conversion plan as volume grows
Significant partner capital at risk (balance sheet)	Personal guarantee framework; guarantee cap provisions; capital call mechanics and the consequences of non-funding in the operating agreement

The founding team should complete this mapping before engaging legal counsel for formation work. A team that cannot tell its attorney which rows of this table apply to their company has not done enough pre-engagement work, and it will pay for the gap in legal fees and document revisions.

CHAPTER 2: KEY TAKEAWAYS

1. A real estate development company is not a single business model. The three models, balance sheet developer, sponsor or manager, and integrated platform, have different revenue structures, capital requirements, legal and regulatory implications, and organizational needs. Choosing the right primary model at formation is among the most consequential decisions the founding team will make.
2. The balance sheet developer model requires real partner capital, exposes the partners to personal guarantee risk on construction debt, produces lumpy project-based revenue, and avoids securities law complexity in most cases. It suits teams with sufficient capital that want to build a track record without outside investor exposure.
3. The sponsor or manager model raises equity from outside investors for each project, produces several revenue streams (fees plus promoted interest), and requires

securities compliance infrastructure from the first investor relationship. Its prerequisite is a credible, auditable track record and the relationships to support capital-raising.

4. Deal-by-deal syndications are the natural starting point for most emerging sponsors. Discretionary funds become appropriate once the track record, investor base, and organizational infrastructure are in place, usually after two or three completed projects.
5. The 24-month operating budget is not optional analysis. It is the foundational planning document that determines how much capital the company needs at formation, how long it will last, and what happens when it runs out. Build it honestly before formation and before any partner compensation commitments are made.
6. The build-versus-buy decision on core functions bears directly on cost structure, regulatory exposure, and quality of execution. Functions central to the company's advantage, including deal origination, construction oversight, and investor relations, should generally stay internal. Functions where outside specialists offer real efficiency, including legal, accounting, and property management, can be outsourced productively in the early years.
7. Proprietary deal flow is the company's most important and most fragile operational asset. Institutionalize it in company-managed systems, protect it through IP ownership and non-solicitation provisions in the operating agreement, and treat it as the company's property rather than any individual partner's.
8. The model decisions in this chapter are the direct inputs to every structural, legal, and governance decision in the parts that follow. Doing this analysis before engaging counsel reduces legal fees, produces better-tailored documents, and prevents the costly structural corrections that arise when lawyers have to discover a client's business model in the middle of a drafting engagement.

WHAT COMES NEXT

Chapter 3 takes up entity structure and formation architecture: how to select and build the right legal structure for the operating company, why the choice of entity type, state of formation, and ownership hierarchy carries consequences across the whole life of the business, and the formation sequence that puts the structure in place correctly. The model decisions made in Chapter 2 are the primary inputs to the structural choices in Chapter 3.

See also: *Appendix A (Partners' Term Sheet Template) • Appendix B (Entity Structure Comparison) • Appendix H (Formation Documents Checklist) • Appendix J (Glossary)*

CH. 3

PART II: ENTITY STRUCTURE & FORMATION ARCHITECTURE

Choosing the Right *Entity Structure*

How to select and build the right legal structure for the operating company, and why the choice of entity type, state of formation, and ownership hierarchy carries consequences across the entire life of the business.

Most real estate professionals who have formed a company carry a story about their entity structure. There is the single LLC set up at a kitchen table that proved inadequate the moment the first construction lender asked for a single-purpose entity. There is the operating agreement pulled from a legal website that said nothing about what happens when a partner wants to leave. There is the GP entity that was formed correctly but whose operating agreement was silent on how the carry would be split among the founders, a detail that seemed unimportant right up until the first promoted interest distribution became real money.

Entity structure is the legal architecture on which every other decision rests. It is the set of liability walls that protect the founders personally, the tax framework that determines how the business's economics flow to the partners, the governance machinery that lets the company function efficiently, and the regulatory interface that shapes how the company appears to investors, lenders, and regulators. This chapter explains what the right structure looks like, why it matters, and how to put it in place correctly.

Why Entity Structure Matters More Than Most Founders Realize

When a founding team asks an attorney to form their company, the attorney responds with questions that can sound purely technical: which state, which entity type, how many members, what ownership percentages? None of these is procedural. Each answer shapes the company's legal, tax, and operational reality for years. The entity structure has to accomplish several things at once:

- Protect each founding partner from personal liability for the company's obligations, including claims from investors, lenders, contractors, and subcontractors that arise in the course of the company's development activities.
- Create the tax framework through which the company's income, deductions, and capital gains flow to the partners as efficiently as possible.
- Satisfy the structural requirements of construction lenders, bridge lenders, and joint venture partners, who have specific expectations about the entities they deal with.
- Draw clear governance lines that define who has authority over what and how decisions get made. Without those lines, every significant decision becomes a potential trigger for partner conflict.
- Stay flexible enough to absorb new partners, outside investors, new projects, and an evolving business model without forcing a wholesale restructuring.

No single entity type does all of this equally well for every company in every situation. The right answer depends on the business model decisions made in Chapter 2, the partners' specific tax circumstances, the lenders and investors the company expects to work with, and the regulatory

framework that applies to its activities. This chapter works through those considerations in the order the founding team will actually face them.

The Entity Type Decision: LLC, LP, Corporation, and the Alternatives

Entity type is the most fundamental structural choice. Each type carries a different default liability framework, a different default tax treatment, and a different governance structure that the governing documents either modify or confirm. For development companies the decision is fairly focused: the LLC dominates most situations, the LP matters in specific institutional contexts, and corporations are almost never the right answer for this kind of business.

The Limited Liability Company: Why It Dominates

The limited liability company combines the three features a development company needs: liability protection for every owner, pass-through taxation by default, and governance flexibility through the operating agreement. It is the dominant structure for operating companies, development companies, and sponsor entities for good reason, and choosing anything else calls for a specific, compelling justification.

The LLC's liability protection means the members, the founding partners, are not personally liable for the entity's debts, obligations, and legal claims simply because they own membership interests. A lender that is not repaid by the LLC cannot reach the partners' personal assets automatically, and a contractor owed money by the LLC cannot garnish the founders' bank accounts. The protection is not absolute, since personal guarantees, fraud, and a failure to observe entity formalities can each pierce it, but it is a real protection that sets the LLC apart from running the business in the partners' individual names.

Pass-through taxation means the entity itself pays no income tax. The company's income, deductions, losses, and credits flow through to the members' individual returns in proportion to their ownership, or in whatever proportions the operating agreement specifies, subject to the substantial economic effect rules of the tax code. For a development company this matters in two ways: ordinary income from fees and development profits is taxed once at the partner level rather than twice at the corporate and individual levels, and depreciation deductions on real property pass through to the partners and can offset other income on their returns.

Governance flexibility is, in practice, the LLC's most distinctive advantage for a real estate company. The Delaware LLC Act lets the members design almost any governance structure they want through the operating agreement. They can create multiple classes of membership interests with different economic and voting rights, modify or eliminate default fiduciary duties, provide for any distribution waterfall the economics require, restrict transfers, impose vesting, and build detailed deadlock resolution mechanisms. No corporate statute offers the same contractual freedom.

The Limited Partnership: When It Applies

The limited partnership, historically the dominant structure for private equity and real estate investment funds, still matters in specific development contexts. Its defining feature is the two-class structure: the general partner, who has full authority to manage the partnership and bears unlimited personal liability, and the limited partners, who have no management authority and whose liability is capped at their invested capital.

In practice the general partner of any real estate LP should itself be an LLC. That is the standard arrangement that insulates the people behind the GP from the unlimited liability the GP's position formally carries. The chain runs from the individual founding partners, who own membership

interests in a GP LLC, to that GP LLC, which serves as general partner of the LP. The individuals' liability is limited to their interest in the GP LLC, and the GP LLC's liability as general partner is itself limited by the LLC's protection. For a development company, the LP becomes relevant in two contexts:

- Project-level fund vehicles aimed at institutional investors who are used to the LP and GP structure, including pension funds, endowments, and family offices that have long deployed capital through limited partnership agreements, may require or strongly prefer an LP for the fund vehicle rather than an LLC. Here the LP is the fund entity, and the company's GP entity, itself an LLC, serves as general partner.
- Some state tax planning strategies run more efficiently through LP structures than LLCs. The analysis depends on the states where the company operates, the partners' tax profile, and the nature of the company's income, and it calls for coordination between legal counsel and the company's CPA.

For the operating company itself, the LP is rarely the right choice. The managing partner's unlimited liability, even buffered by a GP LLC, adds complexity without giving the operating company any meaningful advantage over a simple LLC.

Why Corporations Are Almost Never the Right Answer

C-corporations and S-corporations come up for development companies now and then, usually because a founder knows the corporate form from prior experience outside real estate. For this use, neither generally fits.

The C-corporation's core problem here is double taxation. Corporate income is taxed at the entity level, currently at a flat 21 percent federal rate, and taxed again when distributed to shareholders as dividends. For a business built to generate development profits and fee income that should reach the founders as efficiently as possible, double taxation undoes the very economics the business exists to create. The depreciation deductions that make real estate tax-efficient also stop passing through to individual partners in a C-corporation, because the entity absorbs them.

The S-corporation avoids double taxation through pass-through treatment, but its structural restrictions make it incompatible with most development company structures. The restriction that matters most here is that an S-corporation cannot have another corporation, LLC, or partnership as a shareholder. That means the GP entity, which the operating company would typically own, cannot be an S-corporation if the operating company is itself an LLC. It also means the company cannot admit an institutional investor, a family office that operates through an entity, or any other non-individual owner.

The C-corporation becomes relevant in only two narrow cases: when the company intends to seek venture capital from a firm that requires corporate form, and even then only for the management company rather than the deal entities, or when there is a realistic path to a public listing of the management company at meaningful scale. Both are exceptions, not the starting point.

The Series LLC: A Useful Tool With Important Limitations

Several states, including Delaware, Texas, and Wyoming, among others, allow a series LLC, a structure in which a single parent LLC establishes multiple protected series, each with its own assets, liabilities, and members, separated by internal liability walls from the other series and from the parent.

The appeal for a development company is obvious. Instead of forming a new LLC for every project, with its filing fees, registered agent costs, and administrative overhead, the company could set up a new series of the parent for each project and achieve the liability isolation of a separate entity without the formation cost. The practical reality is more complicated:

- The enforceability of the liability walls between series remains legally unsettled in most jurisdictions. Delaware's statute is well drafted and the framework is sound, but there is limited case law actually testing whether the inter-series walls hold in bankruptcy, in litigation, and across state lines where another state's courts may not recognize Delaware series LLC law.
- Lenders are often reluctant to deal with series LLCs because the title insurance, collateral, and bankruptcy analysis grows more complex. A construction lender that requires a single-purpose borrower may not accept a series of a parent LLC as a substitute.
- Interstate operations add complexity. If a Delaware series LLC does business in a state that does not recognize series LLCs, that state's courts may not honor the inter-series protections.

The series LLC is not a poor choice in every context. For a company that operates only in a state with robust series LLC law, works with lenders and investors sophisticated enough to evaluate the structure, and has counsel experienced with it, the series LLC can deliver real administrative efficiency. It should be adopted deliberately for that reason, not chosen as a default to avoid the cost of separate project entities.

The Multi-Entity Architecture: Why Two Entities Are Better Than One

A development company that intends to sponsor outside investor capital, or that anticipates doing so in the future, almost always benefits from a two-entity architecture rather than a single operating company. The two entities are the operating company, which runs the management business, and a separate GP or sponsor entity, which serves as general partner or managing member of each deal vehicle and fund.

For a company that will never raise outside capital, a pure balance sheet developer with no intention of bringing in equity partners, the single operating company may be entirely sufficient. But for any company that might one day work with outside investors, the two-entity architecture is worth building from the start.

The Operating Company

The operating company is the primary business entity, the parent from which everything flows. It employs all staff, holds the intellectual property and licenses, signs the major vendor and service contracts, manages the banking relationships, and owns or controls the GP or sponsor entity. From the founders' perspective, this is the entity in which they hold their equity and whose operating agreement governs their relationship with one another. Its functions in a development business:

- Employs all personnel and carries the employment obligations, including payroll, benefits, workers' compensation, and employment practices liability.
- Holds the real estate licenses the company's activities require, including developer licenses where required, contractor licenses where the company acts as owner-builder, and property management licenses where the company self-manages assets.
- Owns the intellectual property, including the company brand and trademarks, underwriting models, proprietary processes, CRM data, investor lists, and website and domain.
- Enters into the consulting, professional services, and vendor agreements at the management company level.
- Owns or controls the GP or sponsor entity, so that the operating company captures the fee income and promoted interest economics that flow through it.

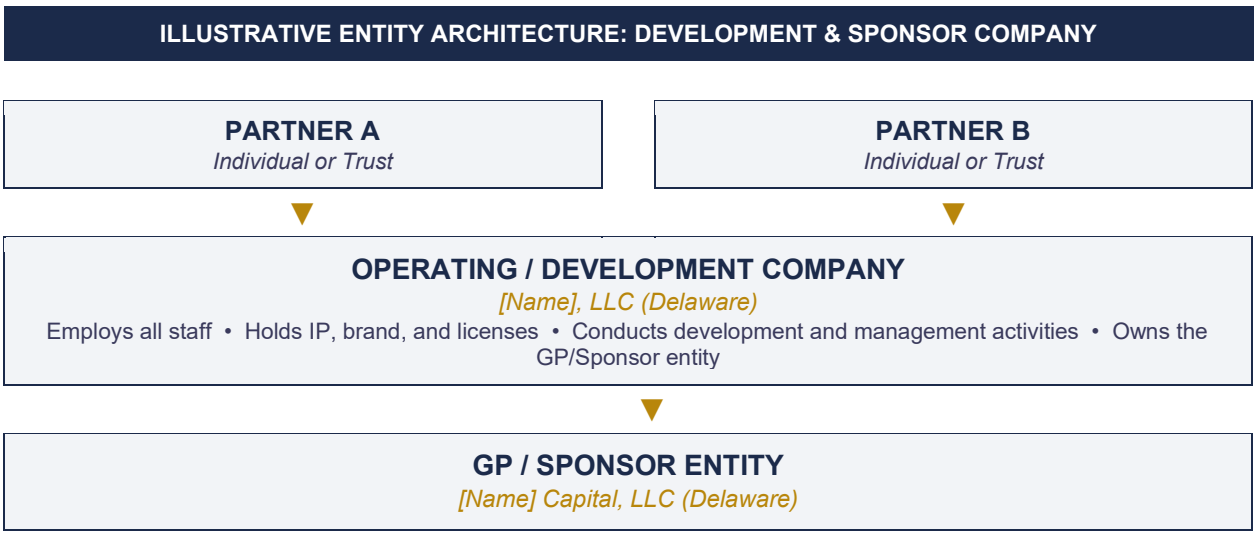
The GP or Sponsor Entity

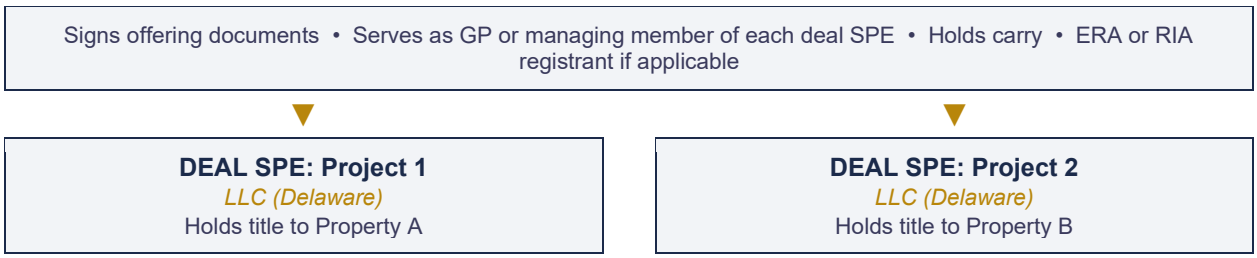
The GP or sponsor entity is a separate LLC that serves as general partner or managing member of each deal-level vehicle in which outside investors participate. It executes the operating agreement or limited partnership agreement as sponsor, it is the entity named in the private placement memorandum as manager, and its fiduciary obligations run to the outside investors. Keeping this separate from the operating company, rather than having the operating company serve directly as GP, is both practical and important:

- **Liability containment.** Investor claims from a failed deal or alleged mismanagement run to the GP entity first. Keeping it separate creates a legal barrier that has to be breached on its own before a disappointed investor's claims can reach the operating company's assets and the company's other projects and relationships.
- **Regulatory positioning.** If the company's activities make it an investment adviser under the Investment Advisers Act, because it manages private funds for compensation, the GP or sponsor entity is the one that files as an Exempt Reporting Adviser or registers as a Registered Investment Adviser. Housing that filing in a separate entity keeps the investment adviser compliance footprint out of the operating company's broader activities.
- **Investor expectations.** Institutional investors and sophisticated family offices expect the GP to be a standalone entity with clearly identified principals, its own compliance program, and financial statements independent of the operating company. A company where the GP and the operating company are one entity often fails this due diligence test.
- **Carry allocation flexibility.** The GP entity's operating agreement governs how the promoted interest is allocated among the founders for each deal, and that allocation can differ from the equity ownership percentages in the operating company. A partner who sources most of the deals might take a larger share of the carry than their equity percentage would suggest, and a capital partner might take a smaller share. Documenting these allocations in the GP entity's operating agreement prevents the disputes that arise when verbal understandings about carry are never written down.

The Entity Chart

Before any entity is formed, the founding team should prepare a complete entity chart showing the proposed ownership hierarchy at every level. The chart serves as both the brief for legal counsel, which eliminates the discovery process that runs up legal fees, and the basis for the CPA's review of the structure's tax implications before any formation steps are taken. The diagram below shows the standard two-entity architecture for a development and sponsor company, including the deal-level single-purpose entities where projects are held.





Each box is a separate legal entity. Arrows denote 100 percent ownership unless noted. Deal SPEs are formed separately for each project.

A few aspects of this structure deserve emphasis. The operating company sits above the GP or sponsor entity in the ownership chain, so it captures the GP entity's economics, both fee income and promoted interest distributions, and passes them to the founders through the operating company's waterfall. The deal-level SPEs are formed separately for each project and owned by the appropriate mix of the GP entity, as managing member, and the deal's investors, as non-managing members. And the founders' primary legal relationship is with one another inside the operating company, while the GP entity governs the company's relationship with investors.

State of Formation: The Delaware Decision and Its Practical Consequences

Every entity is formed in a specific state, and the choice of state carries legal, tax, and practical consequences distinct from, though related to, the entity type decision. The choice that matters most for a development company is whether to form in Delaware or in the state where the company's principal office sits.

The Case for Delaware

Delaware's standing as the preferred state for professional businesses rests on three concrete advantages that matter to a development company.

First, the Delaware LLC Act is the most sophisticated and flexible LLC statute in the country. It was built around maximum contractual freedom: it lets the operating agreement override nearly every statutory default, create bespoke governance, modify or eliminate fiduciary duties within limits, and accommodate the full range of economic arrangements sophisticated partners might want. When counsel drafts a complex operating agreement with multiple classes of interests, customized waterfalls, modified fiduciary duties, and detailed deadlock mechanics, those provisions rest on that statutory flexibility. Some states' LLC statutes impose mandatory rules that cannot be contracted around, which limits what the operating agreement can do.

Second, the Delaware Court of Chancery is a specialized business court whose judges have spent their careers interpreting corporate and LLC law. It has produced decades of detailed precedent on the Delaware LLC Act, so when a disputed provision arises, there is a body of case law that lets the parties and their counsel predict how it will be resolved. That predictability has real value when disputes turn serious and the stakes are high. Courts in other states, working from less developed statutes, can produce less predictable outcomes in novel situations.

Third, Delaware formation is what institutional counterparties expect. A company whose operating entity or GP entity is formed somewhere else, particularly in a state without well developed business entity law, will draw questions from institutional investors, lenders, and co-investment partners during due diligence. Those questions are not necessarily disqualifying, but they add friction that Delaware formation removes.

The Foreign Qualification Requirement

The most important practical consequence of Delaware formation for a company that primarily operates elsewhere is the foreign qualification requirement. A Delaware entity that conducts business in another state, which generally includes having its principal office there, having employees there, or regularly transacting business there, must register as a foreign entity in that state. Foreign qualification involves:

- Filing a foreign qualification application with the Secretary of State where business is conducted, usually a straightforward filing that requires the entity's formation documents and a certificate of good standing from Delaware.
- Appointing a registered agent in the home state to accept legal process and official notices on the entity's behalf.
- Paying the home state's annual filing fees or franchise taxes, which vary significantly by state.
- Filing annual or biennial reports with the home state, in addition to Delaware's annual franchise tax.

These costs are real but modest for most companies, typically $200 to $800 per year per state in fees, plus a registered agent's annual fee of $50 to $300. For a company that will deal meaningfully with institutional counterparties, the cost is justified by the advantages of Delaware formation. For a small, purely local developer that will never seek institutional capital or work with sophisticated financial counterparties, the home state may be the more practical choice.

State Comparison for Formation

State	Primary advantages	Primary considerations	Best suited for
Delaware	Most flexible LLC Act; Court of Chancery expertise; deep case law; institutional familiarity	Higher formation costs; foreign qualification required in home state; annual franchise tax	GP and sponsor entities; operating companies of platforms seeking institutional capital; any company with multi-state lender or investor relationships
Wyoming	Strong charging order protection; no state income tax; lower fees; growing institutional acceptance	Less extensive case law than Delaware; somewhat less institutional familiarity	Smaller balance sheet platforms; operating companies where cost efficiency matters and institutional capital is not anticipated
Texas	No state income tax; strong economy; growing business law sophistication; no foreign qualification cost if operating in Texas	Less established LLC case law than Delaware; mixed institutional familiarity	Texas-centric operations; early-stage companies focused on local markets; balance sheet developers not seeking outside capital
Home state	Avoids foreign qualification cost; local counsel familiarity; no dual compliance burden	Often a less sophisticated LLC statute; potentially less governance flexibility; limited institutional recognition	Purely local balance sheet developers; companies never expected to seek institutional capital, outside investors, or multi-state lender relationships

The recommendation that emerges is straightforward. Form the GP or sponsor entity in Delaware regardless of where the operating company is formed, because that is the entity institutional investors and regulators will scrutinize most closely. The operating company can reasonably be formed in the home state for a purely local balance sheet developer, with Delaware the better choice for any company that anticipates raising outside capital or working with institutional lenders.

Deal-Level Entities: Why Every Project Needs Its Own LLC

Every project in which outside investors participate, and ideally every significant project even without outside investors, should be owned by a separate single-purpose entity, a Delaware LLC formed specifically to hold that one project. This is not optional overhead. Lenders, investors, and title companies require it, for sound legal and financial reasons.

The Lender Requirement

Every institutional construction lender, and nearly every bridge lender, requires the borrowing entity to be a single-purpose entity, one whose sole purpose is to own and operate the subject property and whose organizational documents bar it from taking on other business or incurring other debt. The lender's rationale is bankruptcy remoteness: if the borrower files for bankruptcy, the lender's collateral should not be tangled up with the other assets and liabilities of a larger operating company. A single-purpose entity achieves that isolation by limiting its permitted activities to one property.

A company that holds several projects in one LLC creates a problem for construction lenders that cannot easily be fixed afterward. The lender cannot accept a multi-project entity as a single-purpose borrower, so the company ends up forming a new entity to hold the specific project anyway, doing at the closing table the work it should have done before the project started.

The Liability Isolation Rationale

Beyond the lender requirement, the deal-level SPE structure isolates liability between projects. If a construction defect claim, a personal injury on the site, or an environmental liability arises on a specific project, the claimant's primary recourse is against the project entity, not against the operating company or the other project entities. Without the SPE structure, the operating company and all of its projects are exposed to every claim arising from every project.

This benefit is real, but it demands the same discipline as the operating company's own liability protection. The SPE has to be maintained as a separate entity with separate bank accounts, separate accounting records, and separate contract execution. An SPE that commingles funds with the operating company, or that the founders treat as an alter ego, provides no more protection than having no SPE at all.

Tax Planning at the Project Level

Project-level SPEs also make deal-specific tax planning far cleaner. Cost segregation studies, the engineering analyses that accelerate depreciation by identifying personal property and land improvements with shorter lives than the building itself, are run at the property-owning entity level and produce benefits that flow to that entity's members. Bonus depreciation elections, Section 1031 like-kind exchange planning, and Opportunity Zone Fund structuring all execute more cleanly when each project sits in its own entity.

If several projects share one entity, their tax attributes, including income, losses, and depreciation, are merged for tax purposes. The SPE structure preserves the ability to allocate each project's attributes to the investors in that project rather than mixing them across the operating company's broader activities.

Investor Economics

In a deal-by-deal syndication, each investor commits to a specific deal, and the project-level SPE is the vehicle that documents that commitment. The investor's subscription agreement admits them as a non-managing member of the deal SPE, the SPE's operating agreement governs their economic rights, including the preferred return, the distribution waterfall, and the promoted interest, and the SPE's disposition proceeds ultimately fund the investor's return.

Holding several projects in one entity would force investors in deal A to be co-members with investors in deals B and C, creating governance complexity, cross-contamination of deal economics, and the chance that investors in a performing deal are dragged down by the underperformance of another project in the same entity. The deal-level SPE structure removes all of that by keeping each deal's investors, economics, and governance separate.

Entity Type Comparison: What the Founding Team Needs to Know

The table below consolidates the entity type comparison across the dimensions most relevant to a development company's formation decision. It is meant to support the conversation between the founding team and their legal and tax counsel, not to replace it.

Feature	LLC	LP	C-Corp	S-Corp	LLP
Liability protection	All members	LPs only; GP unlimited (use LLC as GP)	All shareholders	All shareholders	All partners
Pass-through taxation	✓ Default	✓ Default	✕ Double tax	✓ With limits	✓ Yes
Governance flexibility	Very high	Moderate	Moderate	Low	Moderate
Entity owner restrictions	None	None	None	No entities; 100-shareholder cap	None
Institutional familiarity	Very high	High	Moderate	Low	Low
Best for operating company	✓ Primary	Rarely	Only for IPO or VC path	✕ Restrictions	Rarely
Best for GP/sponsor entity	✓ Primary	✕ GP liability	✕ Double tax	✕ Owner limits	✕ Rarely
Best for deal-level SPE	✓ Primary	If LP required	✕ Generally no	✕ No	✕ No
Delaware statute quality	Best in class	Strong	Strong	Typical	Varies

The Operating Company's Organizational Needs at Formation

Forming the right entity type in the right state is necessary but not sufficient. At formation the company also faces a set of organizational decisions and administrative steps that are easy to overlook in the rush from formation to operations. Getting them right at the start costs far less than fixing them later.

The Operating Agreement

The operating agreement is the most important document the company will ever execute. It governs the partner relationship, establishes the governance structure, defines the economic arrangement, and frames every significant decision the company will make over its life. Chapter 4 is devoted entirely to it because it deserves that depth. The structural point here is simple: the operating agreement must be in place before the company conducts any meaningful business, and it should be drafted by experienced counsel from a detailed Partners' Term Sheet, not pulled from a template website or adapted from a prior company's documents without careful review.

Federal Employer Identification Number

The company's Federal Employer Identification Number, the EIN, is required to open a bank account, hire employees, file tax returns, and enter into most professional service agreements. It is

obtained from the IRS by filing Form SS-4, which can be done online and usually produces an EIN within minutes for domestic entities. This is an administrative step the founding team can handle directly, but it has to be done for the operating company, the GP or sponsor entity, and each deal-level SPE as they are formed.

Registered Agent

Every entity formed in any state must maintain a registered agent, an individual or company with a physical address in the state of formation who is available during business hours to accept legal process, official government notices, and service of legal documents on the entity's behalf. The registered agent's address is a matter of public record in the state's entity database.

For Delaware entities operating primarily elsewhere, the company needs a registered agent in both Delaware and the home state, or each state where the entity is foreign-qualified. Commercial registered agent services, companies that act as agent for thousands of entities, charge between $50 and $300 per year per entity per state, which is usually more practical than using an individual's home address or a founding partner's personal address.

State Tax Registrations and Licenses

Beyond the registered agent, the company may need to register for state income tax withholding, state sales tax for any retail activities, and state payroll taxes, along with any industry-specific licenses in the states where it operates. Development companies usually do not need a contractor's license at the entity level unless they act as their own general contractor, but they may need a real estate broker's license if a principal conducts licensed brokerage activity under the company's name.

Licensing requirements vary significantly by state and by the specific activities the company conducts. Legal counsel should review the company's intended activities and advise on all applicable licensing before the company begins operating in any new state.

Banking and Financial Infrastructure

The company must open separate bank accounts for the operating company, the GP or sponsor entity, and each deal-level SPE before any funds are received into those entities. This is more than good organizational practice. It is a legal and regulatory requirement when outside investor capital is involved. Commingling investor funds with the operating company's accounts is a serious compliance violation that can expose the company and its principals to securities regulatory action and civil liability. The bank account structure should track the entity structure:

- **Operating company account.** Receives fee income from deal entities and management activities; pays operating expenses, salaries, and distributions to partners.
- **GP or sponsor entity account.** Receives promoted interest distributions from deal entities; allocates to the operating company if the GP is owned by it, or distributes directly to partners if the GP is owned directly by them.
- **Deal-level SPE accounts.** Receive investor capital contributions, construction loan proceeds, and project revenues; pay project expenses and make distributions to investors and to the GP entity according to the waterfall.

Signature authority on each account must match the entity's governance structure as defined in the operating agreement. A bank account that lets a single partner withdraw funds unilaterally from a deal entity in which investors have committed capital is a financial control failure waiting to become a legal problem.

Partner-Level Documents: What Each Founder Must Sign

Along with the entity-level documents, the articles or certificate of formation, the operating agreement, and the EIN applications, each founding partner must execute a set of partner-level documents that establish the partner's individual relationship with the company and protect it against risks the entity-level documents do not address.

Equity Grant Agreements

If founding partners receive their equity in exchange for future services rather than an immediate cash purchase at fair market value, which is the case in most development company formations where equity reflects an expectation of future contribution, those interests should be documented in a written equity grant agreement. The grant agreement specifies the membership interest being granted, the vesting schedule that applies to it, which Chapter 5 treats in full, the consequences of departure on unvested interests, and the Section 83(b) election mechanics where applicable.

Without a written grant agreement, the equity interest exists by virtue of the operating agreement, but the vesting terms are not separately documented in a form the partner has specifically acknowledged. That gap matters when a departure occurs and the vested and unvested calculation becomes contested.

IP Assignment Agreement

Every founding partner must execute an intellectual property assignment agreement at formation. It assigns to the company all intellectual property the partner develops in connection with the company's business, including underwriting models and analysis tools built for company use, market research and analysis prepared for the company's strategy, investor materials and subscription documents, operating procedures and project management systems, branding and design work, and proprietary processes developed for the company's operations.

The assignment should also address intellectual property the partner brings to the company at formation from prior activities, specifying which pre-existing IP is being contributed and on what terms, and which the partner keeps personally and merely licenses to the company for its use. Without IP assignment agreements, a departing partner can legitimately claim ownership of intellectual property they created during the company's operation, even where it was built using company resources and intended for company use, and the resulting dispute is expensive and avoidable.

Confidentiality and Non-Solicitation Agreements

Apart from the confidentiality and non-solicitation provisions in the operating agreement, each founding partner should execute a standalone confidentiality and non-solicitation agreement. The standalone document serves two purposes. It is more likely to be enforceable in some jurisdictions as an independent contract supported by adequate consideration than as a clause buried in a complex multi-topic operating agreement, and it can be extended to non-partner key employees and service providers in the same format, creating a consistent confidentiality framework across the company's personnel.

Chapter 14 addresses the scope, enforceability, and drafting of non-compete and non-solicitation provisions in detail. The point at formation is that these documents should be executed at or before entity formation, not after the company has been operating and the question of what specific confidential information exists has grown harder to define.

Spousal Consent

In community property states, which are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin, a founding partner's membership interest may be

treated as community property under state family law, giving the partner's spouse a potential community property claim to a share of the interest, in many of those states up to half, in a divorce. The operating agreement's transfer restrictions do not eliminate this risk, because a divorce court can order a transfer of the community property interest to the non-partner spouse regardless of what the operating agreement says about transfers.

The most practical protection is a spousal consent document, in which the partner's spouse acknowledges the operating agreement's transfer restrictions, consents to being bound by them in a divorce, and acknowledges that any community property interest is subject to the buyout provisions of the operating agreement rather than the general transfer provisions of state family law.

Spousal consent documents are not ironclad. A divorce court that finds the provisions unconscionable, or that applies its own equitable authority, may override them. But they are a meaningful and commonly used tool for managing a real and frequently overlooked risk, and they should be executed at formation, while the relationships are in good standing and no one objects to signing.

The Formation Sequence: A Step-by-Step Process

With the structural decisions of this chapter made and the partner-level conversations of Chapters 1 and 2 complete, the founding team is ready to engage legal counsel and run the formation sequence. The steps below reflect the recommended order of operations, recognizing that the actual timeline will depend on counsel availability and the complexity of the chosen structure.

Step 1: Finalize the entity chart and Partners' Term Sheet. Before any document is drafted, prepare the complete entity chart showing every proposed entity, its type, its state of formation, and its ownership. Review it with both legal counsel and the CPA to confirm the structure achieves the desired liability, tax, and governance outcomes. The Partners' Term Sheet from Chapter 1 gives counsel the brief for the operating agreement.

Step 2: Form the operating company. File the certificate of formation or articles of organization for the operating company in the chosen state. Obtain its EIN. Engage a registered agent in the state of formation and any states where the company will conduct business. Begin the operating agreement drafting process, which will take several weeks of drafting, review, and revision before execution.

Step 3: Form the GP or sponsor entity, if applicable. If the business model decisions of Chapter 2 call for a separate GP or sponsor entity, file its certificate of formation in Delaware and obtain its EIN. Draft its operating agreement with particular attention to the promoted interest allocation among the founders and the governance provisions that apply specifically to the GP's management of deal vehicles.

Step 4: Execute all partner-level documents. Before any business activity begins, execute the equity grant agreements, IP assignment agreements, confidentiality and non-solicitation agreements, and spousal consent documents in community property states. These should be dated concurrent with or before the formation date.

Step 5: Open bank accounts. Open separate accounts for the operating company and the GP entity with an appropriate commercial bank. Establish signature authority that matches the operating agreement's governance provisions. Do not deposit investor funds into any account until the securities law compliance infrastructure is in place, as Chapter 19 describes.

Step 6: File foreign qualifications. File foreign qualification registrations in every state where the operating company or GP entity will conduct business. Appoint registered agents in each

additional state. Note the annual filing deadlines and fees for each state and add them to the company's compliance calendar.

Step 7: Complete state tax registrations and licenses. Register with state tax authorities as required and obtain any required business licenses. Confirm whether any real estate, contractor, or property management licenses are required in the company's operating states, and start those applications if needed.

Step 8: Establish the deal-level SPE template. Work with counsel to prepare a standard-form operating agreement for deal-level SPEs. Having a template ready before the first deal is under contract lets the company form and populate each deal entity quickly when a transaction moves to closing, rather than drafting deal documents from scratch under a closing deadline.

The True Cost of Formation Shortcuts

Formation shortcuts, whether template operating agreements, single-entity structures pressed into multiple purposes, formation without a completed Partners' Term Sheet, or delaying partner-level documents until after operations begin, are among the most reliably expensive decisions a development company can make. The legal fees for a thorough formation are paid once. The legal fees for litigating a partnership dispute that proper documents would have prevented are paid repeatedly, over years, by partners who have become adversaries.

A comprehensive operating company formation, including the operating agreement, partner-level documents, and entity formation, typically costs between $20,000 and $55,000 in legal fees from an experienced firm. Adding the GP entity and its operating agreement adds another $8,000 to $20,000. Preparing a deal-level SPE template adds $5,000 to $12,000. For a company that may manage hundreds of millions of dollars in projects over its life, these are not large costs.

The cost of correcting a poorly structured formation after the company has been operating, including restructuring entities, redrafting operating agreements that have already generated disputes, and addressing securities law violations from undocumented investor transactions, consistently runs two to five times the cost of getting it right the first time. Formation is an investment with one of the highest expected returns in the company's entire history.

CHAPTER 3: KEY TAKEAWAYS

1. The limited liability company is the dominant entity type for the operating company, the GP or sponsor entity, and the deal-level SPEs, because it combines liability protection, pass-through taxation, and governance flexibility in a way no other type matches. The limited partnership fits specific fund vehicles aimed at institutional investors. Corporations are almost never the right answer.
2. The series LLC is useful in specific circumstances but carries unsettled law and lender acceptance challenges that make it unsuitable as a default. Adopt it deliberately, with experienced counsel, only where it offers real advantages over forming separate SPEs.
3. A company that raises outside capital benefits from a two-entity architecture: an operating company that runs the management business and a separate GP or sponsor entity that sponsors each deal vehicle. The separation delivers liability containment,

regulatory positioning, investor due diligence credibility, and carry allocation flexibility that a single entity cannot.

4. Delaware is the preferred state of formation for the GP or sponsor entity and for operating companies expected to seek institutional capital, work with sophisticated lenders, or raise outside capital. The home-state foreign qualification requirement adds modest annual cost that the advantages of Delaware formation more than justify.
5. Every development project, and certainly every project with outside investors, should sit in a separate single-purpose entity. Construction lenders require it, it isolates liability between projects, it enables deal-specific tax planning, and it keeps investor economics clean and separate.
6. Partner-level formation documents, including equity grant agreements, IP assignment agreements, confidentiality and non-solicitation agreements, and spousal consent documents in community property states, are not optional add-ons. They protect the company against specific failure modes the entity-level documents do not address.
7. The formation sequence matters. Finalize the entity chart and Partners' Term Sheet before counsel begins drafting. Form the operating company and GP entity before any business activity begins. Execute partner-level documents concurrent with formation. Open bank accounts before any funds are received. File foreign qualifications before conducting business in any state other than the state of formation.
8. Formation shortcuts are among the most reliably expensive decisions a development company can make. A comprehensive formation engagement covering the operating company, the GP entity, and a deal-level SPE template runs roughly $33,000 to $87,000 in legal fees from experienced counsel. Correcting a poorly structured formation consistently runs two to five times that amount.

WHAT COMES NEXT

Chapter 4 takes up the operating agreement in depth: the eleven provisions every real estate company operating agreement must contain, why template agreements are almost always inadequate, and how the agreement's specific provisions create the governance framework, the economic arrangement, and the dispute resolution mechanisms that protect every founding partner over the life of the business. The operating agreement is the company's most important document, and Chapter 4 treats it with the depth that importance requires.

See also: *Appendix B (Entity Structure Comparison) • Appendix H (Formation Documents Checklist) • Appendix J (Glossary: LLC, LP, series LLC, SPE, foreign qualification, GP, operating agreement)*

CH. 4

PART II: ENTITY STRUCTURE & FORMATION ARCHITECTURE

The Operating Agreement:

The Company's Foundational Document

What the operating agreement must cover, why template agreements are almost always inadequate, and how a comprehensive, negotiated agreement protects every founding partner over the life of the business.

The operating agreement is the governing document of the development company's partnership. It defines who owns what, who can do what, what happens when partners disagree, and what happens when someone wants to leave. It is the document that the founders' heirs, lenders, investors, and opposing counsel will read most carefully when something goes wrong. It is also the document most often treated as a formality, signed quickly so the company can get on with the work that feels more pressing.

This chapter takes the operating agreement seriously. It works through the eleven provisions that every development company operating agreement must address, explains what each one does, describes the state law defaults that govern when a provision is missing or vague, and identifies the questions the founding partners must answer before their attorney can draft a provision that actually serves them. The aim is not to turn founders into lawyers. It is to produce founders who understand what they are signing.

What an Operating Agreement Is and What It Governs

An operating agreement is the contract among the members of a limited liability company that governs the company's internal affairs. It is the LLC's counterpart to a corporation's bylaws and shareholder agreement combined, a single document that sets both the operational rules by which the company is managed and the rights and obligations of the owners toward one another and toward the company. It governs, among other things:

- The ownership interests of each member, including their percentage interests, the classes of interests if more than one exists, and the economic rights attached to each class.
- How the company is managed, whether by a designated manager or managing member with authority to act on the company's behalf or collectively by all members.
- What decisions require what level of approval, from routine operational matters any officer can handle to fundamental decisions that require unanimous member consent.
- How profits, losses, and distributions are allocated among the members, whether proportionally to ownership or in some other agreed manner.
- What happens when a member wants to sell or transfer an interest, including whether the remaining members hold a right of first refusal, what restrictions apply, and what approvals are required.
- What happens when a member dies, becomes disabled, divorces, goes bankrupt, or is removed for cause, covering the full range of departure scenarios and the economic and governance consequences of each.
- How disputes between members are resolved, from good-faith negotiation through mediation and arbitration, and the deadlock mechanisms that keep governance gridlock from destroying the company.

- The protections each member holds against overreach by the majority or the manager, including information rights, veto rights over fundamental decisions, appraisal rights, and the right to seek judicial relief.

The operating agreement is not a template exercise. It is the product of the founding team's specific decisions about how they want the company governed, translated into enforceable provisions by experienced counsel. A well-drafted agreement reflects decisions the team has made and agreed on explicitly. A poorly drafted one, or worse, a template that was never reviewed or customized, reflects decisions the team never actually made, because the state law defaults fill the gaps in their place.

The Consequences of Operating Without One

In most states an LLC can be validly formed and legally operated without ever executing an operating agreement. The articles of organization, the filing that creates the entity, are the only required document. Everything else is optional as a matter of state filing requirements.

That optionality is a trap. An LLC operating without an executed agreement is governed entirely by the state's default LLC statute, which was written to fill gaps for parties who failed to address something, not to serve as the affirmative governance framework for a professional real estate partnership. The defaults in most states do the following:

- Distribute profits and losses equally among all members regardless of capital contributions, which produces absurd results for a partnership where one partner contributed $2 million and another contributed no capital.
- Require the consent of all members for nearly every significant decision, including ones most companies would want to delegate to a managing partner for efficiency.
- Offer almost no guidance on what happens when a member dies, becomes incapacitated, divorces, or wants out, leaving those questions to be worked out in real time, under pressure, with no pre-agreed framework.
- Create no vesting schedule or buyback right, so a partner who leaves after six months takes their full equity interest with them.
- Allow any member, in some states, to withdraw and demand a return of their contribution, which could force the company to liquidate assets or borrow to buy out a departing member at the worst possible time.

Operating without an agreement is most common among teams who are eager to start and view the agreement as a bureaucratic delay. It is a form of optimism that assumes everything will go well and no one will ever need to consult the document. Real estate development is a business where things regularly do not go as planned, where partners' circumstances change, and where the absence of a pre-agreed framework for handling those changes makes them more expensive and more damaging every time.

The Template Operating Agreement Problem

Many founding teams use a template operating agreement, pulled from a legal form website, adapted from a prior company's agreement, or supplied by an online incorporation service, on the theory that any written document beats none. That theory is partly right. A written document of some kind is better than nothing. But a template that was not drafted for a development company, that does not reflect the team's actual agreements, or that

contains provisions the founders never read and do not understand creates its own category of risk.

Templates are built for broad applicability across many business types and many states. They are not built for the governance issues specific to a development company: the project-level approval process, the related-party transaction policy for construction contracts, the treatment of development management fees among partners with different project roles, or the mechanics of buying out a partner whose project went sideways and whose continuation in the partnership has become untenable.

The test of a properly drafted operating agreement is not whether it exists. It is whether, when a specific hard situation arises, a partner's death, a disputed project decision, a partner demanding to be bought out, the document gives a clear, workable answer that all parties accept as having been agreed. A template fails that test more often than it passes.

The Eleven Provisions Every Real Estate Company Operating Agreement Must Address

The sections below cover the eleven categories of provision that belong in every development company operating agreement. Each appears as a provision card identifying the purpose, the state law default that governs in its absence, and what the founding team must specify for the provision to do its job. The depth of treatment varies, since some require more detail than others, but all eleven are essential.

Defined Terms and Entity Information

§1

Defined Terms, Entity Information & Recitals

Purpose. Establish the company's identity, the names and ownership percentages of all members, and precise definitions of the key terms used throughout the document, so that every provision means what the parties intended.

State law default. *State law defines some terms by statute but leaves most business-specific terms undefined. Without defined terms, provisions that use them become ambiguous and contested.*

What to specify. The company's legal name, state of formation, principal office, and registered agent. Each member's legal name, membership interest percentage, and initial capital contribution. Definitions of every term used with a specific intended meaning, including Majority, Supermajority, Cause, Transfer, Permitted Transfer, Fair Market Value, Development Project, and Related Party Transaction. The defined terms section is the least exciting part of the agreement and the one that produces the most disputes when it is inadequate.

Founding teams who read the agreement at a high level consistently underrate defined terms. Consider an undefined Majority in a three-member LLC. Does it mean a majority of the members by count, two of three; a majority of the membership interests by percentage, more than 50 percent of economic ownership; or a majority of the members present at a validly convened meeting with a quorum? Those are three different outcomes. If the agreement is silent and the three members hold 40 percent, 35 percent, and 25 percent, a vote on a critical decision could go differently depending on which reading applies.

The recitals should also state the company's intended business purpose, not as a rigid constraint but as a shared statement of intent that gives interpretive context to every other provision. For a development company, the recitals should describe the type of development the company intends to do, the geographic markets it will operate in, and whether it will raise outside investor capital.

Capital Contributions and Capital Accounts

§2

Capital Contributions, Capital Accounts & Additional Capital

Purpose. Document each member's initial capital contribution and the ongoing framework for capital account maintenance, additional contributions, and the consequences of failing to fund a capital call.

State law default. *Most states default to equal profit and loss allocation regardless of capital contributions, which is almost never what a development company intends. There is typically no default mandatory capital call mechanism.*

What to specify. The specific dollar amount, form (cash, property, or services), and deadline for each member's initial contribution. The method for maintaining capital accounts consistent with the substantial economic effect rules of IRC Section 704(b). The circumstances under which additional contributions can be required, including who has authority to make the call, the notice period, and the partner approval threshold. The consequences of failing to fund a call, including whether and how the non-funding member's interest is diluted, whether the funding members can treat the shortfall as a loan at a penalty rate, and whether sustained non-funding triggers a buyout right.

Capital account maintenance deserves attention because it serves two purposes founding teams often do not fully grasp. First, capital accounts track each member's economic interest for the substantial economic effect rules, the Treasury Regulations under IRC Section 704(b) that decide whether a partnership's allocations will be respected for tax purposes. An agreement that allocates losses to a member whose capital account cannot absorb them without going negative, absent a deficit restoration obligation or a qualified income offset, may have those allocations disregarded by the IRS, with unexpected tax results for everyone. This calls for coordination between the agreement's economic provisions and the tax provisions drafted with the company's CPA.

Second, capital accounts determine distribution rights in a liquidation. When the company winds down and distributes its remaining assets, members receive distributions according to their positive capital account balances rather than their percentage interests. In a company that has allocated significant losses or depreciation to certain members, the capital account balances and the percentage interests can diverge substantially, so the liquidation distributions differ from what the percentages would suggest. This is by design, and it surprises founders who have not thought it through.

Profit, Loss, and Distribution Allocations

§3

Allocations of Profit, Loss & Distributions

Purpose. Define how the company's economic results, both taxable income and loss and actual cash for distribution, are divided among the members.

State law default. *Most states default to allocating profits and losses in proportion to capital contributions; some default to equal allocation regardless of contributions. Neither reflects what most development partnerships intend.*

What to specify. The allocation of net profits and losses for tax purposes, typically in proportion to each member's interest percentage but subject to the substantial economic effect rules of Section 704(b) and the special allocation rules of Section 704(c) for contributed property. The timing and priority of distributions, including when they are made (quarterly, annually, or deal by deal), who approves them, and the minimum cash reserve required first. Whether distributions are pro rata to percentage interests or subject to a preferred return, a guaranteed minimum, or a waterfall that prioritizes one class over another. The mandatory tax distribution provision: the formula by which the company makes minimum distributions to cover members' estimated taxes on phantom income.

The mandatory tax distribution provision deserves particular attention, because it addresses one of the most disruptive features of pass-through taxation. A development company that generates taxable income, from fees, from cancellation of debt, or from depreciation recapture on a disposition, allocates that income to its members on their K-1s, creating a tax liability for each member whether or not any cash was distributed to fund it. The mandatory tax distribution provision requires the company to make a minimum cash distribution to each member, calculated as their allocable share of taxable income multiplied by an assumed combined federal and state tax rate, so members have the cash to pay the tax without dipping into personal reserves.

This should be one of the first things the team discusses when reviewing the draft. Without it, in any year the company generates taxable income without matching cash distributions, which is common in development, members owe tax from their own pockets. For partners drawing below-market compensation in the early years, an unexpected tax bill on phantom income can cause real personal hardship.

Management Structure and Authority

§4

Management Structure, Authority & Decision-Making

Purpose. Define how the company is managed day to day, who can act on its behalf without prior approval, and what decisions require member approval at various thresholds.

State law default. *Most states default to a member-managed structure in which all members have equal management rights and authority to bind the company regardless of ownership percentage. That default is rarely appropriate for a multi-member development company.*

What to specify. Whether the company is member-managed or manager-managed. For most professional development companies, a manager-managed structure with a designated Managing Member or Managing Partner who holds day-to-day authority works better than one that requires collective consent for everything. The scope of the manager's authority: what the manager can do alone, such as routine contracts below a defined dollar threshold, routine hiring, and operational decisions within an approved budget, and what requires member approval. Which decisions require majority approval, which require a supermajority, and which require unanimous consent. The process for removing or replacing the manager. Officer roles and their authority.

The decision authority framework is covered in depth in Chapter 8, because it is one of the most consequential governance choices the team will make. For the operating agreement, the key point is that the decision authority provisions have to be specific enough to actually govern. A provision

giving the manager authority over ordinary course decisions, without defining ordinary course, has resolved nothing. It has created a framework for arguing about whether any given decision falls inside or outside an undefined category.

Specific dollar thresholds are the most workable approach. The manager can sign contracts up to $50,000 without member approval; contracts between $50,000 and $250,000 require majority approval; contracts above $250,000 require a supermajority. Paired with a list of decisions that always require a defined approval threshold regardless of dollar amount, such as hiring and firing key personnel, acquiring or disposing of real property, incurring debt above a defined amount, commencing or settling litigation, and entering related-party transactions, this approach produces a governance framework that functions.

Transfer Restrictions and Permitted Transfers

§5

Transfer Restrictions, ROFR & Permitted Transfers

Purpose. Control who can own membership interests by restricting voluntary transfers, establishing a right of first refusal for the remaining members, and defining the limited transfers permitted without full member approval.

State law default. *Most states let a member transfer the economic interest in an LLC by default, the right to receive distributions, but not the governance rights, which require the other members' consent. That default is often inadequate, because it lets a member sell the economic interest to an outsider while the remaining members are stuck with a financial partner they did not choose.*

What to specify. A complete prohibition on voluntary transfers during a defined lock-up period after formation, with limited exceptions for estate-planning transfers to revocable trusts or wholly owned entities. A right of first refusal after the lock-up: any member wishing to transfer must first offer the interest to the others on the same terms as the proposed third-party sale. The ROFR mechanics: notice period, exercise period, purchase mechanics, and what happens if it is not exercised. The limited categories of permitted transfers. A prohibition on indirect transfers that would circumvent the direct restrictions.

Founders often think of transfer restrictions as purely defensive, a way to keep unwanted parties out. They matter just as much as an internal governance tool. A company where a founding partner can quietly sell part of an interest to a third party takes on governance complexity the others never bargained for, shifts the balance of economic interests, and can create securities law problems if the interest is sold without the appropriate investor qualification procedures.

The estate-planning exceptions are important and should be drafted carefully. A transfer to a revocable trust in which the member is the sole trustee and sole current beneficiary is functionally the same as the member continuing to hold the interest, since the same person controls the trust. The agreement should permit transfers to trusts or entities only if the member keeps exclusive control of the transferee, and should require the transferee to execute and be bound by the operating agreement before the transfer is complete.

Member Departure: Resignation, Removal, Death, Disability, and Divorce

§6

Member Departure: All Scenarios and Their Consequences

Purpose. Provide a complete framework for every scenario in which a member's relationship with the company changes, by choice or otherwise, so the company

can keep operating and the departing member's interest can be valued and transferred without a legal crisis.

State law default. *State law defaults on departure are inconsistent, often punitive, and almost never designed for a professional partnership. Some states let members withdraw and demand liquidating distributions; others restrict withdrawal but give no guidance on valuation or buyout mechanics.*

What to specify. Voluntary resignation, including the consequences of leaving before full vesting (forfeiture of unvested interests or buyback at cost) versus after (buyback at fair market value on a defined timeline). Termination for cause, including a specific and objective definition of cause, the determination process, cure periods for remediable breaches, and the economic consequences. Good leaver versus bad leaver treatment. Death: the economic interest passes to the estate while governance rights do not, with life-insurance-funded buyout mechanics and a timeline for the estate to sell back the interest. Disability: a defined standard confirmed by independent medical evaluation, the transition of management authority, and the buyout mechanics. Divorce in community property states: the spousal consent requirement, the restriction on transfer to a divorcing spouse, and the buyout obligation if a court orders a transfer.

The definition of cause is the most litigated single provision in the departure section of any operating agreement. The team should insist on a specific, objective definition that resists weaponization by the majority against a minority partner who has simply fallen out of favor. A workable definition of cause typically requires one of the following: conviction of a felony; fraud or willful material misrepresentation regarding the company's affairs; gross negligence or willful misconduct causing material harm to the company; or a material, uncured breach of the operating agreement, with a defined cure period of at least 30 days after notice.

A vague definition, such as conduct detrimental to the company's best interests or failure to meet performance expectations, hands the majority the ability to manufacture a cause determination and trigger bad leaver consequences against a partner it simply wants out. The cure period matters just as much. Requiring written notice of the alleged breach and a defined window, commonly 30 to 60 days, in which the affected partner can cure before the determination becomes final keeps the cause mechanism from being used as a surprise ambush.

Vesting of Membership Interests

§7

Vesting Schedules, Cliff Provisions & Acceleration

Purpose. Protect the company against the departure of a founding partner before they have delivered the value their equity allocation anticipated, by making that equity earned over time through continued service.

State law default. *State law has no concept of vesting for LLC membership interests. Without a specific vesting provision, a member who leaves on the company's first day takes 100 percent of their interest with them.*

What to specify. The vesting schedule, including the period over which each interest vests (commonly four years), whether vesting is time-based, milestone-based, or a hybrid, and the cadence of vesting after the cliff (monthly or quarterly). The cliff, including the minimum service period before any vesting (commonly twelve months), the consequence of leaving before it (forfeiture of all interests), and the amount that vests on the cliff date (commonly 25 percent).

Acceleration: whether unvested interests accelerate on a change of control alone (single trigger) or only on a change of control plus involuntary termination (double trigger), and whether they accelerate on involuntary termination without cause. The treatment of unvested interests on departure: forfeiture, repurchase at cost, or repurchase at fair market value depending on the circumstances. The Section 83(b) election: whether the member should file within 30 days of receiving the interest to start the capital gains holding period.

Vesting is the provision that most effectively protects a multi-partner development company against one of its most common failure modes: a founding partner who receives significant equity at formation, contributes for a year or two, and then leaves, taking a permanent ownership stake in a business whose later value was built almost entirely by the partners who stayed.

Without vesting, a two-partner company where Partner A departs after 14 months still has Partner A as a 50 percent owner, entitled to distributions, information rights, and potentially approval rights over major decisions. Partner B, who stayed and built the company, must either live with a passive and possibly obstructive co-owner or fund a buyout at the current market value of those interests, a price that reflects the value Partner B has created since Partner A left.

The Section 83(b) election needs particular care, because it carries a hard 30-day deadline from the date the interest is received. Interests granted subject to a vesting schedule are treated as substantially nonvested restricted property under IRC Section 83. If the member does not file an 83(b) election within 30 days, the tax treatment defaults to income recognition at each vesting date equal to the fair market value of the interest on that date. A timely 83(b) election causes the member to recognize income, if any, at the grant date based on the interest's value then, typically zero for a newly formed company with no established value, and starts the capital gains holding period running from the grant date. Missing the 30-day window eliminates this option permanently, and it cannot be corrected.

Fiduciary Duties, Conflicts of Interest, and Related-Party Transactions

§8

Fiduciary Duties, Conflict Policies & Related-Party Transactions

Purpose. Define what the managing member and other members owe to the company and to each other, how conflicts are disclosed and managed, and the process for transacting with related parties.

State law default. *Delaware law imposes default duties of loyalty and care on LLC managers and managing members. These can be modified, but not eliminated entirely, through the operating agreement. Other states vary in their default framework.*

What to specify. The scope of each member's and the manager's fiduciary duties, including whether the agreement modifies the default duty of loyalty (for example, to permit outside business activities that would otherwise violate it) or the duty of care (for example, to limit liability to gross negligence rather than ordinary negligence). The corporate opportunity doctrine as applied to the company: must a member offer the company every opportunity within its investment criteria, or may the member pursue what the company declines, and what is the disclosure process. The related-party transaction policy: any transaction between the company and a member or a member's affiliate must be disclosed in writing to all members, approved by the disinterested members of the management committee, and on terms no less favorable to the company than an

unrelated third party would offer. Outside business activities and what requires disclosure or consent.

The corporate opportunity doctrine matters especially for a development company, where individual partners are constantly exposed to opportunities through their market relationships, site visits, and broker contacts. The doctrine requires a partner who learns of an opportunity within the company's investment criteria to offer it to the company before pursuing it personally. If the company declines or cannot pursue it, the partner may then take it individually.

The key drafting question is how broadly the company's investment criteria are defined for this purpose. A company that defines its criteria as any real estate development opportunity in Texas has effectively barred its partners from pursuing any Texas development deal individually, which may be more restrictive than they intended. A company that defines its criteria narrowly, such as multifamily development of 100 units or more within the Dallas city limits, gives its partners much more individual latitude.

The related-party transaction policy is just as important and deserves careful drafting for a development company, where related-party transactions are common: a partner whose family owns a construction company; a partner who is also a licensed broker receiving a commission on a company acquisition; a partner whose separate firm provides property management to the company's projects. Each creates a potential conflict that should be managed through disclosure and disinterested committee approval rather than prohibited outright.

Information Rights, Books, and Records

§9

Information Rights, Books, Records & Reporting

Purpose. Ensure every member has access to the financial information and company records they need to understand their investment, monitor management, and exercise their governance rights.

State law default. *State law gives members a right to inspect books and records, but the scope of that right, the notice required, and the format of the information are not always clear under the default.*

What to specify. The specific reports each member receives, including monthly bank statements, quarterly unaudited financial statements, annual tax returns and K-1s by a defined date, and audited or reviewed financial statements if applicable. The timeline for each report, such as quarterly financials within 45 days of quarter-end, annual financials within 90 days of year-end, and K-1s by a stated delivery date. The right of any member to inspect the books and records on reasonable notice during business hours. Confidentiality obligations on information obtained through inspection. The standard for financial statement preparation: GAAP-based audited statements where outside investors or lenders require them, or tax-basis statements where the company is purely partner-funded.

From the partners' personal tax planning perspective, the K-1 delivery deadline is one of the most operationally important provisions in the whole agreement. Partners cannot file their individual returns until they receive the company's K-1, the document that reports their share of the company's income, deductions, and credits for the year. An agreement that says nothing about the K-1 delivery date leaves the partners dependent on the company's goodwill and operational

efficiency, which may fall short when the company is running several active projects with complex tax attributes.

For a company that raises outside investor capital, the information rights provision also has to account for investor-level reporting, usually handled in the deal-level SPE operating agreements rather than the operating company's, and it should be consistent with what the private placement memorandum represents to investors about reporting frequency and format.

Dispute Resolution and Deadlock Mechanisms

§10

Dispute Resolution, Mediation, Arbitration & Deadlock

Purpose. Provide clear, efficient mechanisms for resolving partner disputes without litigation, and specific procedures for breaking governance deadlocks that would otherwise stop the company from making necessary decisions.

State law default. *Without a dispute resolution provision, partner disputes are resolved through litigation in the courts of the state whose law governs the agreement. Litigation is expensive, slow, public, and badly damaging to business relationships.*

What to specify. The escalation process: a mandatory good-faith negotiation period (commonly 30 days), then mandatory non-binding mediation, then binding arbitration under defined rules (JAMS or AAA) as the final forum for all disputes other than those seeking injunctive or declaratory relief. An equitable relief carve-out that lets any party seek injunctive relief or specific performance in a court of competent jurisdiction, without going through arbitration, for disputes involving irreparable harm, such as breach of a non-compete, misappropriation of trade secrets, or unauthorized use of company funds. Deadlock provisions: a definition of deadlock, the conditions that trigger a remedy, and the chosen mechanism (shotgun buy-sell, appraisal-based buyout, or independent tie-breaker). The seat of arbitration and the governing law.

Deadlock is the governance failure mode that most threatens a development company's ability to function. A two-partner company with a 50/50 ownership split, the most common structure for a two-partner founding team, is exposed to deadlock on any decision that requires majority approval, since either partner can block it by withholding a vote. Without a deadlock mechanism, a genuine disagreement over a material decision, whether to proceed with a project, whether to hire a particular executive, whether to accept a joint venture offer, can paralyze the company indefinitely.

The shotgun buy-sell, described in full in Chapter 17, is the most commonly used deadlock tool for two-partner companies. Its mechanics are worth understanding: one partner names a price per unit at which they are willing either to buy the other's interest or to sell their own, and the other partner then chooses whether to buy or sell at that price. Because the naming partner does not know which side of the trade they will end up on, the mechanism creates a strong incentive to name a fair price.

The shotgun mechanism has a known weakness: it favors the financially stronger party, who can credibly threaten to buy at any price the other names. A founding team with very different financial resources should discuss this asymmetry honestly before choosing the shotgun, and should consider whether an appraisal-based buyout or an independent tie-breaker fits their circumstances better. Chapter 17 addresses each mechanism in detail.

Dissolution and Wind-Down Procedures

§11

Dissolution, Wind-Down & Liquidation

Purpose. Define when the company will be dissolved, how its operations are wound down and obligations satisfied, and the order in which remaining assets are distributed to members after all debts are paid.

State law default. *State law provides for judicial dissolution in certain circumstances (deadlock, fraudulent conduct, inability to carry on the business) but does not address voluntary dissolution in detail. Without a provision, the wind-down follows statutory defaults that may not reflect what the partners want.*

What to specify. The events that trigger voluntary dissolution: a unanimous member vote, the written agreement of a supermajority, achievement of the stated business purpose, or expiration of a defined term. The wind-down process: who manages the liquidation, the order in which liabilities are satisfied, and how remaining assets are distributed. The order of distribution in liquidation, typically third-party creditors first, then debts to members such as partner loans, then members in proportion to positive capital account balances. A prohibition on distributions that would render the company insolvent. Provisions for contingent liabilities that may not be known at the time of dissolution.

The dissolution provision is the one most teams assume they will never need and the one that becomes most critical when the partnership reaches the end of its natural or forced life. For a development company with active projects at dissolution, projects under construction, projects with committed investor capital, projects subject to lender loan agreements, the wind-down is not a matter of distributing leftover cash. It involves completing or selling projects, satisfying lender obligations, managing investor relationships through the wind-down of each deal vehicle, and handling the regulatory obligations that attach to securities offerings as they are concluded.

The provision should address in-process projects directly: the company's obligation to complete projects underway, the members' obligations to support that completion from personal resources if company funds fall short, and the timeline within which the remaining assets of each project entity are distributed after its wind-down.

The Operating Agreement for the GP or Sponsor Entity

The discussion above covers the operating agreement for the primary operating company, the entity in which the founders hold their equity and whose agreement governs their relationship with one another. If the company uses a two-entity architecture, as discussed in Chapter 3, the GP or sponsor entity needs its own operating agreement, and that document carries specific provisions distinct from the operating company's.

What the GP Entity Operating Agreement Must Address

The GP entity's operating agreement governs its relationship with the deals it manages and the promoted interest it earns. Its most important provision, and the one most often left ambiguous in the rush to form the entities and begin operating, is the allocation of the promoted interest among the founders for each deal or fund the GP entity manages. The agreement must address:

- The allocation of carried interest or promoted interest among the founders for each deal or fund: equal division, proportional to ownership in the operating company, role-based (the deal-sourcing partner takes a larger share of carry from deals they sourced), or a hybrid. This allocation need not match the equity percentages in the operating company, and it should

reflect the founders' honest assessment of who creates the most value in deal-by-deal execution.

- The conditions under which a partner's carry participation is reduced or eliminated. If a partner leaves, do they keep their carry on deals closed before departure? On deals in negotiation at departure? On future deals? The answer shapes both the economic framework and the departing partner's incentive to cooperate in a clean transition.
- The clawback obligation at the partner level. If the GP entity has to return carried interest distributions to investors because a deal underperformed, how is that obligation shared among the founders? Does each bear it in proportion to their carry receipt, or under a more complex allocation? Is it funded from each partner's personal resources or from a carry escrow the GP entity maintains?
- Management authority over the GP entity's activities: who can execute deal documents on its behalf, who can commit it to a new deal, and what approval is required before it enters a new investment management relationship.

The Undocumented Carry Agreement: The Most Expensive Omission in Development Company Formation

Of all the provisions founding teams leave out of their agreements, the failure to document the carry allocation in the GP entity's operating agreement is the most reliably expensive. The carry is often the single largest source of economic value in the entire structure, the performance-based reward for creating investor returns, and over the life of a successful platform it typically dwarfs fee income. Yet it is the provision most commonly left to a verbal understanding that each partner remembers differently three years later.

The scenario recurs with grim regularity. Two or three partners form a company. They discuss how the carry will be shared, and each leaves with a clear memory of the conversation, but no one writes it down and no one asks the attorney to put it in the GP entity's operating agreement, because everyone feels good about the relationship and the document seems fine without it. The company succeeds. The first fund generates a meaningful carried interest distribution. The partners discover, at the exact point when the money becomes real, that they remember the agreement differently.

The cost of that discovery includes legal fees for a dispute that can easily run to several hundred thousand dollars per side in arbitration, damage to the partner relationship that is rarely repaired, and the distraction from operations during what should be a period of celebration and reinvestment. The cost of documenting the carry allocation at formation is a few additional hours of attorney time, usually included in the standard operating agreement drafting engagement.

What the GP Entity Operating Agreement Must Specify About Carry

1. The specific percentage of carried interest received by the GP entity that is allocated to each founding partner, expressed as a percentage of the total carry received, for example Partner A 50 percent, Partner B 30 percent, Partner C 20 percent.
2. Whether this allocation is uniform across all deals the GP manages, or varies by deal based on each partner's role, for example the deal-sourcing partner receiving an additional 10 percent of carry on deals they sourced, with the remainder split equally.
3. The consequences of partner departure for carry participation: which deals a departed partner continues to share in, typically deals closed before departure and sometimes deals in advanced negotiation, and which they forfeit.

4. The clawback allocation: how each partner's obligation to return carry under a clawback provision is calculated and funded.
5. The modification mechanism: what vote or approval is required to change the carry allocation for future deals, and whether any change affects deals already in progress. If the GP entity's operating agreement contains none of these provisions, the carry allocation is governed by the entity's default distribution rules, which in most states means equal distribution regardless of each partner's contribution to the deals that generated the carry. That default may not reflect what the partners intended, and by the time the question becomes live, it will be too late to agree.

The Operating Agreement as a Living Document

An operating agreement executed at formation is not fixed and permanent. It is a framework the founding team agreed to at a particular moment, under a particular set of circumstances, with a particular group of partners. As those circumstances change, as the company grows, as partners' personal situations evolve, as new partners are admitted, as the business model shifts, the agreement should be revisited and updated.

Circumstances That Trigger Operating Agreement Review

The agreement should be reviewed and potentially amended whenever any of the following arises:

- **The admission of a new partner.** Admitting a new partner changes ownership percentages, governance dynamics, and potentially the economic arrangement. The new partner's equity terms, vesting schedule, carry participation, and governance rights have to be addressed, either by amending the operating agreement or through a separate admission agreement incorporated by reference.
- **A significant change in the founders' relative roles.** If one partner takes on materially more or less operational responsibility than originally contemplated, the compensation, carry allocation, and possibly the equity allocation may need to be revisited. The agreement should provide a defined process for raising and addressing role changes, rather than leaving them to ad hoc renegotiation under pressure.
- **The company's first capital raise from outside investors.** Moving from a balance sheet model to a sponsor model, or from informal investor relationships to structured securities offerings, changes the regulatory environment and creates new obligations the agreement may not currently address.
- **A significant change in applicable law.** Tax law changes, such as the TCJA's changes to the treatment of carried interest, securities law updates, or changes in the state LLC statute may require amending provisions drafted to conform to prior law.
- **The departure or death of a partner.** Executing the departure mechanics the agreement contemplates is the right response when a departure occurs, but the remaining partners should also review whether the agreement still serves them in the changed configuration and amend it if needed.

The Amendment Process

The agreement should specify how its own provisions are amended: who may propose amendments, what threshold of member approval is required to adopt one, and whether any

provisions are super-protected and can be amended only with a higher threshold or the specific consent of the partner whose rights are affected. A common and sensible approach:

- Most provisions can be amended by a supermajority of the membership interests, for example 66.7 percent or 75 percent.
- Provisions that directly affect a specific member's individual rights, their ownership percentage, vesting schedule, or carry allocation, can be amended only with that member's written consent, regardless of what the supermajority might otherwise approve.
- Certain fundamental provisions, the dissolution events, the definition of cause, the deadlock mechanism, require unanimous consent to amend, because they exist specifically to protect every member from being overridden by the majority on the most critical questions.

The amendment process should also state that informal course-of-dealing adjustments to operations, decisions made without a formal amendment, do not amend the operating agreement unless documented in a written amendment signed by the required threshold of members. The risk of inadvertent modification by conduct is real. If the company consistently distributes profits 60/40 when the agreement specifies 50/50, a court in some jurisdictions might find the parties modified the agreement by course of dealing. An express anti-modification clause prevents that.

The Annotated Table of Contents: What a Complete Agreement Looks Like

Below is the table of contents for a comprehensive development company operating agreement, with brief annotations explaining the purpose of each article. This is not a template. It is a structural guide showing how a complete agreement is organized and what it covers.

Article	Title	Content summary
1	Definitions	All defined terms used in the agreement, including Member, Manager, Interest, Majority Interest, Supermajority Interest, Cause, Transfer, Permitted Transfer, Fair Market Value, Development Project, Related Party, and roughly 20 to 40 additional defined terms depending on the company's complexity
2	Formation	Name, state of formation, registered agent, principal place of business, purpose, and term of the company
3	Members and Capital	Initial members and their ownership percentages; initial capital contributions (amounts, forms, and deadlines); capital account maintenance methodology; additional capital call authority and mechanics; member loan provisions
4	Allocations	Allocation of net profits and losses for tax purposes; special allocations required by Sections 704(b) and 704(c); mandatory tax distribution provision; allocation of items of income, gain, loss, deduction, and credit
5	Distributions	Distribution policy and timing; priority of distributions; reserve requirement; distribution approval authority; distributions in kind
6	Management	Manager-managed structure and designation of the Managing Member; scope of the manager's unilateral authority; decisions requiring majority, supermajority, and unanimous consent; officer roles and authority; indemnification of manager and officers
7	Meetings and Voting	Annual meeting requirements; special meeting procedures; notice requirements; quorum; voting rights; written consent in lieu of meeting
8	Transfer Restrictions	Lock-up period; prohibition on voluntary transfers; right of first refusal mechanics; permitted transfer exceptions; drag-along rights; tag-along rights; indirect transfer prohibition; admission of a transferee as a member
9	Vesting and Departure	Vesting schedules for each member's interest; cliff provisions; acceleration triggers; good leaver and bad leaver definitions and consequences; departure mechanics for

Article	Title	Content summary
		resignation, termination for cause, termination without cause, death, disability, and divorce; valuation methodology for buyout; payment timeline and mechanics
10	Fiduciary Duties	Scope of the manager's and members' fiduciary duties; corporate opportunity policy; related-party transaction policy and approval process; outside business activities; confidentiality obligations
11	Information Rights	Members' right to financial reports; reporting timeline and format; inspection rights; confidentiality obligations applicable to inspection
12	Dispute Resolution	Good-faith negotiation period; mandatory mediation; binding arbitration under JAMS or AAA rules; equitable relief carve-out; governing law and seat of arbitration; deadlock definition, trigger conditions, and resolution mechanism
13	Tax Provisions	Tax elections; partnership representative designation; centralized partnership audit regime opt-out if eligible; Section 754 election; withholding obligations; tax return filing obligations
14	Dissolution and Winding Up	Events triggering voluntary dissolution; wind-down procedure; management of wind-down; order of liquidating distributions; treatment of contingent liabilities
15	Miscellaneous	Entire agreement; amendment process, including super-protected provisions; anti-modification clause; waiver; severability; counterparts; notices; governing law; integration
Exhibit A	Member Schedule	Legal names, addresses, ownership percentages, and capital contributions of each founding member
Exhibit B	Vesting Schedules	The specific vesting schedule applicable to each member, including cliff date, vesting cadence, and acceleration provisions
Exhibit C	Decision Authority Matrix	The complete table of decisions and their required approval levels, as described in Chapter 8 of this handbook

Selecting the Right Legal Counsel for Operating Agreement Drafting

The operating agreement is only as good as the attorney who drafts it. A comprehensive, properly customized agreement for a development company calls for an attorney with specific experience in real estate company formation, not a general business attorney who occasionally forms LLCs, and not a real estate transactional attorney whose practice centers on property acquisition and disposition rather than entity governance.

What to Look For

The founding team should look for counsel with the following background:

- Demonstrated experience forming real estate development and investment companies, including operating agreements with the governance provisions described in this chapter. Ask the attorney for examples of the agreements they draft and the provisions they typically include for development companies.
- Familiarity with the tax provisions of an LLC operating agreement, the capital account mechanics, the allocation provisions under Section 704(b), and the mandatory tax distribution structure, and a practice of coordinating with the client's CPA on the economic provisions. An attorney who drafts economic provisions without CPA coordination is creating tax problems the CPA will later have to diagnose and fix.
- Securities law knowledge sufficient to recognize when the company's intended activities will cross into the securities framework and to advise on the compliance implications. For a company that intends to raise outside capital, this knowledge is essential even at formation.
- A clear understanding of the Partners' Term Sheet process and a practice of drafting from a completed Term Sheet rather than starting from a standard form and modifying it to fit.

What to Bring to the Operating Agreement Drafting Engagement

The team will get the most efficient and most accurate agreement from their attorney if they arrive with:

- The completed Partners' Term Sheet from Chapter 1, covering all agreed economic and governance positions.
- The entity chart from Chapter 3, showing the proposed ownership hierarchy.
- A clear statement of which of the eleven provisions in this chapter have specific, agreed positions and which still need further partner discussion before drafting begins.
- Any provisions from prior operating agreements, at previous companies where the founders worked, that they found effective and would like to incorporate or improve on.
- The names, addresses, and ownership percentages of all founding members for the Member Schedule, Exhibit A.

The Investment Perspective on Legal Fees

A comprehensive operating agreement for a development company, drafted by experienced counsel from a detailed Partners' Term Sheet, typically costs between $15,000 and $40,000 in legal fees. For a multi-entity structure that also requires a GP entity operating agreement and a deal-level SPE template, add another $12,000 to $30,000. The total formation legal investment for a properly documented development company platform is typically $27,000 to $70,000.

The cost of resolving a partnership dispute that a properly drafted agreement would have prevented is consistently higher by an order of magnitude. Arbitration of a significant partner dispute, whether over a disputed carry allocation, a contested termination for cause, or a deadlocked company, routinely generates $200,000 to $600,000 in legal fees per side, plus the management distraction, business disruption, and reputational damage that cannot be quantified.

The operating agreement is not a cost. It is the insurance policy for the company's most important asset, the partnership itself, and the premium, the legal fees, is modest relative to the value of what it protects.

CHAPTER 4: KEY TAKEAWAYS

1. The operating agreement is the governing document of the company's partnership. It defines ownership, management authority, economic rights, departure mechanics, and dispute resolution for every significant event in the company's life. A well-drafted agreement is the founding team's most important legal investment; an inadequate one is among their most expensive mistakes.
2. Operating without an executed agreement subjects the company to state law defaults built to fill gaps, not to govern a professional real estate partnership. Those defaults distribute profits equally regardless of capital contributions, require collective consent for most decisions, and give almost no guidance on what happens when partners' circumstances change.
3. Template agreements are inadequate for most development company contexts. They are built for broad applicability across many business types and many states, not for the specific governance needs of a development company: project-level approval processes, related-party transaction policies for construction contracts, carry allocation,

and the departure mechanics that protect the company from a partner who contributed for a year and then left.

4. Eleven provisions must appear in every development company operating agreement: defined terms; capital contributions and accounts; profit, loss, and distribution allocations, including the mandatory tax distribution provision; management structure and authority; transfer restrictions and a right of first refusal; member departure mechanics for every scenario; vesting schedules with cliff and acceleration provisions; fiduciary duties, conflicts, and a related-party transaction policy; information rights and reporting; dispute resolution and deadlock mechanisms; and dissolution procedures.
5. The GP entity operating agreement needs its own provisions governing the promoted interest allocation among the founders. The failure to document the carry allocation in a specific, written provision is the most reliably expensive omission in development company formation. By the time the carry distribution becomes material, it will be too late to establish a shared recollection of what was verbally agreed.
6. The operating agreement is a living document that should be revisited whenever the company admits new partners, changes business models, raises outside capital for the first time, or experiences a significant change in the founders' relative roles. The amendment process should distinguish provisions that can change by supermajority from provisions that require the specific consent of the partner whose rights are affected.
7. The total legal investment for a properly documented development company formation, including operating agreements for both entities and a deal-level SPE template, is typically $27,000 to $70,000 from experienced counsel. The cost of litigating the disputes that inadequate documentation produces is consistently higher by an order of magnitude.

WHAT COMES NEXT

Chapter 5 completes Part II by taking up partner equity allocation in depth: how equity is divided among the founders, how it is protected through vesting schedules and cliff provisions, and how the Section 83(b) election works. Part III then turns to the economics and governance of the partnership: how profits interests and promoted interests are structured (Chapter 6), how the founders pay themselves, structure distributions, and handle capital calls (Chapter 7), and how decision-making authority is allocated through the company (Chapter 8). These chapters build on the operating agreement framework established here and address specific provisions within it in the depth they require.

See also: *Appendix A (Partners' Term Sheet Template) • Appendix D (Decision Authority Matrix) • Appendix H (Formation Documents Checklist) • Appendix J (Glossary: operating agreement, capital account, substantial economic effect, cause, deadlock)*

CH. 5

PART II: ENTITY STRUCTURE & FORMATION ARCHITECTURE

Partner Equity Allocation:

Dividing the Company

How founding equity is divided, what frameworks make that process honest and defensible, how equity is protected through vesting, and what happens to equity when a partner departs, under every scenario.

No conversation in forming a real estate company is harder than the one about equity, harder than governance, harder than compensation, harder even than what happens if a partner leaves. Those other conversations are the kind that complex problems usually are: a right answer exists somewhere, and with enough work and goodwill the partners can find it. Equity is hard in a different way. It asks each partner to value their own contribution out loud, to weigh their partners' contributions with the same candor, and to settle on a number that reflects both, with no ambiguity left to hide behind.

This chapter offers a framework for that conversation. The aim is not to make it comfortable but to make it candid and productive. Equity allocation done with care, documented correctly and protected through sensible vesting and departure mechanics, is one of the best investments a founding team can make in the long-term health of the partnership.

The Psychology of Equity Conversations

Understanding why equity conversations are consistently hard is the first step toward having one well. The difficulty is rarely analytical; it is relational. The conversation asks each partner to do two things at once that pull in opposite directions: state the value of their own contribution clearly and specifically, and assess, with equal candor, the contributions of the people they are about to trust with their professional future.

Founding teams who are friends, former colleagues, or longtime collaborators add another layer. Putting a number on each person's relative worth, which is what equity allocation ultimately does, can feel like an act of judgment that sits uneasily next to the warmth of the partnership the founders are trying to build. There is a strong social pull toward the equal split precisely because it sidesteps that judgment. Everyone gets the same amount, no one is ranked above anyone else, and the uncomfortable conversation never has to happen.

The trouble with letting social comfort drive the allocation is that equity division is not primarily a relational decision. It is a business decision with long-term legal and financial consequences. A team that picks a 50/50 split because it feels equal, rather than because the contributions are equal, has made a decision the operating agreement will enforce for years, through good markets and bad, through periods of lopsided effort, and through changes in each partner's personal circumstances that no one can foresee at formation.

The goal of this chapter is to give the founding team a structured framework that turns the equity conversation from a relational negotiation, where social dynamics distort the analysis, into a contribution-based assessment, where the specific facts about what each partner brings set the starting position for the negotiation.

Separating Three Distinct Economic Relationships

One of the most common sources of confusion in the equity conversation is the blurring of three distinct economic relationships that the operating agreement addresses separately. Founding equity, guaranteed payments or compensation, and promoted interest are not the same thing. They govern different outcomes, accumulate over different timescales, and should be negotiated independently rather than collapsed into a single ownership percentage.

Founding Equity in the Operating Company

Founding equity is the partners' long-term residual ownership interest in the management company itself. It is the claim on the company's enterprise value if the company were sold. It determines how profits are ultimately distributed to the partners once operating expenses, compensation, and all other obligations are met. And it is what a partner takes with them, to the extent it has vested, if they depart.

Founding equity should reflect the whole of each partner's contribution to building the business: capital invested, relationships brought, deal flow generated, operational expertise provided, and platform work done before formation. Because it is the long-term residual claim, it should be forward-looking as well as backward-looking, reflecting not just what has been contributed to date but what each partner is expected to contribute over the company's early years.

Guaranteed Payments and Operational Compensation

Guaranteed payments are the ongoing cash compensation the company pays its partners during operations, independent of profitability. They are the LLC equivalent of a salary. A partner who receives a $150,000 guaranteed payment per year is entitled to that payment before any profit-sharing distributions are made, whether the company earned more or less than $150,000 in profit.

Guaranteed payments should track each partner's operational role and time commitment, not their equity ownership. A partner who owns 40 percent of the equity but works half-time should not receive the same guaranteed payment as a partner who owns 35 percent and works full-time. The guaranteed payment is compensation for services; the equity distribution is the return on ownership. Conflating the two, by paying partners in proportion to equity regardless of time commitment, is a common structure that breeds resentment when one partner contributes more operationally than their equity share suggests.

Promoted Interest in Development Projects

The promoted interest, or carried interest, is the performance-based compensation earned by the GP or sponsor entity when development projects generate returns above the investors' preferred return threshold. It is governed by the GP entity's operating agreement rather than the operating company's, and its allocation among the founding partners need not mirror, and often should not mirror, their equity ownership percentages in the operating company.

Promoted interest should reflect each partner's specific contribution to the deals that generate it: who sourced the deal, who managed entitlement, who oversaw construction, who raised the investor capital. A partner who sources most of the company's deals may reasonably receive a larger share of the promoted interest than their operating company equity would suggest; a capital partner who brought significant equity but plays a smaller role in deal execution may reasonably receive less. Chapter 6 addresses promoted interest allocation in detail.

The practical upshot of separating these three relationships is that founding partners can hold genuinely asymmetric arrangements that are still fair. A partner who owns 40 percent of the company, receives a $180,000 guaranteed payment for an operational leadership role, and earns 50 percent of the promoted interest because they source most of the deals is in a very different economic position than their 40 percent equity alone would suggest. That arrangement may be

entirely appropriate given the actual structure of contributions, but it has to be documented explicitly, because the operating agreement's default is to tie every economic outcome to the equity percentage.

The Contribution Matrix: Making the Assessment Objective

The Contribution Matrix, set out in detail in Appendix C, is a structured tool for converting the equity conversation from a subjective negotiation into a documented, weighted assessment of specific contributions. Its value is not that it produces an objective answer, since equity allocation never has one, but that it creates a shared factual foundation from which the negotiation can proceed.

The matrix works in stages. The founding partners first agree on the categories of contribution relevant to their company and the weight to assign each one. Then each partner independently scores their own and the others' contributions on a consistent scale. The resulting weighted scores give the equity conversation a numerical starting point grounded in documented facts rather than vague impressions.

The Contribution Categories

For a development company, the contribution categories and their typical weight ranges are set out below. Appendix C develops these into a complete scoring worksheet.

Contribution category	What it encompasses for a development company	Typical weight range
Capital at Formation	Cash contributed to the operating company at formation; committed future co-investment in company projects; ability to provide personal guarantees on construction debt	10 to 25%
Deal Flow & Site Sourcing	Proprietary relationships with landowners, brokers, and site-control sources; a demonstrable history of generating development opportunities in the target market; a current active pipeline	15 to 25%
Track Record	An auditable history of completed development projects, including asset class, project size, cost management, delivery timing, and returns achieved, and whether that record is held as a principal or as a principal at a prior employer	10 to 20%
Investor & Capital Relationships	The depth and activity of relationships with equity capital sources; a documented history of investors committing capital to prior projects; a realistic assessment of deployable capital from the network over the next 24 months	10 to 20%
Development & Construction Expertise	Experience managing entitlement processes, design teams, and municipal relationships; a demonstrated ability to oversee construction execution, cost management, and schedule adherence	10 to 20%
Platform Development Work	Pre-formation work building the business: systems created, investor relationships cultivated, deals originated, and contracts negotiated before the partner formally joined the venture	5 to 15%
Professional & Technical Skills	Legal, accounting, engineering, technology, or other professional expertise that would otherwise be outsourced; licenses held that benefit the company	3 to 10%
Time Commitment	Full-time versus part-time; a confirmed start date; the absence of competing obligations; availability for the roles that matter most to the company's early execution	5 to 15%

The weight on each category should reflect what the company needs most at its current stage. A company at inception whose most urgent need is capital to survive the ramp-up period will weight capital more heavily than one that is already well capitalized but short on deal flow. A company building toward a capital raise will weight investor relationships more heavily than one that intends to develop on its balance sheet for the first several years.

The partners must agree on the weights before any individual scoring begins. If they cannot agree on the relative importance of each category, if one partner believes deal flow deserves 30 percent of the weight while another believes it deserves 10 percent, that disagreement should be surfaced and resolved first, because the disagreement itself is an important signal about how the partners view the relative value of each other's contributions.

Specificity as a Prerequisite

The matrix only produces useful output if the inputs are specific. The partners have to apply a discipline of specificity to their contribution descriptions that most teams resist, because it feels confrontational:

- Not "I have strong investor relationships" but "I have nine active investors who together committed $14 million to my prior four projects, and I have had preliminary conversations with five of them about participating in this company's first deal."
- Not "I have development experience" but "I served as project manager on seven multifamily projects between 2016 and 2024, with a combined construction cost of $62 million, an average cost-to-budget variance of minus 2.1 percent, and an average schedule variance of plus three weeks."
- Not "I bring capital" but "I am prepared to contribute $600,000 at formation, co-invest up to $500,000 alongside the company on each deal, and provide a personal guarantee on the first construction loan up to a limit of $3,000,000."

Specificity serves two functions. First, it forces each partner to verify their own claims, to confirm that the track record they represent is accurate, that the investor relationships are active, and that the capital commitment is affordable. A partner who discovers, while documenting their contribution, that the track record is thinner than remembered or the investor relationships less active than assumed has gained valuable information before the allocation is set rather than after.

Second, specificity gives the other partners a fair basis for evaluation. "Strong investor relationships" cannot be evaluated. Nine investors who have committed $14 million to prior projects can be, and that figure can be compared against, say, twelve investors who have committed $8 million or four who have committed $22 million. Specific, documented information lets the partners make an informed assessment rather than an impressionistic one.

Using the Matrix Without Surrendering Judgment

The Contribution Matrix produces weighted scores for each founding partner. Those scores are a starting point for the conversation, not a binding formula. The partners should review them together, discuss the underlying assumptions, and adjust for considerations the matrix cannot fully capture. Common reasons to adjust from the matrix result:

- **Future contributions the matrix cannot quantify well.** A partner who will be full-time in four months but is currently in transition is making a future commitment that current-state scoring undervalues. The allocation can account for it, subject to a milestone vesting condition that requires the partner to actually deliver it.
- **The founders' collective judgment about which contributions matter most now.** Even if the scores suggest a 45/55 split, the partners might agree that a 50/50 split better reflects the complementary nature of their contributions and the collaborative dynamic they want to build. That is a legitimate outcome of the process.
- **Negotiated adjustments for contributions that are hard to score objectively.** One partner's willingness to relocate to support the company's primary market, another's willingness to defer compensation longer than the rest, another's willingness to provide personal guarantees at a level the others cannot match. These adjustments work when they are explicit and agreed rather than implicit and assumed.

Vesting: The Operating Agreement's Most Important Partnership Protection

Vesting is the mechanism by which founding equity is earned over time rather than granted outright at formation. Without vesting, a founding partner who receives equity at formation and departs six months later takes 100 percent of it with them, a full ownership stake in a business to which they contributed for a fraction of its formative period. With vesting, the departing partner keeps only the equity actually earned through continued service, and the unvested remainder is either forfeited or bought back at a price that reflects the contribution made, not the current value of a fully contributing partner.

Vesting is not a punishment, and it does not imply the departing partner did anything wrong. It is an alignment tool. It ensures that equity granted in anticipation of long-term contribution actually tracks long-term contribution. Every professional partnership of any sophistication uses vesting for that reason.

Time-Based Vesting: The Standard Structure

Time-based vesting is the most common structure and the clearest to administer. Under a time-based schedule, each founding partner's equity vests ratably over a defined period, almost always four years in the first instance, with a one-year cliff at the start. The mechanics of the standard four-year, one-year cliff structure:

- **Before the cliff date (Month 12).** Zero equity is vested. A partner who departs for any reason before completing twelve months of service forfeits 100 percent of their equity interest, or is bought out at original cost, effectively zero for equity received for future services.
- **On the cliff date (Month 12).** 25 percent of the partner's total equity interest vests in a single tranche. This is the cliff vesting, the reward for completing the minimum commitment period.
- **After the cliff (Months 13 to 48).** The remaining 75 percent vests ratably, monthly or quarterly. Monthly vesting is more precise; quarterly is more administratively convenient. At the standard monthly rate, each month after the cliff vests about 2.08 percent of the total equity, which is one forty-eighth of the total.
- **Month 48.** The partner is fully vested. From this point there is no further forfeiture risk on departure.

Timing	Vested %	Example (40% partner)	Departure consequence
Month 6	0%	0% of company	100% forfeiture; zero interest
Month 12 (cliff)	25%	10% of company	10% retained; 30% forfeited or bought at cost
Month 18	37.5%	15% of company	15% retained; 25% forfeited or bought at cost
Month 24	50%	20% of company	20% retained; 20% forfeited or bought at cost
Month 36	75%	30% of company	30% retained; 10% forfeited or bought at cost
Month 48	100%	40% of company	Full 40% retained; no further forfeiture

The cliff serves a specific and important function. Without it, a partner who departs after six months would be entitled to one eighth of a four-year schedule, a meaningful equity stake in a company they contributed to for half a year. The cliff removes that outcome by requiring a minimum commitment period before any vesting begins. It is the operating agreement's answer to the partner

who is enthusiastic at formation but discovers, within months, that the venture is not what they expected or that another opportunity looks more attractive.

The specific parameters, the length of the total vesting period, the cliff duration, the vesting cadence, should reflect the founding team's circumstances. A team that has worked together for years before forming this entity may reasonably shorten the period to two or three years. A team that includes a partner joining from a significant prior commitment with an uncertain transition timeline may extend the cliff to 18 months.

Milestone-Based Vesting: Accountability for Role-Specific Contributions

Milestone-based vesting ties the vesting of equity to specific, defined business objectives rather than the simple passage of time. It is most useful when the team has a clear sense of each partner's primary contribution and wants the allocation to reflect actual delivery of that contribution rather than merely showing up. Milestone vesting for a development company might include:

- A deal-sourcing partner: equity vests on sourcing and closing a defined dollar volume of development projects within a defined period, for example $30 million in total project cost within the first 24 months.
- A capital-raising partner: equity vests on raising a defined amount of investor equity for the company's projects, for example $15 million in committed LP capital within 36 months.
- A construction management partner: equity vests on completing a defined number or value of projects on or near budget and schedule, for example two multifamily projects delivered within 10 percent of budget and 60 days of schedule within 48 months.

The challenge of milestone vesting is defining milestones that genuinely reflect the partner's contribution rather than market conditions outside their control. A deal volume milestone in a market that turns hostile to development is harder to hit than the same milestone in a favorable market, through no fault of the partner. An investor capital milestone in a year when institutional capital is frozen is harder than in a year when capital flows freely.

The solution is to define milestones around activities the partner controls, not purely around outcomes that depend on market conditions: specific sites under contract rather than completed deals that depend on favorable entitlement outcomes; specific investor meetings held and relationships actively cultivated, as a leading indicator of capital commitments rather than a substitute for them; specific construction phases completed rather than disposition proceeds that depend on a sale market.

Hybrid Vesting: The Recommended Approach

For most founding teams, a hybrid structure combining time-based and milestone-based elements gives the best balance between the stability of time-based vesting and the accountability of milestone-based vesting. A typical hybrid divides each partner's equity into two pools:

- **A service pool,** often 60 to 70 percent of the partner's total equity, that vests on a time-based schedule with a cliff, providing reliable accumulation for any partner who stays through the vesting period regardless of market conditions.
- **A performance pool,** the remaining 30 to 40 percent, that vests on achievement of defined milestones specific to each partner's primary role. This component creates direct accountability for the contribution that justified the partner's allocation without making all of the equity contingent on potentially uncontrollable outcomes.

The hybrid structure suits development company partnerships where partners have genuinely different roles. The deal-sourcing partner's service pool vests on time regardless of deal volume; the performance pool vests when deals actually close. The capital-raising partner's service pool vests on time; the performance pool vests when investor capital is actually committed. Each partner

has the security of knowing service will be rewarded over time and the accountability of knowing the specific promised contribution must be delivered to earn the full allocation.

Acceleration: What Happens to Unvested Equity When Something Changes

Acceleration provisions define the circumstances under which unvested equity vests earlier than the schedule would otherwise provide. They are most commonly triggered by two events: a change of control of the company, meaning a sale, merger, or acquisition, and the involuntary termination of a partner by the company without cause.

Single-trigger acceleration accelerates unvested equity on the occurrence of a defined trigger event, most commonly a change of control. A partner whose equity accelerates on a change of control is fully vested the moment the company is sold. This favors the partner and disadvantages an acquiring company, which is taking on a management team whose equity has fully vested and who therefore have less financial incentive to stay with the combined entity.

Double-trigger acceleration requires two conditions before unvested equity accelerates: typically a change of control, and the partner's termination without cause or resignation for good reason within a defined period following it, commonly 12 to 24 months. This preserves the retention value of unvested equity for an acquirer who intends to keep the management team while still protecting the partner against being forced out after a sale and losing equity they would have earned through continued service.

For the involuntary termination without cause trigger, entirely apart from any change of control, the team should agree on whether a partner removed without cause receives full acceleration of all unvested equity, partial acceleration (the cliff tranche plus some additional amount), or none. Full acceleration for involuntary termination without cause is the most partner-protective approach and reflects the principle that a partner removed through no fault of their own should not lose equity they would have earned through continued service.

Good Leaver and Bad Leaver: The Framework for Departure Consequences

Not all departures are alike. A founding partner removed by the company without cause stands in a very different position from one terminated for defrauding the company's investors. A partner who resigns after five years of full contribution is not in the same place as one who leaves after six months to join a competitor. And a partner who dies in service should not be treated like one forced out by the others through a manufactured cause determination.

The good leaver and bad leaver framework is the operating agreement's response to that reality: a structured approach that applies different economic consequences to different departure scenarios, calibrated to the degree of the partner's fault and the nature of their contribution.

The Good Leaver

A good leaver is a partner whose departure, however disruptive, does not reflect misconduct or voluntary abandonment of the business. Good leaver treatment is the more favorable of the two frameworks, typically letting the departing partner keep their vested equity at fair market value and, in some cases, receive partial or full acceleration of unvested equity. Good leaver departures typically include:

- **Death.** Always treated as a good leaver departure, regardless of other circumstances. The deceased partner's estate is entitled to the full fair market value of the vested equity interest, with unvested interests either forfeited, if the operating agreement does not provide for

acceleration on death, or accelerated, which is the more common and humane approach for a founding partner.

- **Permanent disability.** Treated as a good leaver departure when the partner cannot perform their material duties for a defined period, most commonly 120 to 180 consecutive days, or 180 days in any 12-month period, as confirmed by an independent medical evaluation. The partner keeps vested equity at fair market value; unvested equity may be forfeited or partially accelerated depending on the operating agreement.
- **Involuntary termination without cause.** A partner removed by the company through a formal removal provision, without a finding of cause. Good leaver treatment reflects the principle that the company, having chosen to end the relationship, should not at the same time strip the partner of the economic value their service generated.
- **Resignation after a defined minimum tenure.** Some operating agreements treat voluntary resignation as a good leaver departure if the partner has served for a minimum period, often the full vesting cliff, sometimes longer. This recognizes that a partner who has contributed through the company's formative years has earned the right to leave on reasonable terms even before fully vesting.

The Bad Leaver

A bad leaver is a partner whose departure reflects conduct the company is entitled to treat as a forfeiture of the favorable treatment a good leaver receives. Bad leaver consequences are materially less favorable: typically forfeiture of unvested equity and buyback of vested equity at original cost or nominal value rather than fair market value. Bad leaver departures typically include:

- **Termination for cause.** As discussed in Chapter 4, cause must be defined specifically and objectively in the operating agreement. The bad leaver consequences reflect the principle that a partner who commits fraud, willful misconduct, or a material uncured breach of the operating agreement should not benefit from the fair market value of an interest in a company they have damaged.
- **Voluntary resignation before the cliff date.** A partner who leaves voluntarily before meeting the minimum service commitment has not earned their equity, and the operating agreement can reasonably treat the departure as a bad leaver event. Some agreements treat all pre-cliff voluntary resignation as bad leaver regardless of circumstances; others distinguish resignation for good reason, such as a partner leaving because the company materially changed its business model, from resignation for no reason or to chase a competing opportunity.
- **Material breach of the non-compete or non-solicitation provisions.** A partner who leaves and immediately solicits the company's investors or hires away its employees is not merely departing; they are actively harming the company they are leaving. Bad leaver consequences reflect that harm and create a financial disincentive against it.

The Complete Departure Scenarios Table

The table below consolidates the full range of departure scenarios for a development company partnership. In a more detailed form specific to the founding team's agreed positions, it should appear as an exhibit to the operating agreement, or in Appendix E of this handbook as a standalone reference document.

Departure trigger	Leaver type	Unvested equity	Vested equity price	Governance and other consequences
Death	Good (always)	Full acceleration; estate retains 100%	FMV; paid to estate over a defined timeline	Economic interest passes to the estate; management rights do not; the estate must accept a buyout if the company elects

Departure trigger	Leaver type	Unvested equity	Vested equity price	Governance and other consequences
Permanent disability (defined)	Good	Partial or full acceleration depending on the OA	FMV; paid over 12 to 24 months	Management authority transitions immediately; the company may continue operating without the partner
Involuntary termination without cause	Good	Partial or full acceleration; company election	FMV; paid over 12 to 24 months	Non-compete and non-solicitation remain in effect; information access ceases
Voluntary resignation (post-cliff, full tenure)	Good (with time)	Forfeited; no acceleration	FMV for vested equity	Non-compete and non-solicitation remain; transition assistance may be required
Voluntary resignation (pre-cliff)	Bad	100% forfeited	Original cost or nominal value	Non-compete and non-solicitation in full effect; no transition bonus
Divorce (community property state)	Not a departure	Vesting schedule unaffected	Spouse's share subject to ROFR mechanics at FMV	The company must approve any transfer to a spouse; the spouse must execute the OA; management rights do not transfer
Bankruptcy of a partner	Bad (effectively)	Forfeited per the OA; trustee takes subject to restrictions	OA restrictions enforceable against the trustee	Immediate ROFR triggered on the bankruptcy estate's interest; the company may buy at FMV or original cost per the OA
Termination for cause	Bad	100% forfeited	Lower of original cost or nominal value	Immediate loss of all governance rights; non-compete and non-solicitation fully enforceable
Material non-compete breach	Bad	Forfeited per the OA	Below FMV; a specific penalty multiplier	The company may seek injunctive relief; an attorney fees and damages clause typically applies

Valuation Methodology for Buyouts

The most technically difficult question in the departure framework is how the company values the departing partner's equity interest for buyout purposes. The methodology chosen determines the economic outcome of every departure, good or bad, and it has real incentive effects on how willing partners are to leave voluntarily and how exposed they are to being forced out.

Fair Market Value: The Standard for Good Leaver Buyouts

Fair market value is the price at which a willing buyer and willing seller, each with reasonable knowledge of the relevant facts and neither under compulsion to transact, would agree to exchange the interest. It is the standard used in nearly all good leaver buyouts because it reflects the economic value the departing partner earned through their contribution to the business.

The difficulty is that fair market value is not self-executing. A development company's equity is not publicly traded; there is no observable market price. Fair market value has to be determined through a defined process, and that process must be specified in the operating agreement before a departure occurs. Common approaches:

- **Formula-based valuation.** The operating agreement specifies a formula, typically a multiple of trailing revenue, trailing EBITDA, or assets under management, that sets the company's total equity value, from which each partner's pro-rata interest is calculated. It is simple to administer and avoids the cost and delay of a valuation process, but the formula has to be calibrated to the actual economics of a development company. A multiple of trailing revenue can distort results for a company with lumpy, project-based revenue; a multiple of assets

under management may suit a sponsor company whose enterprise value tracks fee-generating assets.

- **Agreed valuation.** If the parties can agree on a value at the time of departure, no formal appraisal is needed. Many operating agreements provide a short negotiation window of 30 to 60 days for the company and the departing partner to agree on a price, with a formal appraisal process as the fallback if they cannot.
- **Independent appraisal.** An independent business valuator, selected through a defined process, determines the fair market value of the company and the departing partner's interest. A common process: each party selects a qualified appraiser; the two appraisers try to agree on a value; if they cannot within a defined period, they select a neutral third appraiser whose determination is binding. The independent appraisal is reliable but slow and expensive, which makes it better suited to high-stakes departures than routine ones.

Discounts Applicable to Minority Interests

In standard business valuation practice, a minority interest in a closely held company is worth less than its pro-rata share of total equity value for two reasons: the minority interest cannot control the company's operations and decision-making (the lack-of-control discount), and it is illiquid, with no ready market for it (the marketability discount). Together these discounts can reduce a minority interest's value by 20 to 40 percent or more from the pro-rata total equity value.

For good leaver buyouts of minority partners, the operating agreement should specify whether the buyout price is based on the pro-rata total equity value without minority discounts or whether standard discounts apply. Most well-negotiated agreements for professional partnerships eliminate the minority discounts for buyout purposes. The minority partner whose departure triggers a buyout is not selling to an outside market where those discounts apply; they are selling to their co-owners, who will receive the full pro-rata benefit of the company's value.

For bad leaver buyouts, minority discounts may be applied as an additional economic consequence, or the price may be set at original cost, which makes the discount question moot. The operating agreement should be explicit about which approach applies in each departure scenario.

Payment Timeline and Mechanics

The operating agreement must specify not just the price of the buyout but when and how it is paid. A full-value buyout at fair market value is meaningless if the company cannot fund it. Common payment structures:

- **Lump sum at closing.** The company pays the full amount on a defined date, commonly 60 to 90 days after the triggering event or after fair market value is determined. Appropriate when the company has sufficient liquidity or can draw on a line of credit.
- **Installment payments.** The company pays the buyout price in defined installments over 12 to 36 months, with interest on the unpaid balance at a defined rate. This is more realistic for most development companies, which do not hold large cash reserves. The agreement should specify the interest rate, typically prime plus 1 to 2 percent, the payment schedule, and the consequences of default.
- **Seller note with security.** The departing partner receives a promissory note for the buyout amount, secured by the equity interests themselves. The note bears interest and matures on a defined date, and the security gives the departed partner a claim against the equity if the company defaults.

Adding New Partners: Equity Dilution and Admission Terms

No founding team stays constant forever. A senior employee earns a way into the partnership after exceptional performance. A co-GP relationship calls for economic participation at the platform level. A strategic hire brings capabilities the founders lack. The operating agreement has to address how new partners are admitted, on what economic terms, and how their admission affects the existing partners' interests.

The Dilution Question

When a new partner is admitted to the operating company with an equity interest, the founding partners' percentage ownership falls. The dilution is mathematically inevitable: the pie stays the same size and a new slice is cut from it. What is not inevitable is how the dilution is distributed among the existing partners.

The operating agreement should specify whether new partner dilution reduces all existing partners' interests pro-rata, preserving the ratio between them, or is allocated differently, for example by protecting one founding partner from dilution below a defined floor as a condition of their initial investment. The most common approach is pro-rata dilution among all existing partners, which preserves the balance of power within the founding team while reducing each partner's absolute percentage.

Valuation at Admission

At what valuation is a new partner admitted? The answer has real economic consequences for both the new partner and the existing ones.

For admissions in the company's first two to three years, before the business has established significant value, a new partner often receives a profits interest rather than a capital interest. They do not pay for the current value of the business and instead participate only in future appreciation from the date of admission. The profits interest structure, addressed in detail in Chapter 6, lets the company grant a meaningful economic participation to a valued team member without requiring a capital purchase they may not be able to afford and without diluting the founders' share of the business's current value.

For admissions at a later stage, when the company has established assets under management, a track record, and meaningful enterprise value, new partners must either pay for their interest at a valuation that reflects that value or receive a profits interest with a threshold equal to the company's current value. The operating agreement should establish the framework for valuation at admission: who determines the valuation, what methodology applies, what approval threshold is required, and what vesting schedule the new partner's interest carries.

The New Partner's Carry Participation

A particularly sensitive admission question for development companies that sponsor outside investor capital is whether a new partner will receive a share of the carried interest earned by the GP entity. Several approaches are common:

- **Prospective carry only.** The new partner participates in the promoted interest from all deals or funds launched after their admission date but not in those already in progress. This is the cleanest approach in accounting terms and the one that minimizes the retroactive economic impact on the founding partners.
- **Full carry participation from admission.** The new partner immediately participates in all carried interest distributions, including those from existing deals and funds. This is the most attractive offer to a prospective partner but can significantly reduce the founders' economic expectations on existing deals.

- **Negotiated transition.** The new partner's carry participation increases over time or vests as they demonstrate contribution to the deals generating the carry. This hybrid suits situations where the new partner's contribution to particular deals is clear and can be documented.

The GP entity's operating agreement must address new partner carry admission with the same precision as the founding partners' initial carry allocation. A verbal agreement about a new partner's carry that is never documented creates the same category of expensive dispute as the undocumented founding carry allocation discussed in Chapter 4.

Equity Allocation Failure Patterns: Three Scenarios

The scenarios below illustrate the most common failure patterns in development company equity allocation. Each reflects a real and recurring dynamic that well-drafted equity provisions would have prevented.

Failure Pattern 1: The Unexamined Equal Split

Scenario. Three partners form a development company with a 33.3/33.3/33.3 equity split. Partner A contributes $800,000 in capital, sources all of the company's first three projects, and works full-time from day one. Partners B and C contribute $200,000 each, stay part-time for the first 18 months, and provide investor relationships that generate $6 million in committed equity from their networks.

What happened. After two years and two completed projects, Partner A controls operations and deal flow, while Partners B and C's investor networks have been essential to raising the equity for each deal. All three own exactly one-third. Partner A believes they are carrying a disproportionate operational load for their share. Partners B and C believe their investor relationships, which have funded everything the company has built, are worth exactly what their equity reflects. The resentment compounds and eventually surfaces in a formal dispute over the allocation of fees on the third project.

The prevention. An explicit, contribution-based allocation that separately quantifies capital, deal flow, investor relationships, and operational time commitment. Even if the result had been the same 33.3/33.3/33.3 split, documenting the basis for it would have created a shared understanding of what each partner's contribution entailed and what expectations attached to it.

Failure Pattern 2: Equity Without Vesting

Scenario. Two partners form a development company with a 60/40 split and no vesting schedule. Partner A, at 60 percent, brings the operational expertise, manages construction, and sources most deals. Partner B, at 40 percent, brings investor relationships and capital. Fourteen months in, Partner B receives a compelling offer to become a partner at a larger real estate firm and resigns.

What happened. Partner B keeps 40 percent of the development company, a fully vested, permanent ownership stake, entitled to 40 percent of all distributions, all information rights, and all approval rights on major decisions. Partner A, who remains, must either run the company with a 40 percent partner who is not contributing, and who may have competing interests at another firm, or fund a buyout at the full fair market value of a 40 percent interest in a company Partner A has substantially built over the preceding fourteen months.

The prevention. A four-year vesting schedule with a 12-month cliff. At fourteen months, Partner B would have vested about 29 percent of their 40 percent interest, the 25 percent cliff tranche plus two months of ratable vesting. The unvested 71 percent, roughly 28 percent of the company, would have been forfeited or bought at original cost. Partner A would have kept control and avoided funding a full market-value buyout of a departing partner's contribution.

Failure Pattern 3: The Undefined Cause Trigger

Scenario. Three partners own a development company. Over two years, the relationship between Partner C and Partners A and B deteriorates badly, with disagreements about project decisions, compensation expectations, and strategic direction. Partners A and B decide they want Partner C out. The operating agreement defines cause as conduct that the majority of the Management Committee reasonably believes is detrimental to the best interests of the company.

What happened. Partners A and B, as the majority, vote to find Partner C in breach of cause and execute the bad leaver buyout at original cost, a fraction of the fair market value of Partner C's vested interest. Partner C argues that the cited conduct consists of disagreements over legitimate business decisions, not misconduct. The arbitration over whether the cause determination was proper costs each side $180,000 and takes 20 months. The arbitrator ultimately finds the cause provision too vague and concludes the majority used it to execute an opportunistic buyout.

The prevention. A specific, objective definition of cause requiring a finding of fraud, willful misconduct, conviction of a felony, or a material and uncured breach of a specific operating agreement provision, with a 30-day cure period for remediable breaches and an independent arbitrator finding required before bad leaver consequences can be imposed. A vague cause definition satisfied by any conduct the majority "reasonably believes" is detrimental is a weapon available against any minority partner at any time.

What the Equity Documents Must Contain

The equity allocation framework described in this chapter is implemented through several specific documents, all of which should be executed at or before the date of formation. The founding team should confirm with legal counsel that each of the following is present and complete before the company begins operations.

The Operating Agreement

As discussed in Chapter 4, the operating company's operating agreement must contain:

- The Member Schedule showing each founding partner's name, ownership percentage, and initial capital contribution.
- The complete vesting schedule for each founding partner's interest, including cliff date, vesting cadence, performance milestones if applicable, and acceleration triggers.
- The good leaver and bad leaver framework, with specific definitions, consequences, and valuation methodology for each departure scenario.
- The buyout mechanics: who has the right to purchase (the company, the remaining partners, or both); the timeline for election and closing; and the payment structure.

- The transfer restriction provisions: lock-up period, right of first refusal, drag-along, and tag-along rights.
- The new partner admission framework: required approval threshold, valuation methodology, dilution mechanics, and carry participation terms.

Equity Grant Agreements

Each founding partner should execute a separate equity grant agreement documenting:

- The specific membership interest granted, including percentage, class, and units if units are used.
- The consideration for the grant, whether cash, property, or future services, with the specific amount or description.
- The vesting schedule applicable to the interest, with reference to the operating agreement's vesting provisions.
- The Section 83(b) election mechanics: the partner's acknowledgment that they have been advised of the election, the 30-day deadline, and whether they intend to make the election.
- The representations and warranties the partner is making about their ability to acquire the interest and their understanding of its terms.

The Section 83(b) Election

Each founding partner whose equity is received subject to a vesting schedule, which is every founding partner whose equity was not purchased at full fair market value for cash, should strongly consider filing a Section 83(b) election with the IRS within 30 days of the grant date. This is not a provision of the operating agreement. It is an individual tax election each partner must make for themselves.

The election causes the partner to recognize any income associated with the grant at the grant date rather than at each vesting date. For a newly formed company with no established value, where the fair market value of the interest at grant is zero or nominal, this means the partner recognizes zero income at the grant date. Going forward, the equity's appreciation is taxed at capital gains rates, assuming the interest has been held for the required period, rather than as ordinary income as each tranche vests.

The 30-day deadline is absolute and cannot be extended for any reason. A partner who misses it has permanently lost the ability to make the election. The consequence of missing it is ordinary income recognition at each vesting date equal to the fair market value of the vesting tranche on that date. If the company has grown significantly in value between the grant date and the vesting dates, the partner may owe substantial ordinary income taxes on each vesting event without receiving any cash distribution to fund them.

The specific tax consequences of the election, including whether it is beneficial in any given partner's situation, depend on individual circumstances and should be evaluated by each partner with their personal tax advisor. The point is to ensure that every founding partner is aware of the election, understands the deadline, and has the chance to make an informed decision before the window closes.

CHAPTER 5: KEY TAKEAWAYS

1. Equity allocation in a development company involves three distinct economic relationships that must be negotiated separately: founding equity in the operating company (the long-term residual ownership claim); guaranteed payments or

operational compensation (payment for services, independent of profitability); and promoted interest, or carried interest (performance-based compensation from development projects). Collapsing the three into a single equity percentage produces arrangements that are rarely fair and frequently disputed.

2. The Contribution Matrix makes the equity conversation more objective by requiring each partner to document specific, verifiable contributions across the categories that matter for a development company: capital, deal flow, track record, investor relationships, development expertise, platform work, technical skills, and time commitment. Specificity is essential: documented facts rather than vague impressions create a shared foundation for the negotiation. Appendix C develops these into a full scoring worksheet.
3. Vesting protects the partnership against early departure. The standard structure, four-year vesting with a one-year cliff, ensures that equity reflects actual long-term contribution rather than the promise of it. Hybrid vesting, combining time-based and milestone-based elements, is the recommended approach for development company partnerships where partners hold clearly differentiated primary roles.
4. The good leaver and bad leaver framework applies different economic consequences to different departures. Good leavers (death, disability, involuntary termination without cause) keep their vested equity at fair market value. Bad leavers (termination for cause, pre-cliff voluntary resignation, non-compete breach) forfeit unvested equity and receive vested equity at original cost or below. The definition of cause must be specific, objective, and resistant to weaponization by the majority against a minority partner.
5. The valuation methodology for buyouts must be specified in the operating agreement before a departure occurs, not negotiated under the pressure of an actual departure. Formula-based valuation (most efficient), agreed valuation with a fallback to independent appraisal (most flexible), and independent appraisal (most reliable for large disputes) are the three primary approaches. The agreement should state whether minority interest discounts apply; for most professional partnerships, they should not.
6. The Section 83(b) election has a 30-day deadline from the date the interest is granted, cannot be extended, and produces materially different tax outcomes for partners who miss it. Every founding partner should be specifically advised of the election, understand the deadline, and make an informed decision about whether to file before the window closes.
7. The three failure patterns, the unexamined equal split, equity without vesting, and the undefined cause trigger, are the most common and most expensive equity disputes in development company partnerships. All three are entirely preventable through the provisions described in this chapter.

WHAT COMES NEXT

Chapter 6 takes up profits interests and promoted interests: how to compensate partners and key employees with equity participation without diluting the founders' ownership of the company's current value, and how the promoted interest works when the company manages outside investor capital. It develops profits interest structure, Section 83(b) mechanics, and the tax treatment of carried interest in depth, with practical guidance on arrangements that are both fair and tax-efficient.

See also: *Appendix C (Contribution Matrix & Equity Allocation Worksheet) • Appendix E (Partner Exit Scenarios Table) • Appendix J (Glossary: vesting, good leaver, bad leaver, cause, Section 83(b), fair market value, profits interest)*

CH. 6

PART III: ECONOMICS, COMPENSATION & GOVERNANCE

Profits Interests, Promoted Interests

and Carried Interest Arrangements

How to compensate partners and key employees with equity participation without diluting the company's current value, and how the promoted interest works when the company manages capital for outside investors.

Two of the most powerful tools in a development company's compensation architecture, the profits interest and the promoted interest, are also two of the most widely misunderstood. They get conflated with each other, confused with phantom equity or options, and documented loosely in ways that create tax problems, governance disputes, and disappointed expectations. This chapter takes both seriously.

The profits interest lets a development company grant equity participation to a partner or key employee without requiring them to buy the company's current value, and to do so with tax treatment that makes it meaningfully more efficient than cash compensation. The promoted interest, or carried interest, is the performance-based reward earned by the company's GP or sponsor entity when development projects deliver returns above the investors' preferred threshold. Both instruments call for careful structuring, precise documentation, and a clear grasp of the tax framework that governs them.

The Profits Interest: What It Is and What It Is Not

A profits interest is a membership interest in an LLC, or a partnership interest in a partnership, that entitles the holder to participate in the entity's future profits and appreciation but represents no share of the entity's current value as of the grant date. The holder has a real equity stake, with everything that implies for capital account maintenance, tax reporting, and governance rights, but that stake starts with zero current liquidation value.

The defining feature of a profits interest is simple. On the date it is granted, if the company were immediately liquidated, the holder would receive nothing from the profits interest. Everything above zero from the moment of grant forward is what the profits interest captures. The existing owners keep 100 percent of the current value; the profits interest holder participates only in the growth from the grant date.

This threshold characteristic is what separates a profits interest from a capital interest. A capital interest, which is what a founding partner receives when they contribute cash or property for their membership interest, is an immediate claim on the entity's current value. A partner who contributes $1,000,000 for a 25 percent interest in a company worth $4,000,000 holds a capital interest: they could in theory liquidate the company today and receive $1,000,000. A profits interest holder cannot. Their stake is entirely forward-looking.

When Profits Interests Are Used

Profits interests are most common in three scenarios, each of which uses the structure's ability to grant meaningful economic participation without requiring the recipient to buy the existing equity at current value:

- **Compensating a key employee with an equity stake in the management company.** A talented asset manager or development director who has been with the company for two

years and contributed materially to its success deserves more than a salary increase. But the company is worth $3,000,000 as a going concern; requiring the employee to buy a 10 percent stake at $300,000 is not realistic, and simply handing them a capital interest worth $300,000 triggers immediate ordinary income tax at that value. A profits interest starting above the current $3,000,000 threshold, so the employee would receive nothing from a hypothetical liquidation today but participates in all appreciation above $3,000,000, grants meaningful equity participation without the immediate tax hit.

- **Admitting a new operating partner to the management company.** A new partner joining an established company brings future contributions, including deal flow, investor relationships, and operational expertise, rather than a historical record of contribution to the current entity. A profits interest starting at the current company value lets the new partner share fully in future growth without taking a slice of value the existing partners created before the new partner arrived.
- **Compensating strategic advisors, co-GP partners, or key consultants.** Arrangements in which a service provider's compensation is tied to the performance of a specific project or the overall management company, without requiring any cash investment from the service provider.

The Tax Treatment of Profits Interests: The IRS Safe Harbor

The favorable tax treatment of profits interests is one of the main reasons for their widespread use in private equity, venture capital, real estate development, and fund management. Under a properly structured grant, the recipient pays no income tax at the time of grant despite receiving a real equity interest. That outcome rests on an IRS administrative safe harbor established in Revenue Procedure 93-27 and clarified by Revenue Procedure 2001-43.

Revenue Procedure 93-27: The Foundation of Favorable Treatment

Revenue Procedure 93-27 provides that the IRS will not treat the receipt of a profits interest for services as a taxable event if three conditions are met:

- The profits interest is not a substantially certain payment: it does not entitle the holder to a fixed or reasonably determinable amount within a short period. This rules out arrangements that are economically equivalent to a cash bonus but dressed up as equity to defer tax.
- The profits interest does not relate to a substantially certain and predictable stream of income from highly liquid assets: this mainly excludes interests in investment funds whose assets are publicly traded securities or their equivalents. For a development company whose projects are illiquid, this condition is generally met without difficulty.
- The service provider does not dispose of the profits interest within two years of receipt: if the holder sells or transfers the interest within two years of the grant, the favorable treatment is retroactively revoked. This creates a minimum holding period that overlaps naturally with the typical vesting schedule.

If all three conditions are met, the grant is not a taxable event. The recipient owes no federal income tax on receipt, whatever the interest might theoretically be worth. Going forward, the holder's allocable share of the company's income, gain, and appreciation flows through to their individual return with the character it had at the company level, so a profits interest holder's share of long-term capital gain from the appreciation and sale of a real estate project is taxed at long-term capital gains rates rather than ordinary income rates.

Revenue Procedure 2001-43: Extending the Safe Harbor to Unvested Interests

Revenue Procedure 2001-43 extended the safe harbor of Rev. Proc. 93-27 to profits interests subject to vesting schedules. Without it, the tax-free treatment at grant might apply only to immediately vested interests, which would create a timing problem for the common case where the holder must stay with the company for a defined period before earning the full interest.

Under Rev. Proc. 2001-43, the grant of an unvested profits interest is not taxable even when the interest is subject to forfeiture on departure before vesting, provided the company and the service provider treat the service provider as the owner of the profits interest from the date of grant for all federal income tax purposes. This treat-as-owner requirement means the holder must appear in the partnership's books and records as a partner from the grant date, must receive a K-1 allocating their share of income and loss, and must report that income and loss on their individual return, even during the unvested period.

The alternative to relying on Rev. Proc. 2001-43 is for the service provider to file a Section 83(b) election within 30 days of the grant, electing to recognize any income at the grant date, typically zero since the interest has no current liquidation value, and to be taxed on later appreciation at capital gains rates from the grant date forward. Rev. Proc. 2001-43 provides that filing a Section 83(b) election is not required to preserve the favorable treatment, but filing it is permitted and, in some circumstances, advisable.

The Section 83(b) Election: To File or Not to File

Whether a profits interest holder should file a Section 83(b) election is a tax planning question that turns on each partner's situation and should be worked through with their personal tax advisor. The founding team should still understand the mechanics well enough to make sure the election is available and that no partner defaults into an unfavorable outcome because no one raised it.

The main benefit of filing for a profits interest is that it starts the capital gains holding period from the grant date rather than the vesting date. For an interest that vests over four years, the gap between grant and full vesting can be significant. If a partner files at grant and holds the interest more than five years before a sale, all of the appreciation from the grant date is taxed at long-term capital gains rates. Without the election, only the appreciation from each vesting date forward qualifies for long-term treatment, tranche by tranche, and the holding period for each tranche starts on its vesting date.

The main risk of filing is that if the partner forfeits the interest before vesting, by leaving before meeting the conditions, they cannot recover any tax paid on the basis of the election. For a profits interest with zero current liquidation value, however, any income recognized at the grant date is also zero, so this risk is largely theoretical in the typical development company context.

The 30-day deadline is absolute. The election must be filed with the IRS within 30 days of the date the interest is received, it cannot be extended for any reason, and there is no provision for a late election whatever the cause of the delay. Every new profits interest grant should be accompanied by explicit written advice to the recipient about the election, the deadline, and the need to consult their personal tax advisor before the window closes.

Capital Account Requirements

A valid profits interest under the IRS safe harbor requires the entity to maintain capital accounts for all partners, including profits interest holders, in accordance with the substantial economic effect rules under Treasury Regulation Section 1.704-1(b). Among other things, these rules require:

- Capital accounts that reflect each partner's economic interest in the company: a positive balance represents a partner's stake in the company's assets, and a negative balance creates an obligation to restore the deficit.
- Liquidating distributions made according to positive capital account balances rather than percentage ownership. A profits interest holder with a zero capital account on the grant date

receives zero in a hypothetical liquidation that day, which is precisely the threshold requirement for a valid profits interest.

- Operating agreement provisions that preserve the economic effect of the capital account framework through the life of the partnership, including on liquidation.

These requirements are one reason profits interests must be granted under a carefully drafted operating agreement rather than a simple side letter or grant agreement. The operating agreement has to contain the specific economic provisions, the book-up rules, the liquidation priority language, and the allocations of income and gain, that make the capital account framework work correctly from the date of each grant. An operating agreement that lacks these provisions does not support valid profits interests, whatever the grant agreement says.

Structuring a Profits Interest: The Practical Requirements

Understanding the legal and tax framework is necessary but not sufficient. The founding team also needs the practical requirements for granting and maintaining a valid profits interest, because the mechanics can be more demanding than they first appear.

Setting the Threshold Value

The threshold value of a profits interest is the liquidation value of the company on the grant date, the amount that would go to the existing owners if the company were liquidated immediately after the grant. Because the holder receives nothing below this threshold, it marks where the existing owners' claim ends and the profits interest holder's participation begins.

The threshold must be a specific, documented number. For a newly formed company with no established value, it may be zero or nominal, since the company has no significant assets and no going-concern value a third party would pay for. This is the most common situation for profits interests granted to founding partners at inception or to early employees before the company has a track record.

For an established company with meaningful assets under management, a demonstrated track record, and recurring fee income, the threshold is a non-trivial number that must be set through a good-faith valuation. An unreasonably low threshold understates the value of the interest at grant and risks IRS recharacterization as a capital interest with immediate income recognition. A reasonable, documented threshold, supported by observable market data, comparable transactions, or a qualified business valuation, supports the favorable treatment the parties intend.

The Book-Up Mechanism

When a new profits interest holder is admitted to an existing LLC, the company performs a book-up of its assets: all assets are marked to current fair market value for book, or capital account, purposes, and the resulting unrealized gain or loss is allocated to the existing members' capital accounts, not to the new holder. This ensures the new holder's capital account starts at zero, or reflects only the current fair market value of their future interest, while the existing members' accounts reflect 100 percent of the company's current value.

The book-up is a technical accounting step that must be reflected in the operating agreement and carried out on the company's books at the time of each grant. Without it, the capital account framework does not properly reflect the threshold structure, which can undermine the favorable tax treatment. This is another reason profits interest grants require coordination among the attorney drafting the operating agreement, the CPA maintaining the books, and the tax advisor reviewing the overall structure.

Grant Documentation

Each profits interest grant must be documented with a written grant agreement specifying:

- The specific percentage or amount of the profits interest being granted.
- The threshold value as of the grant date.
- The vesting schedule, whether time-based, milestone-based, or hybrid, with specific cliff provisions and acceleration triggers.
- The consequences of departure before vesting: forfeiture provisions and the good leaver and bad leaver framework.
- The treat-as-owner election: a confirmation that the company and the service provider will treat the service provider as a partner from the grant date for all federal income tax purposes.
- Notice of the Section 83(b) election: a written acknowledgment that the grantee has been informed of the election, the 30-day deadline, and the need to consult a personal tax advisor.
- Any applicable transfer restrictions: the profits interest is typically subject to the same restrictions as the company's other membership interests.

Without a written grant agreement, the profits interest exists by virtue of the operating agreement's economic provisions but lacks the documented parameters, particularly the threshold value and the treat-as-owner election, that support its favorable tax treatment.

Profits Interests and Phantom Equity: The Tax Efficiency Comparison

Phantom equity is a contractual arrangement under which a service provider receives cash payments calculated by reference to the company's equity value, without actually receiving an equity interest. The provider is entitled to a cash payment equal to what they would have received had they held a specified equity percentage when a defined triggering event occurs, typically a sale of the company, a distribution event, or an annual valuation.

Phantom equity has one significant administrative advantage: it does not require the provider to be admitted as a partner, which eliminates the capital account maintenance, the K-1 reporting, and the treat-as-owner complexity of a real profits interest. From the company's perspective, phantom equity is a liability that grows with the company's value, not an equity instrument.

Its disadvantage from the provider's perspective is decisive: all phantom equity payments are taxed as ordinary compensation income when received, subject to income tax at the highest applicable rates and to payroll taxes. For a development company that mainly generates long-term capital gains from real estate appreciation, a phantom equity holder's inability to benefit from capital gains rates is a material economic disadvantage relative to a profits interest holder.

Factor	Profits interest	Phantom equity
Tax treatment at grant	Tax-free under the Rev. Proc. 93-27 safe harbor if properly structured	No tax at grant; no equity received
Tax treatment on distributions	Character flows through from the company: long-term capital gain, ordinary income, and so on, based on the company's underlying income	Ordinary compensation income and payroll taxes on all payments, regardless of the company's underlying income character
Capital gains rates available	✓ Yes, on appreciated value held for the required periods	✕ No, all payments taxed as ordinary income
Partner status	Holder is a partner; receives a K-1; capital account maintained	No partner status; cash payment only; simpler reporting
Holding period for long-term gain	Starts on the grant date with an 83(b) election, or the vesting date without one	Not applicable; no holding period concept

Factor	Profits interest	Phantom equity
Administrative complexity	Higher: K-1, capital account maintenance, book-up on admission	Lower: contractual payment; no partnership accounting
Economic alignment	Strong: an actual equity stake with all economic consequences	Good: economic equivalent without equity complications
Best used when	The recipient will benefit from the company's capital gains character and is a genuine long-term participant	The recipient prefers simplicity; tax efficiency is secondary; a short-term arrangement

For most development company contexts the conclusion is clear. When the company generates significant long-term capital gains from property appreciation, which is the expected outcome for a successful platform, the profits interest is materially more tax-efficient than phantom equity. The administrative complexity of profits interests is real but manageable with proper legal and accounting support. The tax cost of phantom equity is a permanent and compounding disadvantage.

The Promoted Interest: Performance-Based Compensation for Managing Outside Capital

A promoted interest, also called carried interest or carry, is the economic reward the GP or sponsor entity earns from a development project or fund when investors receive returns above the agreed preferred return threshold. It is a disproportionate share of the project's profits: investors contribute 100 percent of the equity capital and receive the first returns, the preferred return, while the sponsor contributes management expertise and deal execution and receives a share of the profits, the promote, larger than its proportionate equity contribution would otherwise earn.

The promoted interest is the primary mechanism by which real estate development and investment sponsors build significant wealth over a career. Fee income sustains the management company; the promoted interest creates the compounding, capital-gains-taxed wealth that comes from consistently delivering above-threshold returns to investors. Understanding how it works, and how to allocate it fairly among the founding partners, is among the most important topics in this handbook.

How the Promoted Interest Works

The mechanics of the promoted interest are governed by the distribution waterfall in the deal-level SPE's operating agreement or the fund's limited partnership agreement. The basic structure, addressed in detail in Chapter 11:

- **First, return of investor capital.** The LP or non-managing member investors receive back 100 percent of their contributed equity before any profits are shared.
- **Second, the preferred return.** Investors receive a defined annualized return on their invested capital, commonly 8 percent, that must be satisfied before the sponsor participates in profits. The preferred return ensures investors clear a minimum performance threshold before the sponsor earns any carry.
- **Third, the GP catch-up.** If the waterfall includes a catch-up, the GP or sponsor entity receives 100 percent of distributions until it has received a defined share of the total profits above the preferred return, bringing the GP to its agreed promoted interest percentage on a cumulative basis.

- **Fourth, the promoted interest split.** Remaining profits are divided between investors and the GP at the agreed ratio. The most common split is 80 percent to investors and 20 percent to the GP, though this varies by deal type, strategy, and negotiating position.

The 20 percent promoted interest in this example flows to the GP entity, the LLC that serves as general partner or managing member of the deal vehicle. The GP entity's operating agreement then governs how that 20 percent is allocated among the founding partners. That internal allocation is the subject of the next section.

The Promoted Interest Is Not a Salary

The promoted interest is not a salary, a guaranteed payment, or a management fee. It is contingent, performance-based compensation, earned only if, and only to the extent that, investors receive returns above the preferred return threshold. A project that delivers exactly the preferred return and no more generates zero carry. A project that loses money generates zero carry and may generate a clawback obligation.

That contingent character is what makes the promoted interest an effective alignment tool between sponsors and investors: the sponsor's primary reward is tied to the investors' success. A sponsor who earns a 20 percent promoted interest only after investors receive an 8 percent preferred return has a strong incentive to manage the project well, because the reward depends on clearing that threshold.

The contingent character is also why the promoted interest belongs apart from guaranteed payments and management fees in the partners' economic arrangements. A partner entitled to a promoted interest is not guaranteed any carry; the entitlement is to participate in carry if and when it is earned. A partner who needs income during the development period must look to guaranteed payments or management fees. The carry comes later, at disposition, and only if the project performs.

The Tax Treatment of Carried Interest

The favorable tax treatment of the promoted interest has been a defining feature of private equity and real estate fund economics for decades. Because the promoted interest flows through the partnership from the underlying investment, and because the underlying investment consists mainly of appreciated real estate, the sponsor's share has historically been taxed as long-term capital gain when the underlying real estate was held more than one year.

The Tax Cuts and Jobs Act of 2017 changed this through Section 1061 of the Internal Revenue Code. Section 1061 extended the holding period required for long-term capital gains treatment on applicable partnership interests, which include carried interests received by service providers, from one year to three years. For a sponsor's carried interest to qualify for long-term treatment under Section 1061, the underlying investment must be held more than three years.

For development companies whose typical hold period is three to seven years or more, the Section 1061 requirement is often met naturally by the investment strategy. A ground-up project that takes 18 months to entitle, 24 months to build, and 12 months to stabilize before disposition will almost always clear the three-year mark. The impact of Section 1061 is greatest for strategies with shorter intended holds: value-add acquisitions sold within two years of purchase, development projects with immediate for-sale completion, or opportunistic repositioning with a rapid exit.

Founding partners should discuss with their tax counsel how the Section 1061 holding period interacts with their specific strategy and what planning, if any, is available to manage the impact. Several approaches have developed in the market since Section 1061's enactment, including co-investment structures that may qualify for different treatment and careful timing of disposition relative to the three-year threshold.

Section 1061 in Practice: A Numerical Comparison

A development company completes a value-add apartment acquisition in January of Year 1 and sells the project in February of Year 3, about 25 months after acquisition, short of the three-year holding period that Section 1061 requires. The GP entity's promoted interest from the sale is $800,000.

Without Section 1061, the $800,000 would have been taxed as long-term capital gain, since the asset was held more than one year. At a 23.8 percent combined federal rate, which is the 20 percent long-term rate plus the 3.8 percent net investment income tax, the tax is about $190,400, leaving $609,600 net.

With Section 1061, because the holding period is under three years, the $800,000 is recharacterized as short-term capital gain and taxed at ordinary income rates. For a partner in the 37 percent federal bracket, the federal tax is about $296,000 before any state tax, leaving roughly $504,000 net.

The difference is about $105,600 more in federal tax per partner on a single $800,000 carry distribution, as the effective federal rate moves from 23.8 percent to 37 percent on the same economic outcome. For a platform that regularly exits before the three-year mark, that difference compounds across many deals over the life of the company.

Allocating the Promoted Interest Among Founding Partners

The GP or sponsor entity receives the promoted interest from each deal or fund it manages, and the GP entity's operating agreement governs how that interest is distributed among the founding partners. This internal allocation, who among the partners receives how much of the carry from each deal, is one of the most consequential economic decisions the founding team makes, and one of the most commonly left to a verbal understanding that each partner remembers differently when the money becomes real.

The partners must agree on and document the allocation methodology before the GP entity closes its first deal. The choice has direct economic consequences for every project the company completes, and changing the methodology after the first deal has generated meaningful carry creates both legal complexity and interpersonal friction that the initial documentation would have prevented.

The Four Principal Methodologies

There is no universal standard for allocating the promoted interest among a development company's founding partners. The right answer depends on the partners' roles, the company's business model, and the team's judgment about what motivates the contributions that matter most. The four principal methodologies follow.

Equal division. The promoted interest flowing to the GP entity is divided equally among all founding partners, regardless of equity ownership in the operating company and regardless of each partner's role on any given deal.

Equal division is administratively simple and avoids deal-by-deal accounting. Its weakness is that it may not track the actual distribution of value creation: a partner who sources and manages three of four deals receives the same carry as one who sourced none. When the contributions complement one another and the partners see themselves as one team, equal division can be appropriate and durable. When one partner consistently does most of the deal-level work, it becomes a source of resentment.

Equity-proportional allocation. The promoted interest is distributed in proportion to each founding partner's equity ownership in the operating company or the GP entity. If Partner A owns 60 percent and Partner B owns 40 percent, the carry from every deal splits 60/40.

This approach is consistent with the overall economic framework, since the partners receive carry in the same proportions as their operating company distributions. Its weakness is that the equity split reflects the totality of each partner's contribution across capital, relationships, time, and expertise, while the carry from specific deals may be driven mainly by deal-sourcing performance. A partner who owns 60 percent because of a capital contribution may have sourced none of the deals that generated the carry they receive in that proportion.

Role-based allocation. The promoted interest is allocated on each partner's specific contribution to the deal or fund that generated it. Common role-based formulas:

- Deal-sourcing credit: a defined percentage of each deal's carried interest, often 20 to 30 percent of the total carry, goes to the partner who sourced the deal, with the remainder divided equally or proportionally.
- Asset management credit: a defined percentage goes to the partner responsible for managing the asset after acquisition, reflecting the value of ongoing oversight during the hold period.
- Capital-raising credit: a defined percentage goes to the partner who raised the investor equity for the deal, reflecting the value of the relationships that made it possible.

Role-based allocation aligns carry most closely with the activities that generate it. Its main weakness is administrative complexity: allocating at the deal level means tracking each partner's contribution to each deal, which creates bookkeeping obligations and potential disputes about credit when roles overlap or when one partner sources a deal another manages.

Hybrid allocation. A hybrid combines equal or proportional division with role-based allocation. The most common structure divides the promoted interest into two pools:

- A platform pool, commonly 50 to 70 percent of the carry from each deal, divided equally or equity-proportionally among all founding partners, reflecting the collective value of the platform that all partners helped build.
- A performance pool, the remaining 30 to 50 percent, allocated on specific deal-level contributions such as deal sourcing, capital raising, and construction management, for each transaction.

The hybrid recognizes both the collective nature of the business and individual accountability for specific contributions. It is often the most equitable solution because it rewards the platform-building work all partners share and the deal-level work that varies by project. It needs more administrative infrastructure than pure equal or proportional division but far less than a pure deal-by-deal role-based allocation.

A Comparison of the Four Methodologies

Factor	Equal division	Equity-proportional	Role-based	Hybrid
Administrative simplicity	Highest	High	Lowest	Moderate
Alignment with deal-level contribution	Low	Low to moderate	Highest	High
Fairness when contributions are equal	Highest	High	Moderate	High
Fairness when contributions are asymmetric	Low	Moderate	Highest	High

Factor	Equal division	Equity-proportional	Role-based	Hybrid
Potential for dispute	Low (simple formula)	Low (tied to OA equity)	Higher (deal attribution)	Moderate
Best suited for	Closely collaborative teams with interchangeable roles	Partnerships where the equity split closely reflects deal-level contribution	Partnerships with clearly distinct, measurable individual roles	Most development partnerships with differentiated roles and a collaborative culture

Documentation Is Non-Negotiable

Whichever methodology the team chooses, the carry allocation must be documented in the GP entity's operating agreement before the first deal closes. The following scenario recurs often enough to have earned its own place in the cautionary literature of real estate partnership formation.

The Most Predictable Partnership Dispute in Real Estate Development

Three partners form a development company and have an enthusiastic conversation about how carry will be shared. Each remembers it clearly. Partner A recalls that carry would be split equally among all three. Partner B recalls that Partner A would receive an additional 10 percent deal-sourcing credit on deals A sources. Partner C recalls that carry would follow the equity splits of 40/35/25. No one writes it down.

Three years later, the company's first project generates $1.2 million in carried interest. Under equal division, that is $400,000 each. Under equity-proportional, it is $480,000, $420,000, and $300,000. Under Partner B's recollection of the hybrid, with a 10 percent sourcing credit to A off the top and the rest split equally, it is $480,000 for A and $360,000 each for B and C.

Three partners, three honest recollections, three different numbers. Depending on which version controls, a partner's share of this single $1.2 million distribution lands somewhere between $300,000 and $480,000, a spread of $180,000, and the same disagreement repeats on every deal that follows. The legal fees to arbitrate it routinely exceed $150,000 per side, the damage to the relationship is rarely repaired, and the distraction from operations is hard to measure. The entire outcome is prevented by three sentences in the GP entity's operating agreement, drafted before the first deal closes.

Clawback Obligations: The Carry That Can Be Taken Back

The promoted interest is earned at disposition, when the project's proceeds flow through the waterfall. But in an American-style waterfall, with deal-by-deal carry distribution, a sponsor can receive carry from a profitable early exit and then face a clawback if later deals in the same fund underperform and the fund as a whole fails to deliver the promised preferred return to investors.

A clawback requires the GP or sponsor entity, and potentially the individual founding partners personally, to return previously distributed carried interest to the extent those distributions exceeded the sponsor's ultimate entitlement based on the fund's overall performance. It is the investor's protection against a sponsor who took carry from early winners while the full portfolio was still being judged.

Entity-Level and Partner-Level Clawback

The first question in any clawback negotiation is whether the obligation runs to the GP entity alone or extends to the individual founding partners personally. The answer has real practical consequences:

- **Entity-level clawback.** The GP entity returns excess carry from its own assets. If it has retained enough, for example because carry distributions were reinvested rather than paid out to the partners, it can fund the clawback from its own resources without requiring personal contributions.
- **Partner-level clawback.** Each founding partner is personally obligated to return their share of carry subject to clawback. This is the structure institutional investors require, because it backs the obligation with the financial resources of the individuals who made the investment decisions, not just a potentially asset-poor GP entity.

Most institutional fund agreements require partner-level clawback obligations. Founding partners should expect this requirement, understand what it means for their personal financial exposure, and plan accordingly.

The Tax Gross-Up on Clawback

One of the most consequential and frequently overlooked aspects of the clawback is its interaction with the income tax already paid on the original carry distribution. When a partner receives a carry distribution, they pay income tax on it, potentially at long-term capital gains rates if the underlying asset met the required holding period. When the partner later has to return that distribution under a clawback, they are returning pre-tax dollars on which they have already paid tax.

Consider a simple example. A partner receives $500,000 in carried interest in Year 3 and pays $119,000 in federal income tax at a 23.8 percent combined rate, keeping $381,000 after tax. In Year 6, a clawback requires the return of $300,000. The partner repays the full $300,000 in pre-tax dollars, but after the original tax they had kept only about $228,600 of that $300,000; the other $71,400 had already gone to the IRS. Without any offset, returning the gross amount leaves the partner roughly $71,400 worse off than the after-tax benefit they ever actually received on the returned portion.

Well-negotiated fund agreements address this through a tax gross-up provision: the clawback obligation is reduced by the income taxes paid on the returned carry, so the partner is not left worse off, on a net-of-tax basis, than if the carry had never been distributed. Founding partners should insist on a tax gross-up in any agreement that includes a partner-level clawback. The provision should specify the assumed tax rate, often the highest combined federal and state rate applicable to the partner, the timing of the adjustment, and the mechanics of the calculation.

The Carry Escrow as Clawback Reserve

One practical way to manage clawback risk is the carry escrow, or holdback. Rather than distributing 100 percent of earned carry to the partners when it is received, the GP entity retains a defined percentage, commonly 20 to 30 percent of each distribution, in escrow pending the final accounting of the fund's overall performance.

If the fund delivers the promised preferred return on its full portfolio, the escrowed amounts are released to the partners at the end of the fund's life. If a clawback materializes, the escrowed funds satisfy it before any additional return from the individual partners is required. This benefits both sides: investors have a reliable, pre-funded source for clawback satisfaction, and partners reduce their personal exposure and avoid the practical problem of returning carry they received years earlier and have since spent.

Profits Interests for Key Employees: The Practical Framework

One of the most effective uses of the profits interest structure is compensating key employees, including senior asset managers, project managers, and development directors, with an equity participation in the management company that creates genuine long-term alignment without requiring a purchase of the company's current value.

The decision to grant profits interests to employees is an important one that should involve all founding partners and reflect the company's overall equity participation philosophy. The framework below covers the principal decisions in designing an employee profits interest program.

What Percentage Is Appropriate

The appropriate size of a grant for a key employee depends on the role, seniority, the company's stage, and the competitive compensation landscape. There is no universal standard, but typical ranges:

- Senior, partner-track employees, such as asset managers and development directors expected to be on a path to eventual partner admission: 0.5 to 3 percent of the management company, on a fully vested basis.
- Mid-level professionals who are important to operations but not currently on a partner track: 0.1 to 0.75 percent, often structured as a profits interest in specific projects rather than in the management company itself.
- Executive-level hires, such as a CFO, General Counsel, or Head of Capital Markets, joining an established platform where the hire materially changes the company's trajectory: 1 to 5 percent, depending on the role's criticality and the hire's prior compensation expectations.

These ranges are guidelines, not mandates. The right answer depends on the circumstances, the employee's contribution to the company's value, and the founding partners' judgment about appropriate participation for that role.

Vesting and Departure Provisions

Profits interests granted to employees should carry the same good leaver and bad leaver framework as the founding partners' equity, adapted for the employment context. Key considerations:

- **Vesting schedule.** The same four-year schedule with a one-year cliff that applies to founding partners is appropriate for employee profits interests. Some companies use a shorter period (three years) or a shorter cliff (six months) for senior employees hired at a later stage, recognizing that their contributions start generating value immediately and that an excessively long cliff may deter acceptance of the grant.
- **Voluntary departure.** An employee who resigns before full vesting typically forfeits unvested interests and is bought out on vested interests at original cost, effectively zero since the profits interest was granted for no cash consideration. Some companies distinguish departure before the cliff (complete forfeiture) from departure after it (buyout of vested interests at fair market value, which can be substantial for a long-tenured senior employee).
- **Involuntary termination without cause.** The company should treat this as a good leaver departure, letting the employee keep vested interests at fair market value. Terminating an employee and stripping the equity they earned through prior service at the same time is inequitable.
- **Non-compete and non-solicitation.** Profits interest grants to employees should be accompanied by, or conditioned on, the employee's execution of a non-compete and non-solicitation agreement. The grant of equity participation creates a legitimate basis for the restrictions and typically strengthens their enforceability.

The Employee's Section 83(b) Election

The Section 83(b) election matters just as much for employee profits interest holders as for founding partners. The same 30-day deadline applies, and the same consequences flow from missing it. When the company grants a profits interest to an employee, the grant process should include:

- Written notice to the employee of the election, the deadline, and the consequences of filing versus not filing.
- The employee's contact information provided to the company's tax counsel, who should be available to discuss the election with the employee personally.
- A written acknowledgment from the employee confirming receipt of the notice, an understanding of the deadline, and that they have consulted, or chosen not to consult, a personal tax advisor.
- A record in the company's files of whether each employee made the election, since that affects the company's K-1 reporting obligations for that employee.

Common Documentation Failures and Their Consequences

The table below summarizes the most common documentation failures in profits interest and promoted interest arrangements and the specific consequence of each. Every one of these outcomes is preventable through proper documentation at the time of grant.

Documentation failure	Specific consequence	Prevention
No written grant agreement for a profits interest	The IRS may recharacterize the interest as a capital interest with immediate income recognition at grant, or as a payment for services taxable as ordinary income when received	Execute a written grant agreement specifying the threshold value, vesting schedule, and treat-as-owner election at or immediately upon grant
Threshold value not documented	Ambiguity about the current liquidation value at grant creates IRS recharacterization risk and a dispute between company and grantee about the economic terms	Obtain and document a good-faith valuation of the company's current liquidation value at each grant; state the threshold value explicitly in the grant agreement
Section 83(b) election missed by an employee	Ordinary income recognition at each vesting date equal to the then-current fair market value of the vesting tranche; no capital gains treatment on pre-vesting appreciation	Provide written notice of the election and deadline to every recipient; document the notice; obtain written acknowledgment of receipt
No capital account book-up on admission	Existing members' unrealized gain attributed to the new holder; the new holder's capital account does not reflect the threshold structure; IRS recharacterization risk	Coordinate with the CPA to perform the book-up at each grant; ensure the operating agreement authorizes and requires it
Promoted interest allocation not documented in the GP entity OA	Each partner has a different recollection; a dispute at the first material carry distribution generates expensive arbitration	Document the carry allocation specifically in the GP entity's operating agreement before the first deal closes, including the formula, the exceptions, and the modification process
No partner-level clawback provision	If the GP entity distributes carry and is later subject to a clawback, it may have no assets to satisfy the obligation, leaving investors' clawback rights ineffective	Include an express partner-level clawback obligation in the fund agreement and the GP entity's operating agreement; consider a carry escrow holdback
No tax gross-up on clawback	Partners who return carry suffer a net-of-tax loss exceeding the amount returned because they have already paid income tax on the distributions	Include a tax gross-up provision specifying the assumed tax rate and the mechanics of reducing the clawback by taxes paid

CHAPTER 6: KEY TAKEAWAYS

1. A profits interest is a membership interest that entitles the holder to a company's future profits and appreciation but not its current value. The threshold characteristic, zero current liquidation value at grant, is what makes it both a real equity instrument and, under the IRS safe harbor of Revenue Procedure 93-27, a tax-free grant when properly structured.
2. The IRS safe harbor requires three conditions: the interest is not a substantially certain payment; it does not relate to a predictable stream from highly liquid assets; and the holder does not dispose of it within two years. When all three are met, the grant produces no income tax at receipt, and later appreciation is taxed at the character the income has at the company level, often long-term capital gain for a development company.
3. The Section 83(b) election has an absolute 30-day deadline from the grant date that cannot be extended. For profits interests with zero current liquidation value, filing typically costs nothing, since zero income is recognized, but it starts the capital gains holding period from the grant date. Missing the deadline is permanent and uncorrectable. Every recipient must be specifically advised of the election and the deadline.
4. Profits interests are materially more tax-efficient than phantom equity for development companies, because profits interest holders benefit from the capital gains character of the company's underlying real estate income. Phantom equity payments are always taxed as ordinary compensation income regardless of that character.
5. The promoted interest, or carried interest, is the contingent, performance-based compensation earned by the GP or sponsor entity when development projects generate returns above the investors' preferred return threshold. It is the primary mechanism for building long-term wealth in a development company and is taxed at long-term capital gains rates on assets held more than three years under Section 1061.
6. The allocation of the promoted interest among the founding partners must be documented in the GP entity's operating agreement before the first deal closes. The four methodologies, equal division, equity-proportional, role-based, and hybrid, each carry different alignment characteristics and administrative requirements. The hybrid, a platform pool plus a performance pool, suits most development partnerships with differentiated partner roles.
7. Clawback obligations require the GP entity, and potentially the individual founding partners, to return previously distributed carry if the overall portfolio fails to meet the preferred return. Partner-level clawbacks require personal resources to satisfy; carry escrow holdbacks reduce that exposure; and tax gross-up provisions protect partners from net-of-tax losses that exceed the amount returned.

WHAT COMES NEXT

Chapter 7 takes up partner compensation, distributions, and financial arrangements during operations: how the founding partners pay themselves through guaranteed payments and draws, how profits are distributed when they are available, how tax distributions protect partners from phantom income tax obligations, and how capital call mechanics work when the company needs additional partner funding. These are the financial arrangements that govern the partners' day-to-day economic relationship with the company they are building.

See also: *Appendix J (Glossary: profits interest, carried interest, promoted interest, Section 83(b), Rev. Proc. 93-27, threshold value, book-up, clawback, tax gross-up) • Chapter 19 (Securities Law Compliance: implications for carried interest disclosure in PPMs)*

CH. 7

PART III: ECONOMICS, COMPENSATION & GOVERNANCE

Partner Compensation, Distributions *and Financial Arrangements*

How the founding partners pay themselves during operations, how profits are distributed when they are available, how tax distributions protect partners from phantom income obligations, and how capital call mechanics work when the company needs additional partner funding.

How partners get paid, when, and how much, generates more day-to-day friction in a real estate development partnership than almost any other question. It surfaces every month when someone asks why a particular distribution was not made, why guaranteed payments were adjusted, or why a capital call landed in the middle of a deal that was supposed to be profitable. Good intentions do not settle these questions. Operating agreement provisions specific enough to answer them before they become disputes do.

This chapter covers the financial arrangements that govern the partners' day-to-day economic relationship with the company: guaranteed payments, profit distributions, the mandatory tax distribution provision, expense reimbursement, capital call mechanics, and the anti-dilution considerations that protect founding partners against unexpected shifts in their economic position.

The Three Forms of Partner Economic Return

Before the mechanics of each arrangement, it helps to see the three distinct forms through which a founding partner receives economic benefit from the development company. They carry different tax treatment, different timing, and different relationships to the company's performance. Confusing them, or letting the operating agreement be vague about the distinctions, creates both tax and governance problems.

Guaranteed Payments

A guaranteed payment is a payment made to a member of an LLC in their capacity as a member, determined without regard to the company's income. As the LLC equivalent of a salary, it is taxable to the recipient as ordinary income in the year the company's fiscal year ends, regardless of when the cash is actually paid. The company deducts the payment as an ordinary business expense, reducing the taxable income allocated to all members. Two tax distinctions matter:

- **Guaranteed payments are ordinary income to the recipient, always.** Unlike profit distributions, which may carry the character of the underlying income, whether capital gain, Section 1231 gain, or ordinary income, guaranteed payments are always ordinary income. A development company whose ultimate value comes mainly from long-term capital gains on real estate dispositions cannot convert those gains into guaranteed payment income. A guaranteed payment is ordinary income regardless of what generated the cash.
- **Guaranteed payments from an LLC managed by the recipient may be subject to self-employment tax.** A managing member who receives guaranteed payments for services to the LLC is likely subject to self-employment tax, which is 15.3 percent on the first $184,500 of earnings for 2026, with only the 2.9 percent Medicare portion applying above that threshold, on those payments. This is a meaningful additional cost: on a $150,000 guaranteed payment, the self-employment tax adds roughly $18,000 to $21,000 in federal tax burden. The

company's tax structure should address this exposure as part of the overall compensation design.

Profit Distributions

A profit distribution is a distribution of the company's earnings to its members, made in proportion to their ownership interests or in whatever proportions the operating agreement specifies. Unlike guaranteed payments, profit distributions are not separately deductible by the company; the income that funds them has already been allocated to the members on their K-1s and taxed at their individual rates. The distribution itself is a return of capital up to the amount of the partner's capital account, and distributions that drive the capital account below zero create tax obligations that require careful planning.

The tax character of a profit distribution follows the character of the income at the company level. A distribution funded by long-term capital gain passes through as long-term capital gain; one funded by ordinary fee income is ordinary income; one funded by a mix carries mixed character. This is one of the structural advantages of the pass-through entity: the character of income at the company level flows through to the individual partners, unlike a C-corporation, where all distributions are taxed as ordinary dividends regardless of the underlying income's character.

The Promoted Interest

As discussed in Chapter 6, the promoted interest is the contingent, performance-based compensation earned by the GP or sponsor entity, and allocated among the founding partners through the GP entity's operating agreement, when development projects generate returns above the investors' preferred return. It is realized at disposition, not during operations, and its tax treatment depends on the character of the underlying income and the Section 1061 holding period analysis.

The three forms serve different functions in a partner's financial life. Guaranteed payments fund current living expenses; profit distributions return accumulated earnings when the company has available cash; and the promoted interest builds long-term wealth from compounding, capital-gains-taxed development profits. A well-designed partnership agreement addresses all three explicitly, without conflating them or leaving any to the state law defaults.

Guaranteed Payments: Structure, Amount, and Approval

The guaranteed payment structure, how much each partner is paid, when, how adjustments are made, and who approves them, is one of the most operationally sensitive provisions in the operating agreement. It has to be specific enough to prevent disputes about what was agreed, flexible enough to accommodate the company's evolving financial capacity, and connected to the governance framework so that no single partner can unilaterally raise their own compensation.

Setting the Initial Guaranteed Payment Amount

The initial guaranteed payment for each founding partner should reflect two inputs: the partner's market compensation for the role they fill, and the company's realistic ability to sustain that level given the budget developed in Chapter 2. These two inputs frequently conflict in the early years, and resolving that conflict, who bears the shortfall and in what form, is a founding decision rather than an operational one.

The team should resist setting guaranteed payments at each partner's prior market rate if the company cannot sustain those payments from day one. A company that commits to $200,000 per year for each of three founding partners, $600,000 per year in aggregate, before it has earned its first dollar of fee income will deplete its initial capital within 12 to 18 months with no clear plan for

what comes next. The guaranteed payment level should be set against the 24-month budget from Chapter 2, with a clear understanding of which partner is subsidizing the others if revenue falls short. Common approaches:

- **Zero guaranteed payments in Year 1 with a defined trigger for starting payments.** All partners draw from their own reserves during the ramp-up, and the first payments begin at a specific date or when the company hits a defined revenue milestone. This conserves capital and aligns incentives around early revenue, but it requires that all partners have the resources to sustain it.
- **Below-market guaranteed payments from day one.** Each partner receives a defined payment materially below their market rate, funded from initial capital, with a mechanism for increasing payments as fee revenue grows. This is perhaps the most common structure for professional development companies during the ramp-up; it acknowledges that the partners are building something and that full market compensation comes later.
- **Market-rate guaranteed payments, with an explicit understanding that initial capital funds them for a defined period.** Appropriate when one or more partners have a specific need for current income and the team has agreed on the timeline and conditions under which fee revenue will replenish the capital. It requires careful modeling of how long the capital will last.

Asymmetric Guaranteed Payments

Nothing requires all founding partners to receive the same guaranteed payment. A full-time partner may receive more than a part-time one. A partner who brings specialized operational expertise the company would otherwise pay to outsource may receive a higher payment reflecting the market value of that expertise applied daily. A partner who contributes mainly through capital and investor relationships rather than daily operations may receive a lower payment or none at all.

Asymmetric guaranteed payments are legitimate and often appropriate. What makes them work is that they are explicit, agreed, and documented, not implied or assumed. A partner who expects equal compensation with their co-founders and discovers through an operating agreement draft that the arrangement is actually asymmetric has a real grievance if they were not part of that decision. The guaranteed payment structure should be fully disclosed and agreed in the Partners' Term Sheet before any attorney drafts an operating agreement.

Adjustment Mechanisms

The amount agreed at formation is almost certainly not the right number in year three or year five. The company's financial capacity changes, the partners' roles evolve, and market compensation shifts. The operating agreement must specify how guaranteed payments are reviewed and adjusted.

The most common mechanism is an annual review tied to the business plan approval process addressed in Chapter 9. The management committee reviews each partner's payment as part of the annual budget, weighs the company's performance and projections, and approves a payment schedule for the coming year. The key governance question is what threshold of approval is required to modify a payment, and whether a partner can vote on their own payment or must recuse themselves.

Best practice is that modifications to a partner's guaranteed payment require approval by the management committee excluding the partner whose payment is being modified, at a defined majority or supermajority threshold. This keeps any partner from using their governance rights to block a reduction in their own payment when the company's finances truly require it, while keeping the majority from using the review process to punish a minority partner by cutting their payment without cause.

Deferred and Accrued Guaranteed Payments

When the company cannot afford the full payment in a given period, the operating agreement should specify what happens to the unpaid amount. Two principal approaches:

- **Accrual and later payment.** The unpaid amount accrues as an obligation of the company, to be paid when cash flow allows. Accrued guaranteed payments are typically paid without interest, or with interest at a defined rate (often the prime rate), before any profit distributions are made. This treats the deferred compensation as a debt that must be satisfied before equity owners receive profits, which fits the fact that the deferred amount is earned compensation.
- **Forfeiture.** The unpaid amount is forfeited if the company cannot pay it in the current period. This is more conservative for the company, since it eliminates the liability, but it places the entire burden of the shortfall on the partner whose payment went unpaid, which may be inequitable when the shortfall came from the company's decisions rather than any failing of that partner.

The operating agreement should state which approach applies and, if accrual is used, the maximum amount that can accrue before a partner may demand payment even without available cash flow.

The Self-Employment Tax Problem and Strategies for Managing It

One of the most significant tax costs tied to guaranteed payments in a member-managed LLC, or any LLC where a managing member provides services, is the self-employment tax. Understanding it and the strategies for managing it is essential to designing a guaranteed payment structure that serves the partners efficiently.

Why Self-Employment Tax Applies

A member who provides services to the LLC in a management capacity is treated as a general partner for self-employment tax purposes under the IRS's current administrative guidance. General partners pay self-employment tax on their distributive share of the partnership's ordinary income, not just on guaranteed payments. Members in a management role are therefore potentially subject to the tax on both their guaranteed payments and their allocable share of the company's ordinary business income from fee activities.

The self-employment tax rate is 15.3 percent on the first $184,500 of combined wages and self-employment income for 2026, declining to 2.9 percent above that threshold. Half of the tax is deductible from gross income for federal income tax purposes, which reduces the effective cost somewhat but does not eliminate it. For a managing partner receiving a $200,000 guaranteed payment plus a $100,000 allocable share of ordinary business income, the self-employment tax, before the partial deduction, runs roughly $31,000 to $32,000 per year.

Structural Approaches to Managing Self-Employment Tax

Several structural approaches reduce or manage the self-employment tax burden on development company partners, each with a different risk profile and implementation demands:

- **An S-corporation for service income.** Some development companies use an S-corporation, or a partnership that elects corporate treatment for employment tax purposes, as the entity that employs the managing partners, paying them a reasonable salary through the S-corp and distributing the remainder as distributions not subject to self-employment tax. This reduces the tax on the portion paid as distributions rather than salary, but it requires careful calibration of what counts as a reasonable salary and adds entity-level complexity.

- **Allocation of income to investment activities.** Self-employment tax does not reach a member's share of income from investment activities, such as the rental of real property or the appreciation of held assets. A company that owns and holds completed assets alongside its active development and management activities may be able to allocate part of the partners' income to the investment activity, which is not subject to the tax. The allocation must reflect real economic activity and survive IRS scrutiny.
- **Net investment income tax planning.** The 3.8 percent net investment income tax applies to investment income of higher-income taxpayers, but income from active participation in a business, including guaranteed payments and active business income, is not subject to it. Structuring to manage which income is subject to self-employment tax rather than the net investment income tax may be preferable for partners in certain brackets.

Self-employment tax planning is a highly individual analysis that turns on each partner's total income from all sources, their state of residence, and their role in the company. The team should work through this exposure with the company's CPA as part of the compensation design, before the operating agreement is finalized.

Profit Distributions: Policy, Timing, and Approval

Profit distributions are how accumulated earnings, above guaranteed payments and above any required reserves, are returned to the partners as a return on equity ownership. A clear, written distribution policy removes the most common source of partner financial disagreement: when money gets taken out of the company.

The Distribution Policy Decision

The operating agreement must specify when and how distributions are made. The decisions to address:

- **Frequency.** Distributions may be quarterly, semi-annually, annually, or deal by deal as projects are disposed. Most professional development companies distribute quarterly when cash allows, with an annual true-up that reconciles the year's activity against the prior quarterly distributions.
- **Required reserves before distribution.** No distribution should be made if it would leave the company unable to meet near-term obligations. The agreement should set a minimum cash reserve, expressed either as a fixed amount (such as three months of operating expenses) or as a percentage of total cash, that must be maintained before any distribution is approved. This protects operational stability against partners who might prefer current distributions over the liquidity buffer ongoing operations require.
- **Approval authority.** Who can approve a distribution: a single partner or managing member, or a majority of the management committee? Distributions below a threshold might be authorized by the managing member alone, while larger or irregular ones require committee approval.
- **Distribution proportion.** The agreement must state whether distributions are pro rata to ownership percentage or in some other proportion. In the straightforward case, distributions track equity: a 40 percent partner receives 40 percent of every distribution. If the company has classes of interests with different economic rights, the priority among classes must be specified.

Reinvestment and Distribution: The Cultural Decision

Every distribution decision is also a reinvestment decision. Cash distributed to the partners is cash not available for the next deal's pre-development costs, the next key hire, or the company's growing infrastructure. This tension between current partner income and the company's growth capital is a recurring governance challenge the team should discuss as a matter of shared philosophy, not just operating agreement mechanics. Two distinct philosophies tend to emerge:

- **Maximum distribution.** Partners receive the most cash the company can distribute consistent with the reserve requirement, leaving as little as possible in the company. This prioritizes partner financial autonomy, letting each partner decide how to invest their share of the earnings. Its weakness is that it leaves the company dependent on external financing for growth rather than building equity through retained earnings.
- **Strategic retention.** The company retains a portion of earnings above the reserve to fund identified growth needs, such as a planned key hire, a specific market expansion, or the company's co-investment in an upcoming deal. This treats the balance sheet as a strategic asset rather than a pass-through vehicle. Its weakness is that it requires the partners to agree on what the retained capital is for and how long it stays retained, which can become a source of conflict if the priorities are not clearly shared.

Most mature development companies settle on a hybrid: distributing a defined percentage of available earnings quarterly and retaining the remainder in a designated operating reserve and growth capital account, earmarked for specific purposes identified in the annual business plan that the management committee approves as part of the budget process.

The Mandatory Tax Distribution: Solving the Phantom Income Problem

Of all the financial provisions in a development company operating agreement, none is more practically important, or more frequently omitted from template agreements, than the mandatory tax distribution. Understanding why it exists takes understanding the specific way pass-through taxation creates tax obligations without corresponding cash.

The Phantom Income Problem

A pass-through entity, an LLC taxed as a partnership, pays no income tax at the entity level. Instead, its income, deductions, gains, and losses are allocated to each partner on the annual K-1 and taxed at the partner's individual rate, regardless of whether any cash is actually distributed.

The result is a category of taxable income that real estate attorneys and accountants call phantom income: income a partner must report and pay tax on without receiving any cash distribution from the company to fund the payment. It arises in several common scenarios:

- **Cancellation of debt income.** If the company negotiates a reduction in a project loan, for example a construction lender accepting 90 cents on the dollar in a deed-in-lieu settlement, the forgiven debt may be taxable income to the company and its members even though no cash was received.
- **Depreciation recapture at disposition.** Real estate is depreciated over 27.5 years for residential property or 39 years for commercial property. When a project is sold, the depreciation taken during the hold period is recaptured as income at disposition. If the proceeds flow to lenders and investors rather than to the company, the partners may owe recapture tax without a corresponding distribution.
- **Fee income accrual.** If the company uses accrual accounting for tax purposes, it may recognize fee income in a year before the cash arrives. Partners owe tax on the accrued income even if the company's cash position does not support a distribution.

- **Guaranteed payments deferred for cash flow reasons.** As noted above, deferred guaranteed payments are still taxable income to the partner in the year they are earned, even if the cash is paid in a later year.

How the Mandatory Tax Distribution Works

The mandatory tax distribution requires the company to make a minimum cash distribution to each partner calculated to cover the federal and state income taxes the partner owes on their allocable share of the company's taxable income. It is an advance distribution that ensures partners have the cash to pay the taxes the company's operations generate. The mechanics:

- **Step 1.** Calculate each partner's allocable share of the company's taxable income for the relevant period, quarterly or annually depending on the payment schedule.
- **Step 2.** Multiply that allocable share by the assumed tax rate specified in the operating agreement, typically the highest combined federal and state marginal rate applicable to an individual in the relevant jurisdiction, expressed as a single percentage. A common assumed rate for high-income partners in high-tax states is 45 to 55 percent, reflecting federal ordinary income rates, state income taxes, and the net investment income tax.
- **Step 3.** The product is the minimum tax distribution each partner is entitled to receive, regardless of whether a regular profit distribution would otherwise be made that period.
- **Step 4.** The tax distribution is credited against the partner's future distribution entitlements. It is an advance on equity distributions, not additional compensation. Partners who receive tax distributions in excess of what they would otherwise have received under the regular policy repay the excess from their next regular distribution.

Illustrative Tax Distribution Calculation

Facts: a two-partner development company generates $400,000 in taxable income in Year 1 from fee revenue and project closings. Partner A holds 60 percent and Partner B holds 40 percent. The operating agreement's assumed tax rate is 48 percent, reflecting the top federal rate of 37 percent, state income tax of roughly 7 percent, and the 3.8 percent net investment income tax.

Partner A (60 percent): allocable taxable income of $240,000; tax distribution of $240,000 × 48 percent = $115,200.

Partner B (40 percent): allocable taxable income of $160,000; tax distribution of $160,000 × 48 percent = $76,800.

Total mandatory tax distribution: $115,200 plus $76,800 = $192,000.

Without this provision, Partner A owes about $115,200 in income tax, at a 48 percent combined rate on $240,000, from personal resources, with no cash from the company to fund the payment. If Partner A's guaranteed payments did not cover both living expenses and this tax obligation, the strain could be severe.

The Priority of Tax Distributions

Tax distributions should be structured as first-priority distributions, senior to all others, including regular profit distributions. The rationale is straightforward: a partner owed a tax distribution has a current, due-and-owing obligation to the IRS, while regular profit distributions are discretionary. Prioritizing tax distributions ensures the company meets its partners' most immediate financial obligation before making elective distributions.

The agreement should provide that if the company lacks sufficient cash to make the full required tax distribution, it will make a pro-rata partial distribution and supplement it as cash becomes available, before any other distribution. It should also provide that failure to make a required tax distribution is not a breach of the operating agreement, since the provision creates an entitlement rather than an absolute obligation, but that partners who have not received their full tax distribution hold a priority claim on the next available cash.

The Assumed Tax Rate: Choosing the Right Number

The assumed tax rate in the formula is a critical variable that drives both the size of tax distributions and the company's required cash reserves. Set it too low and partners lack the cash to pay their taxes; set it too high and the company over-distributes, reducing the capital available for operations and growth. Common approaches:

- **A single blended rate for all partners.** Easy to administer but necessarily imprecise, since partners may live in different states with different rates. Using the highest applicable state rate, often California's 13.3 percent top individual income tax rate, protects all partners but over-distributes to those in lower-tax states.
- **Partner-specific rates.** The company calculates a separate tax distribution for each partner based on their individual circumstances. More precise but significantly more complex to administer, and it requires annual disclosure of each partner's tax situation to the company.
- **A single rate with an annual true-up.** The company uses a uniform assumed rate during the year, and at year-end each partner discloses their actual effective rate. The company then makes or receives a supplemental distribution or credit to true up to each partner's actual tax cost.

For most development company partnerships, a single blended rate set at the high end of the applicable range is the most practical approach. It errs toward ensuring partners have the cash to pay their taxes, and the modest over-distribution to lower-tax-state partners is a reasonable price for administrative simplicity.

Expense Reimbursement: What the Company Pays and How

Real estate development involves a great deal of expense: travel to evaluate sites, due diligence on potential acquisitions, meals with brokers and investors, conference fees, continuing education, and the daily overhead of running a professional business. The operating agreement must establish clear policies on which expenses the company reimburses, what documentation is required, and who approves reimbursements.

Without a written expense policy, reimbursements are governed by each partner's individual judgment about what the company should pay for, which tends to diverge in ways that generate friction exactly when partner relationships are already stressed. A written policy converts a recurring negotiation into a documented standard that applies equally to all partners.

Categories of Reimbursable Expenses

The policy should address each major category specifically, distinguishing expenses reimbursed without prior approval, expenses that require prior approval, and expenses the company will not reimburse regardless of their apparent business connection:

- **Travel to evaluate sites or attend closings.** Generally reimbursable without prior approval for direct costs (airfare, hotel, ground transportation). The policy should set a reasonable nightly hotel cap and require coach airfare for domestic travel.

- **Business meals and entertainment.** Reimbursable with documentation of the business purpose and attendees, typically subject to a per-person cap for routine meals and a separate approval requirement for larger entertainment.
- **Professional conference and continuing education fees.** Reimbursable for conferences or education directly related to the company's activities, subject to a defined annual cap per partner or an approval requirement above a threshold.
- **Home office expenses.** The policy should state whether partners working primarily from home offices are reimbursed for home office costs (internet, utilities, dedicated space) and, if so, at what rate and with what documentation. Home office deductions are complex under federal tax law and should be structured carefully with the company's CPA.
- **Personal expenses with an incidental business connection.** Explicitly excluded. A first-class flight upgrade, a luxury hotel above the policy cap, golf fees for a round that included one brief business conversation, or a personal vehicle lease allocated partly to business use are all categories where clear exclusions prevent recurring disagreements.

Documentation Requirements

Every reimbursement claim should be supported by a receipt and a brief written description of the business purpose. The IRS requires documentation specific enough to establish the business connection, and the company's policy should require the same level of detail that would support a tax deduction.

The company should use an expense management system, even a simple shared spreadsheet in the early years, graduating to dedicated software as it grows, that creates a documented record of all reimbursed expenses. That record protects the company in an audit, gives all partners visibility into spending on business development and operations, and provides a basis for the annual review of the expense policy.

Capital Calls: When Partners Must Put In More

A capital call is a formal demand by the company that its members contribute additional capital beyond their initial contributions. Calls arise when the company needs funds that current reserves and fee income cannot cover: an operating loss during a slow period, an unexpected working capital need, a co-investment opportunity that requires partner capital, or pre-development costs on a deal before construction financing is in place.

The capital call provisions are among the most consequential and most contentious the founding team will encounter. They determine who bears the burden of the company's cash needs above its initial capitalization, what happens when a partner cannot or will not fund a call, and whether one partner's financial limits can stop the company from making a critical investment.

The Authority to Make a Capital Call

The agreement must specify who can require additional contributions. This sits at the intersection of operational efficiency, which argues for giving the managing partner broad authority to call capital when needed, and partner protection, which argues for requiring approval before any partner must contribute more personal funds. Common approaches:

- **Mandatory calls require unanimous partner consent.** The most protective structure for all partners: no partner can be required to contribute more without agreeing. The weakness is paralysis risk; if one partner has the resources to fund a critical need and is willing to, but another will not consent to a formal call, the company may be unable to access a critical source of funds.

- **Calls above a defined threshold require supermajority approval; calls below it require majority approval.** A tiered approach that demands broad consensus for major capital demands while allowing routine operational calls at a lower threshold.
- **The managing partner may call capital up to a defined annual limit without further approval; calls above the limit require a defined partner approval threshold.** This creates flexibility for modest needs while protecting partners from unilateral demands for large contributions.

Notice Requirements

Capital calls must be preceded by written notice to all partners specifying:

- The total amount being called and each partner's pro-rata share of it.
- The business purpose for which the capital is needed, specific and documented rather than a vague statement of operational need.
- The funding deadline, which should be reasonable given the urgency, commonly 30 days for non-urgent calls and 10 to 15 days for urgent ones.
- The consequences of failure to fund, articulated clearly so that a non-funding partner cannot later claim they did not know what would happen.

Consequences of Failure to Fund: The Dilution and Loan Mechanics

The provisions for what happens when a partner fails to fund a required call are among the operating agreement's most important protections. Without specific, enforceable consequences, a partner who chooses not to fund suffers no economic penalty while their partners bear the full burden of the company's need. The most common consequence structures:

Dilution. The non-funding partner's membership interest is reduced in proportion to their failure to fund, typically at a punitive ratio designed to compensate the funding partners for the risk and burden of funding the call alone.

The mechanics work as follows. If the total call is $300,000 and Partner B, who holds 40 percent, fails to contribute their $120,000 share, Partners A and C, who hold 60 percent combined, fund the full $300,000. Under a two-to-one dilution ratio, Partner B's interest is reduced by $240,000 worth of dilution, which is two times the unfunded $120,000, and Partners A and C receive corresponding increases valued at $240,000.

The dilution ratio, whether one-to-one, two-to-one, or higher, is a negotiated term reflecting the parties' view of how severely a non-funder should be penalized and how strong an incentive to fund is needed. A one-to-one ratio simply adjusts ownership to reflect actual contributions; a two-to-one ratio adds a meaningful penalty. Higher ratios are harder to defend as commercially reasonable if the non-funder challenges them.

Deemed loan from the funding partners. Rather than immediate dilution, the unfunded amount is treated as a loan from the funding partners to the non-funding partner, bearing interest at a penalty rate (commonly prime plus 3 to 5 percent) and secured by the non-funding partner's membership interest. The loan is repaid from distributions the non-funding partner would otherwise receive, before those distributions reach them.

The loan structure preserves the non-funding partner's equity while creating a financial penalty, through above-market interest, and a repayment obligation from future distributions. It is less immediately punitive than dilution but creates an ongoing obligation that can reduce the non-funding partner's return from the company for years.

Suspension of governance rights. The non-funding partner loses voting and information rights during the period of non-funding, and those rights are not restored until the unfunded amount plus

interest is contributed. This may be combined with either the dilution or the loan approach and is particularly significant for a non-funding partner who holds minority veto rights on certain decisions.

The agreement should specify a cure period, the window during which a non-funding partner can contribute the required amount and avoid the permanent consequences. A cure period of 10 to 20 days after the initial deadline is common, giving a partner who missed the deadline for logistical rather than financial reasons a brief chance to contribute without penalty.

Voluntary and Mandatory Capital Calls

Not all capital needs require a mandatory call. The agreement may distinguish mandatory calls, where all partners must contribute their pro-rata share, from voluntary contribution opportunities, where partners may elect to contribute but are not required to.

Voluntary contributions create their own complications. If some partners contribute and others do not, the relative ownership percentages change, the capital account balances diverge, and future distribution entitlements may shift in ways that are hard to unwind if the voluntary contributors later want their relative positions restored. The agreement should specify whether voluntary contributions dilute the non-contributing partners, are treated as partner loans, or are governed by some other mechanism.

Capital Calls and Anti-Dilution Protection

A founding partner who negotiated a specific equity percentage and economic arrangement should consider what happens to that arrangement if a capital call dilutes their interest. Anti-dilution provisions, contractual rights to participate in any call to the extent necessary to maintain a specified minimum ownership percentage, are a legitimate protection for founding partners whose equity position is a key term of joining the venture.

Anti-dilution provisions are not standard in development company operating agreements and are more common in venture capital investment agreements. But for a founding partner whose equity is closely tied to their economic expectations, a partner who agreed to a 40 percent stake as the core term of their arrangement, the ability to hold that stake against dilutive calls is worth negotiating at formation, before the first call arises.

Partner Loans to the Company

As an alternative to mandatory capital calls, the operating agreement may permit partners to lend money to the company when it needs additional funds. Partner loans carry different legal, tax, and governance implications from equity contributions, and the agreement must address each.

Why Partner Loans Are Sometimes Preferable

A partner loan has several structural advantages over an equity call in specific circumstances:

- **Priority in liquidation.** Debt ranks ahead of equity, so a lending partner has a priority claim on the company's assets up to the loan amount before any equity distributions. This may matter to a partner providing capital who does not want to bear the full equity risk of the company's overall performance.
- **Preservation of existing equity ratios.** A loan does not change the partners' relative equity percentages. If diluting the existing structure is undesirable, because one partner is funding a specific project the others cannot afford to co-invest in, a loan provides the capital without restructuring the broader partnership economics.

- **A clear repayment timeline.** A loan has a maturity date and interest rate that create a defined obligation and a clear path to repayment. Equity contributions may not be returned for years, if ever; a loan offers a more predictable cash return to the lending partner.

Required Documentation for Partner Loans

A partner loan must be documented with a formal promissory note executed by the company in favor of the lending partner. The note should specify:

- The principal amount of the loan.
- The interest rate, which must be at least the applicable federal rate published by the IRS to avoid the below-market loan rules under IRC Section 7872, which would impute phantom interest income to the lender and phantom interest expense to the borrower. Using the applicable federal rate as a floor ensures the loan is respected as a genuine arm's-length obligation.
- The repayment schedule: when principal is due, whether early repayment is permitted without penalty, and whether repayment comes from specific sources, such as the first available distributions from a particular project, or from any company funds.
- The priority of the loan relative to other obligations, typically senior to equity distributions but junior to third-party debt unless the parties agree otherwise.
- Default provisions: what constitutes a default, the cure period, and the remedies available to the lending partner on default.

Tax Implications of Partner Loans

Interest paid by the company on a partner loan is generally deductible by the company as a business expense and taxable as ordinary income to the receiving partner. This treatment is well understood and avoids the complexity of equity instruments. But certain structuring errors can convert what looks like a partner loan into a disguised capital contribution, with different tax treatment, if the loan terms are not commercially reasonable or if the loan is, in economic substance, an equity contribution repayable only from profits.

The IRS applies an economic substance test to decide whether a supposed loan is genuine debt or a disguised equity contribution. The factors include whether the loan has a fixed maturity date, whether interest accrues and is actually paid, whether the obligation is unconditional, whether the lender has taken steps to enforce repayment, and whether repayment is contingent on the company's profits. Partner loans that are true debt obligations, priced at commercially reasonable rates with enforceable repayment terms, pass this test without difficulty. Arrangements labeled as loans but functioning as equity, where repayment is expected only if the company is profitable, risk recharacterization.

Building the Financial Arrangement Summary

The arrangements covered in this chapter, guaranteed payments, profit distributions, mandatory tax distributions, expense reimbursement, capital calls, and partner loans, must be addressed specifically and completely in the operating agreement before the company begins operations. The checklist below summarizes the provisions that must be present and what they must specify.

Financial arrangement	What the operating agreement must specify	Common drafting omission
Guaranteed payments	Amount for each partner; payment timing (monthly, quarterly); adjustment mechanism and approval authority; treatment of deferred amounts (accrual or forfeiture); asymmetric payment provisions if applicable	No mechanism for adjusting payments as the company's financial position changes; no specification of the

Financial arrangement	What the operating agreement must specify	Common drafting omission
		approval threshold required to modify any partner's payment
Profit distributions	Frequency; minimum reserve requirement before distribution; approval authority; proportion (pro rata to equity, or otherwise); priority among categories of distribution, with tax distributions first	Silent on the reserve requirement, leaving timing entirely to the managing partner's discretion; no specified frequency, which creates ad hoc decision-making
Mandatory tax distributions	The formula (allocable taxable income multiplied by the assumed tax rate); the assumed rate; priority relative to other distributions; treatment of over-distributions in later periods; quarterly or annual calculation	Missing entirely from template agreements; some agreements reference it without specifying the assumed rate or the priority
Expense reimbursement	Categories of reimbursable expenses; documentation requirements; per-category limits or caps; approval required above defined thresholds; explicitly excluded personal expenses	Silent on personal expense exclusions; no documentation requirement; no defined approval authority for large expense claims
Capital calls	Authority to make a call; notice requirements; funding deadline; consequences of non-funding (dilution mechanics, loan, or rights suspension); cure period; anti-dilution provisions if applicable; voluntary versus mandatory distinction	Consequences of non-funding unspecified or too vague to enforce; no dilution ratio defined; cure period absent
Partner loans	Permission for partner loans; requirement for a formal promissory note; minimum interest rate (at least the applicable federal rate); repayment priority; default and remedy provisions	No interest rate requirement, creating below-market loan exposure; no formal documentation required; no priority specification relative to equity distributions

CHAPTER 7: KEY TAKEAWAYS

1. Partners receive economic benefit from a development company through three distinct channels: guaranteed payments (ordinary income, subject to self-employment tax, independent of profitability); profit distributions (character flows from the company's underlying income); and the promoted interest (contingent, capital-gains-taxed, earned at disposition). Each has different tax treatment, different timing, and a different relationship to the company's performance. Confusing them produces both tax and governance problems.
2. Guaranteed payments must be set against a realistic 24-month budget, not against each partner's prior market rate. Asymmetric payments are appropriate when partners have meaningfully different roles and time commitments. The adjustment mechanism must specify who can modify any partner's payment and whether the affected partner can vote on it. Deferred payments should accrue, with interest, rather than be forfeited, since they represent earned compensation.
3. Self-employment tax is a material cost on a managing member's guaranteed payments and distributive share of ordinary business income. At 15.3 percent on income up to the wage base, it adds roughly $18,000 to $21,000 a year on a $150,000 guaranteed payment. The company's compensation design should address this exposure in coordination with the CPA.
4. The mandatory tax distribution is the operating agreement's solution to the phantom income problem: taxable income allocated to partners on their K-1s without corresponding cash. The provision requires the company to distribute a minimum amount, each partner's allocable taxable income multiplied by the assumed combined tax rate, prioritized above all other distributions and credited against future equity distributions.

5. Profit distribution policy must specify frequency, the minimum reserve before any distribution, the approval authority, and the proportion among partners. The reinvestment-or-distribution philosophy, whether the company retains earnings for growth or distributes the maximum available cash, is a cultural decision the founding partners should share explicitly rather than leave to ad hoc negotiation at each distribution.
6. Capital call provisions are among the most consequential financial provisions in the operating agreement. They must specify the authority to call capital, the notice requirements, the funding deadline, and, most critically, the consequences of failure to fund: dilution (with the specific ratio), a deemed loan from the funding partners (with the interest rate and repayment mechanics), or suspension of governance rights. The cure period prevents permanent consequences from logistical delays.
7. Partner loans are a legitimate alternative to equity capital calls in specific circumstances, but they require a formal promissory note, a commercially reasonable interest rate (at least the applicable federal rate), defined repayment terms, and priority specification. Arrangements labeled as loans but structured as contingent equity contributions risk IRS recharacterization.

WHAT COMES NEXT

Chapter 8 completes Part III with the company's governance structure and decision-making authority matrix: who can act on the company's behalf, what decisions require consensus, and the approval thresholds that run from unilateral managing-partner authority through unanimous consent. It is one of the most operationally consequential and most frequently under-specified provisions of any development company operating agreement. Part IV then turns to operations, beginning with the annual business plan and budget process in Chapter 9.

See also: *Appendix A (Partners' Term Sheet Template: compensation and distribution sections) • Appendix D (Decision Authority Matrix: includes distribution approval authority) • Appendix J (Glossary: guaranteed payment, phantom income, tax distribution, capital call, partner loan, applicable federal rate)*

CH. 8

PART III: ECONOMICS, COMPENSATION & GOVERNANCE

Governance Structure

and Decision-Making Authority

How to design a governance framework that enables operational efficiency without concentrating authority so heavily that minority partners are unprotected, and how to document that framework in a Decision Authority Matrix that actually functions as a governance tool.

Every decision a real estate development company makes is made by someone, and the governance framework determines who. It may be the managing partner acting on their own judgment, the management committee acting by majority, or all the partners acting unanimously. A framework that fits the company lets it decide efficiently, without conflict about who holds the authority. A framework that misfires in either direction, by concentrating too much authority in one partner or by demanding too many approvals for too many decisions, turns the governance structure itself into a source of operational dysfunction.

This chapter approaches governance design from first principles: why the manager-managed structure suits most development companies; how to define the managing partner's authority in terms specific enough to actually govern; how to calibrate the decision authority thresholds that determine when committee approval is required; and how to build a Decision Authority Matrix the company can actually use. That matrix, set out in full later in this chapter, is the central deliverable here and should appear as an exhibit to the operating agreement.

The Fundamental Governance Question: Who Decides?

Governance, stripped of its legal and organizational complexity, comes down to a question of who decides. Every significant action a development company takes, whether committing to a deal, hiring a key person, taking on debt, accepting an investor's subscription, or settling a dispute, requires someone to make a judgment call. The governance framework specifies, in advance and in writing, who is authorized to make each category of decision and under what conditions.

The founding team's governance design has to navigate two pressures that pull in opposite directions:

- **Operational efficiency requires fast, unambiguous decision-making.** A development company operates in a market where opportunities appear and disappear quickly, where construction decisions cannot wait for committee meetings that need advance notice and scheduling, and where counterparties expect a clear point of contact with authority to bind the company. A structure that requires collective approval for every routine decision taxes the company's ability to compete.
- **Partner protection requires meaningful checks on whoever holds day-to-day power.** A minority partner who has committed capital, contributed relationships, and accepted personal guarantee exposure needs to know that the managing partner cannot make decisions that fundamentally affect the company's direction, finances, or risk profile without consultation and approval. Without those checks, minority partners are exposed to outcomes they did not agree to and cannot control.

The framework balances these pressures by matching the level of required approval to the significance of the decision. Routine operational decisions need no additional approval; significant financial commitments need majority approval; decisions that reach the company's structure or strategy need unanimous consent. Calibrating those thresholds is the most important governance design decision the founding team makes.

Manager-Managed and Member-Managed: Choosing the Right Structure

The Delaware LLC Act and its equivalents in other states provide two default governance structures for an LLC: member-managed and manager-managed. The choice between them is the foundational governance decision, because it sets the default scope of authority for the company's principals and shapes every other governance provision that follows.

Member-Managed Structure

In a member-managed LLC, every member has authority to act on behalf of the company and to bind it to contracts and obligations in the ordinary course of business. Decisions are made collectively, typically by a majority of the membership interests unless the operating agreement specifies otherwise. There is no designated manager with special operational authority; all members are co-managers with equal default authority.

The member-managed structure suits small LLCs with few members who all participate actively and who have deliberately chosen to run the business by consensus. It is almost never appropriate for a development company with two or more founding partners holding distinct operational roles, because:

- **Every member has default authority to bind the company.** A member who acts in their own name in a business context, by signing a contract, making a representation, or accepting an obligation, can bind the company even if the others object, as long as the action appears to be in the ordinary course of business. This creates liability exposure from every member's actions, not just the designated manager's.
- **Decision-making requires collective agreement by default.** In a multi-member development company where speed matters and partners hold different areas of expertise, requiring collective consent for all operational decisions creates the kind of friction that slows the company down and breeds conflict about who has authority to act on any given question.

Manager-Managed Structure

In a manager-managed LLC, the operating agreement designates one or more managers with authority to run day-to-day operations and to bind the company within the scope of their authority. The members retain ultimate governance authority over fundamental decisions but delegate operational authority to the manager. The manager may be one or more of the members, a managing member, or a non-member professional manager.

For a development company, the manager-managed structure with a designated Managing Member or Managing Partner is almost always the right choice. It provides:

- A clear point of authority for routine operational decisions, which lets the company respond quickly to deal opportunities and business needs without convening a committee for every judgment call.
- A defined scope for the manager's authority, which lets the manager act confidently within that scope and protects minority partners from overreach outside it.

- Separation between the manager's operational authority and the members' governance rights over fundamental decisions, creating the tiered structure that balances efficiency and protection.
- Clarity for third parties about who can bind the company, which reduces the risk of inadvertent commitments by members who lack authority in the specific context.

Co-Manager Structures

Some founding teams choose a co-manager structure, designating all founding partners as co-managers with equal authority. This is a hybrid between the member-managed and manager-managed frameworks: it removes the distinction between manager and non-managing members, giving all partners operational authority, while keeping the manager-managed label and its governance framework.

Co-manager structures work when the founding partners have comparable roles, comparable time commitments, and a decision-making culture comfortable with joint authority and shared responsibility for every operational choice. They work less well when the partners have distinct roles, one managing construction while another manages investor relations, because co-manager status gives each partner equal theoretical authority over the other's domain, inviting the interference that the operating agreement's role definitions were meant to prevent.

For most development company partnerships, the single-managing-member structure provides cleaner governance lines, even when the managing member is expected to consult with and respect the other partners' expertise in their domains. The operating agreement's consultation requirements and the management committee's approval authority over significant decisions provide adequate protection for the non-managing partners without the ambiguity of shared operational authority.

The Managing Member: Role, Authority, and Limits

Designating a managing member is only the beginning of the governance design. The operating agreement must define with specificity what the managing member can do unilaterally, what they cannot do without committee approval, and how the other partners can hold them accountable for the exercise of that authority.

The Managing Member's Unilateral Authority

The managing member's unilateral authority, the scope of decisions they can make without prior committee approval, should be calibrated to decisions that genuinely require immediate action or that fall within a business plan the committee has already approved. Effective categories of unilateral authority for a managing member of a development company include:

- Executing contracts for goods and services up to a defined dollar threshold (commonly $25,000 to $50,000 per commitment), provided the expenditure is within the approved annual operating budget.
- Managing day-to-day banking: authorizing payments, approving invoices, and managing cash within the company's approved accounts.
- Hiring employees and engaging independent contractors up to a defined salary or engagement threshold, consistent with the approved budget and staffing plan.
- Making routine operational decisions within approved development projects: approving pay applications, managing general contractor relationships, and addressing day-to-day construction issues within the approved budget contingency.

- Conducting investor outreach and relationship meetings without committing to any offering or subscription.
- Engaging outside legal counsel for routine matters, such as contract review and lease negotiation, within a defined cost threshold.

The principle is that unilateral authority should cover decisions falling within parameters the committee has already established through the approved budget and business plan. The committee sets the parameters; the managing member operates within them.

Accountability Mechanisms for the Managing Member

Unilateral authority means little without accountability. The managing member's authority must be paired with specific mechanisms that give the other partners visibility into how it is being exercised:

- **Regular reporting.** The managing member should provide the committee with regular financial reports, project status updates, and operational summaries, at minimum quarterly and more often during active construction. These reports create a contemporaneous record of the managing member's decisions and let the committee spot deviations from the approved plan before they become material.
- **Budget variance reporting.** When actual expenditures deviate materially from the approved budget, typically defined as exceeding any line item by more than 10 percent or by more than a defined dollar amount, the managing member should report the variance to the committee and seek a budget amendment if the variance is expected to continue.
- **Advance notice for decisions approaching the authority threshold.** A managing member about to execute a contract at the top of their unilateral authority, at $48,000 against a $50,000 threshold, for example, should notify the committee before closing. The notice, even without requiring approval at that level, keeps the committee informed and prevents the managing member from repeatedly approaching the threshold on related commitments that, taken together, exceed it.
- **Removal and replacement.** The operating agreement must specify when the managing member can be removed and replaced, the threshold of member approval required, and the process for designating a successor. Without a removal mechanism, the appointment effectively becomes irrevocable, which is untenable if the managing member's performance is unsatisfactory.

Removing and Replacing the Managing Member

Removing a managing member is among the most sensitive governance actions a development company can take, because the managing member is usually also a significant equity holder whose departure from the operational role may create complications under the vesting and departure provisions addressed in Chapter 5. The operating agreement must answer several distinct questions:

- **What threshold of member approval is required to remove the managing member from the managerial role?** Common approaches: a majority of the membership interests (which may mean a single partner in a two-partner company); a defined supermajority (66.7 percent or 75 percent); or any majority excluding the managing member's own vote, the most protective approach for non-managing members.
- **Does removal from the role affect the removed partner's equity, vesting, or economic rights?** In most well-drafted agreements, removal from the managerial role is separate from departure from the company. A removed managing member keeps their equity and economic rights as a member, unless the removal occurs under a specific departure or cause provision that separately triggers those consequences.

- **How is the successor designated?** By the remaining members at a defined threshold, or through a succession plan written into the operating agreement? The answer should be set in advance, not worked out mid-transition when tensions are high.

The Management Committee: Structure and Function

The management committee, the governing body above the managing member's day-to-day authority, is where the founding partners exercise their shared governance rights over significant decisions. It sits between the managing member's routine operational authority and the unanimous member consent required for fundamental decisions, handling the large middle category of decisions that need more than one person's judgment but not necessarily universal agreement.

Composition

For a founding team of two to four partners, the management committee typically consists of all founding partners, each serving by virtue of their membership interest rather than by election or appointment. As the company grows and admits new partners, committee composition should be addressed, either by expanding the committee to include all partners or by setting a defined size, such as five seats, with designated representation rights for different equity classes.

For a larger founding team, composition may involve representation rather than universal inclusion: partners with equity above a defined threshold sit by right, while partners with smaller positions elect a representative for collective representation. Whatever the structure, it must be specified in the operating agreement with the same precision as the other governance provisions.

Voting Rights and Quorum

The operating agreement must specify how committee decisions are made:

- **Per-capita or proportional voting.** Under per-capita voting, each committee member has one vote regardless of equity percentage; under proportional voting, each member's vote is weighted by their membership interest. Per-capita voting is most common for founding teams that consider all partners' judgment equally valuable regardless of ownership. Proportional voting is more common when ownership percentages differ significantly and the majority owner expects greater governance influence to track their larger economic stake.
- **Majority threshold.** What constitutes a majority for routine decisions: a simple majority of votes cast, or a majority of all committee members including those absent or abstaining? The distinction matters when attendance is imperfect or when a strategic abstention is used to affect the outcome without voting against a proposal.
- **Quorum requirements.** What percentage of the committee must be present, in person or electronically, for a meeting to be valid and a vote binding? A quorum of a majority of committee members is standard. Without one, a single member could call a meeting when another cannot attend and take binding action on a significant decision.
- **Written consent in lieu of a meeting.** The operating agreement should permit binding committee action by written consent signed by the required threshold of members, without a formal meeting, so routine approvals can occur without scheduling coordination.

Meeting Requirements

The committee should meet regularly, at minimum quarterly, to review financial performance, discuss the deal pipeline, address personnel matters, and make the decisions within its authority. More frequent meetings are appropriate during active construction or significant capital raises. The operating agreement should specify:

- Minimum meeting frequency: quarterly for a company with active operations; monthly when the company has multiple active projects or is in the middle of a capital raise.
- Notice requirement: the minimum advance notice before a meeting, and who may call an emergency meeting without the standard notice period.
- Agenda: whether an agenda is required in advance, who prepares it, and whether any member can add items.
- Minutes: whether meetings require written minutes and who prepares, distributes, and retains them.

Calibrating Decision Authority: The Three-Tier Framework

The heart of the governance design is deciding which decisions fall into which approval tier. The three-tier framework, unilateral officer authority, management committee approval, and unanimous member consent, assigns every significant decision to the appropriate level based on its stakes, its reversibility, and its implications for the company's fundamental direction.

Tier One: Unilateral Officer Authority

Tier One decisions are those the managing member, and within their defined domains other officers, can make without prior committee approval. A Tier One decision typically:

- Falls within parameters established by the committee through the approved annual business plan and budget.
- Has a financial impact below a defined threshold that reflects routine operational scale.
- Is reversible or correctable if the managing member's judgment proves mistaken: a vendor can be changed, a hire reversed, a routine contract terminated.
- Does not commit the company to a long-term financial or legal obligation that cannot be unwound without significant cost.

Dollar thresholds for Tier One authority vary by company size and deal scale. For an emerging development company with annual revenues below $5 million, a $25,000 to $50,000 threshold is typical. As the company grows, the threshold may rise to reflect the managing member's demonstrated judgment and the company's larger scale.

Tier Two: Management Committee Majority

Tier Two decisions require majority approval from the committee before the managing member can act. They are significant enough to warrant collective review but do not require the higher bar of supermajority or unanimous consent. A Tier Two decision typically:

- Has a financial impact above the Tier One threshold but not of a magnitude that would be extraordinary for the company's scale.
- Involves a commitment of resources or relationships that deserves collective review but can be made efficiently with majority agreement.
- Is significant but does not fundamentally change the company's direction, risk profile, or ownership structure.

Examples of Tier Two decisions in a development company: hiring a key senior employee, executing a letter of intent on a development site, approving a vendor contract above the Tier One threshold, settling a routine dispute or claim below a defined amount, and approving the terms of a construction financing commitment within pre-established leverage parameters.

Tier Three: Supermajority or Unanimous Consent

Tier Three covers the two most significant categories in the hierarchy. They require either a supermajority (typically 66.7 percent or 75 percent) or unanimous consent from all members. The distinction between the two:

- **Supermajority decisions** are significant but do not rise to the level of fundamental decisions that should be subject to veto by any single member. They require more than a bare majority, to prevent a narrow majority from imposing consequential decisions on a meaningful minority, but they do not require universal agreement. Examples: approving a real property acquisition, authorizing new construction financing above 75 percent LTC, entering a new geographic market, and amending most provisions of the operating agreement.
- **Unanimous consent decisions** so fundamentally affect the company's structure, direction, or the rights of individual members that every member must agree before they can be taken. A member who disagrees holds an effective veto, a protection appropriate only for the most fundamental decisions. Examples: admitting a new member, approving a sale or merger of the company, amending the fundamental provisions of the operating agreement (vesting schedules, departure mechanics, the definition of cause, deadlock mechanisms), and voluntary dissolution.

The Over-Governance Trap

One of the most common governance design errors is routing too many decisions through committee approval, leaving the managing member too little room to operate. A company that requires committee approval for every contract above $10,000, every hire regardless of seniority, and every vendor engagement regardless of how routine is not protecting its partners. It is imposing a tax on every operational decision.

The consequences follow predictably. The managing member either seeks approval for every minor decision, consuming committee bandwidth on routine matters and creating delays that harm the company's competitive position, or simply acts without the required approval, building a pattern of technical violations that undermines the governance framework and creates legal exposure if a dispute later arises about whether a decision was properly authorized.

A well-calibrated framework still requires approval for significant decisions; it should. The real test is whether the managing member can run daily operations within their unilateral authority, without convening committee meetings for routine choices. If the managing member is going to the committee more than two or three times a month for routine decisions, the Tier One threshold is set too low.

The Decision Authority Matrix

The Decision Authority Matrix is the operating agreement's specific articulation of the governance framework, a table that maps each significant category of decision to the appropriate approval level. It converts the governance principles in the operating agreement's management section into a usable reference the company's principals can consult before acting.

The matrix is most valuable when it is comprehensive and specific, attached to the operating agreement as Exhibit C, as described in Chapter 4's annotated table of contents. A matrix that covers only broad categories, such as operational decisions requiring one level of approval and

investment decisions another, is less useful than one that addresses specific decision types with enough granularity to resolve ambiguity in real situations.

The matrix below is designed for a two-to-four partner development company with an active development pipeline. It addresses 39 specific decision types across seven categories. The founding team should review it, modify the dollar thresholds and approval levels to fit their governance philosophy and company scale, and include the modified version as an exhibit to the operating agreement.

HOW TO READ THIS MATRIX

Unilateral Officer: the Managing Member or a designated officer may act without prior approval.

Committee Majority: a simple majority of the management committee is required.

Supermajority: 66.7 percent (or 75 percent) of the committee is required.

Unanimous Member: all members must consent.

Dollar thresholds are illustrative for an early-stage development company and should be calibrated to the company's scale.

Category	Decision	Unilateral Officer	Committee Majority	Committee Supermajority	Unanimous Member
Operations	Execute vendor or service contracts up to $25,000	✓			
	Execute vendor or service contracts $25,001 to $100,000		✓		
	Execute vendor or service contracts above $100,000			✓	
	Routine banking and payment of approved expenses	✓			
	Open or close a bank or investment account		✓		
	Engage or terminate service providers (below $25,000 per year)	✓			
Personnel	Hire employees below a defined salary threshold	✓			
	Hire employees above the defined salary threshold		✓		
	Terminate any employee, with or without cause		✓		
	Set or modify partner guaranteed payments			✓	
	Hire or terminate a C-suite officer			✓	
Investment	Commit to evaluate a development opportunity (no binding obligation)	✓			
	Execute a letter of intent on a development site		✓		
	Execute a purchase and sale agreement for real property			✓	
	Approve closing on any real property acquisition			✓	
	Authorize a real property disposition			✓	
	Approve a co-investment or joint venture with another developer				✓
Debt	Approve construction financing below 75% LTC		✓		
	Approve construction financing above 75% LTC			✓	

Category	Decision	Unilateral Officer	Committee Majority	Committee Supermajority	Unanimous Member
	Execute a personal guarantee on construction debt				✓
	Approve a partner loan to the company		✓		
	Execute a capital call on members			✓	
Capital	Conduct investor outreach and relationship meetings	✓			
	Offer interests in a deal to accredited investors		✓		
	Approve the PPM and deal-level offering documents			✓	
	Accept or reject a specific investor's subscription		✓		
	Issue a capital call to deal-level investors		✓		
Legal	Engage outside legal counsel for routine matters	✓			
	Engage outside legal counsel for litigation or regulatory matters		✓		
	Commence litigation or arbitration on behalf of the company			✓	
	Settle a litigation or regulatory matter above $50,000			✓	
	Settle a litigation or regulatory matter below $50,000		✓		
Strategic	Amend the operating agreement (non-fundamental provisions)			✓	
	Amend the operating agreement (fundamental provisions)				✓
	Admit a new member to the operating company				✓
	Approve a sale or merger of the company				✓
	Change the company's primary business or investment strategy				✓
	Enter a new geographic market as a primary focus			✓	
	Approve voluntary dissolution of the company				✓

The thresholds and approval levels in this matrix are illustrative starting points, not fixed standards. A well-capitalized company managing $200 million in annual deal volume will calibrate its thresholds differently than a company in its first year with one active project. The founding team should review and modify each entry before including the matrix as an operating agreement exhibit.

Two entries deserve specific note. First, executing a personal guarantee on construction debt requires unanimous member consent. No partner should be required to accept personal financial exposure on a guarantee without specifically agreeing to that obligation. A managing member with unilateral authority to bind the company to a guarantee would, in effect, have unilateral authority to obligate their co-partners personally, a level of authority no governance framework should grant.

Second, offering interests in a deal to accredited investors requires committee majority approval. This is a securities offering decision with significant regulatory implications. Even when the managing member has negotiated the deal and is confident in the terms, taking the company into a securities offering should be a shared decision among the partners.

Officer Roles and Their Specific Authority

Most development company operating agreements designate the founding partners in dual roles: as members with equity interests and governance rights, and as officers with operational authority. The officer structure provides a practical way to delegate specific operational domains to specific individuals, creating clear lines of responsibility without requiring a committee meeting for every routine decision within each domain.

Standard Officer Designations

The operating agreement should designate specific officers with defined authority for each of the company's primary operational domains. Standard designations for a development company:

- **Chief Executive Officer or Managing Partner:** overall operational authority within the limits of the operating agreement and the Decision Authority Matrix; external representation of the company; signatory authority on contracts within the Tier One threshold; supervision of the other officers.
- **Chief Financial Officer or Finance Partner:** financial reporting and accounting oversight; banking relationships; financial modeling and underwriting; tax compliance coordination with the CPA; investor reporting and K-1 preparation.
- **Chief Operating Officer or Development Partner:** development project management; construction oversight; entitlement and municipal relationships; general contractor and subcontractor relationships; project financial management.
- **General Counsel or Legal Partner, if applicable:** legal compliance oversight; contract management; regulatory filings; securities law compliance coordination; outside counsel management.

Not every development company needs all of these roles at formation. A two-partner company where one handles finance and operations and the other handles development and investor relations may designate two officers with overlapping domains. The point is to document the authority structure, not to replicate a large organizational chart.

Officer Authority and Member Rights

It is worth distinguishing the authority of a partner's officer role from their rights as a member. An officer's authority is operational: the ability to make decisions and take actions on the company's behalf within a designated domain. A member's rights are constitutional: the ability to participate in governance decisions, receive distributions, access information, and exercise the specific rights the operating agreement grants.

A partner removed from an officer role, say the CFO role is reassigned to a newly hired external CFO, keeps their member rights in full. They continue to hold their equity, receive distributions, attend committee meetings, and exercise their governance rights as a member. The officer removal affects only operational authority, not economic or governance rights as an owner. This matters in the context of a managing partner removal: removing someone from operational management authority does not by itself reduce their economic stake in the business.

Minority Partner Protective Rights

The governance framework's legitimacy depends on its ability to protect minority partners against overreach by the majority or the managing member. Without specific, documented minority protections, a minority partner's governance rights may be meaningless in practice if the majority can override them on any decision short of unanimous consent.

Minority protective rights are not a concession the majority makes out of goodwill. They are a structural feature that protects the integrity of the partnership by ensuring minority partners cannot

be systematically shut out of meaningful participation in governance. A minority partner with no real governance protections has effectively made a capital contribution for an economic interest they cannot protect, a structure unlikely to attract sophisticated co-investors and one that creates real legal exposure for the majority under fiduciary duty principles.

Information Rights

Every member should have the right to receive regular financial reporting and to inspect the company's books and records on reasonable notice. As discussed in Chapter 4, these rights should be documented specifically in the operating agreement rather than left to state law defaults. Information rights are a foundational minority protection: a partner who cannot see the company's financial statements and books cannot meaningfully judge whether the managing member is exercising authority appropriately.

Approval Rights Over Actions That Specifically Affect Minority Interests

The operating agreement should identify specific categories of action that, even if they would otherwise require only majority approval, require the specific consent of any partner whose individual interests are directly and disproportionately affected. Actions that typically fall into this protected category:

- Any amendment that modifies the economic or governance rights of a specific partner more than it modifies the rights of the others, such as reducing one partner's distribution percentage without a corresponding change to all partners.
- Any transaction between the company and a partner or an entity affiliated with a partner, a related-party transaction, which should require the specific approval of the disinterested partners.
- Any dilutive issuance of new membership interests that would reduce a specific partner's ownership below a defined floor without that partner's consent.
- Any alteration of the vesting schedule, departure mechanics, or good leaver and bad leaver framework applicable to a specific partner.

The Right to Challenge Management Decisions

In a well-governed company, minority partners should have a practical way to challenge management decisions they believe exceed the managing member's authority or violate the operating agreement. That mechanism is usually the dispute resolution framework addressed in Chapter 17, the escalation from good-faith negotiation through mediation and arbitration. But the dispute resolution framework is only accessible if the minority partner has the information to identify the issue and the governance rights to raise it.

The operating agreement should provide that any member can request a committee meeting to discuss a specific concern about a management decision, that the managing member must call and attend that meeting within a defined period, and that the committee may review and, if appropriate, rescind a decision that exceeded the managing member's authority or violated the operating agreement.

The Governance Risk of Over-Engineering: When Too Many Approvals Create Paralysis

The preceding sections addressed how to build adequate governance protections into the operating agreement. This section addresses the opposite risk: building so many approval requirements into the framework that the company cannot function efficiently as an operating business.

Over-governance is a less discussed but genuinely harmful pattern, particularly in founding teams where one or more partners come from a professional or institutional background in which every decision passes through multiple layers of review. That model may suit a large institution with a sizable compliance staff and a fiduciary obligation to manage systemic risk. It does not suit a nimble development company competing for deals in a market where the best opportunities move fast.

Signs of Over-Governance

The founding team should watch for the following signs that the framework is over-engineered:

- The managing member routinely brings five to ten items per month to the committee that could reasonably be classified as routine operational decisions. If every decision above $10,000 requires committee approval and the company has a $2 million operating budget, the committee is reviewing hundreds of decisions a year that could be handled within expanded managing member authority.
- Deal decisions are delayed because the committee meeting notice period runs past the time by which a commitment must be made. A development company that loses a deal because the committee could not meet within the required notice period has a governance problem, not a deal problem.
- The managing member seeks retroactive approval for decisions already made because the approval process is too cumbersome to use in real time. Retroactive approvals undermine the framework and create uncertainty about whether a commitment was properly authorized.
- Committee members report feeling overwhelmed by governance obligations: too many approvals to review, too many meetings to attend, too much administrative burden for a company of the relevant scale.

The Budget as a Governance Tool

One of the most effective solutions to over-governance is treating the annual budget as a standing approval for all expenditures within it. Rather than requiring committee approval for every contract above a nominal threshold, the operating agreement can provide that all expenditures within an approved line item of the annual budget are automatically authorized, and that the managing member's authority extends to any commitment within the approved budget without further committee action.

Under this framework, the committee's role shifts from approving individual transactions to approving the budget that sets the parameters for all transactions. The committee reviews and approves the annual budget, and any material amendments to it, at a level appropriate for strategic governance. The managing member then has unilateral authority to execute on the approved budget without returning to the committee for each line item.

This approach requires a rigorous annual budget process detailed enough to meaningfully authorize the expenditures the managing member will make during the year. A budget that is specific at the category level but silent at the line-item level does not provide meaningful authorization; the managing member could spend the entire marketing budget on a single conference while the committee believed it would be spread across many activities. Chapter 9 addresses the annual business plan and budget process in the depth this governance tool requires.

CHAPTER 8: KEY TAKEAWAYS

1. Governance design balances two competing pressures: operational efficiency, the fast, unambiguous decision-making a company needs to respond quickly to deal opportunities, and partner protection, meaningful checks on whoever holds day-to-day

power. The framework resolves the tension not by choosing one over the other but by matching the required approval level to the significance of the decision.

2. The manager-managed structure with a designated Managing Member or Managing Partner is almost always the right structure for a development company. It provides a clear point of operational authority, a defined scope for that authority, and a separation between the manager's day-to-day authority and the members' governance rights over fundamental decisions. Co-manager structures work when partners have comparable roles and a consensus decision-making culture.
3. The managing member's unilateral authority should cover decisions that fall within parameters the committee has already established through the approved budget and business plan and that sit below a defined dollar threshold reflecting routine operational scale. That authority must be paired with specific accountability mechanisms: regular financial reporting, budget variance reporting, advance notice for decisions approaching the threshold, and a clear removal mechanism.
4. The three-tier framework, Tier One (unilateral officer), Tier Two (committee majority), and Tier Three (supermajority or unanimous), assigns every significant decision to the appropriate level based on its stakes, reversibility, and fundamental implications. The most common design error is setting Tier One thresholds too low, creating an approval burden that slows operational decisions and leads to retroactive authorization of commitments already made.
5. The Decision Authority Matrix is the operating agreement's specific implementation of the framework, a table mapping 39 specific decision types across seven categories to the appropriate approval level. The matrix should be attached to the operating agreement as an exhibit, and its dollar thresholds calibrated to the company's scale. Personal guarantee obligations and securities offering decisions warrant specific protection regardless of the general threshold levels.
6. Minority partner protective rights are not concessions but structural features that protect the partnership's integrity. Information rights, approval rights over actions that disproportionately affect minority interests, and a practical mechanism for challenging management decisions that exceed the managing member's authority are the three essential minority protections.
7. The annual budget is the most effective tool for preventing over-governance. By treating all expenditures within approved budget line items as pre-authorized, the framework shifts the committee's role from approving individual transactions to approving the strategic parameters within which the managing member operates, which is the appropriate governance function for a management committee in a professional development company.

WHAT COMES NEXT

Chapter 9 begins Part IV with the Annual Business Plan and Budget Process, the governance document that translates the company's strategy into accountable operational commitments. The annual business plan is the primary vehicle through which partners hold each other accountable for specific deliverables, and the approved budget is the governance tool that lets the managing member operate efficiently without returning to the committee for routine approvals. Together, these mechanisms address the over-governance problem while preserving meaningful partner accountability.

See also: *Appendix D (Decision Authority Matrix: the complete matrix from this chapter, formatted as a standalone operating agreement exhibit) • Appendix J (Glossary: manager-managed, managing member, management committee, quorum, unanimous consent, supermajority)*

CH. 9

PART IV: OPERATIONS, FEES & HUMAN CAPITAL

The Annual Business Plan

and Budget Process

How the founding partners create, approve, and operate within an annual business plan, the governance document that translates strategy into accountable operational commitments and lets the managing partner operate efficiently without constant committee oversight.

Most founding teams write a business plan when they are raising their first round of investor capital or pitching a joint venture partner. They spend weeks on the prose, the financial projections, and the market analysis, then file the document away the moment the capital is committed. A year later, when things have not gone exactly as the plan projected, which they never do, the plan survives only as evidence of how optimistic everyone was at the start.

The annual business plan described in this chapter is a different instrument. It is a governance document rather than a marketing one: the operating framework through which partners hold each other accountable for specific, agreed commitments over the coming year, and the standing authorization that lets the managing partner run operations without returning to the committee for approval on routine decisions. Getting this process right, and embedding it in the operating agreement's governance framework, is one of the most practical steps a founding team can take toward a company that actually functions as intended.

The Annual Business Plan as a Governance Document

The annual business plan occupies a specific place in a development company's governance architecture. It sits between the operating agreement, which establishes the permanent framework of governance rights and obligations, and the day-to-day operational decisions of the managing partner. The operating agreement says who has authority; the annual business plan defines what that authority is authorized to accomplish during the current year.

This positioning gives the plan a dual function. It is at once a planning tool, providing a forward-looking roadmap for the year's activities, resources, and targets, and a governance tool, providing the committee with the standing authorization that removes the need for routine approval-seeking on decisions within its scope. Both functions are valuable. The governance function is the one most commonly overlooked.

The Plan as a Standing Authorization

Chapter 8 introduced the annual budget as a governance tool that lets the managing partner operate efficiently within its parameters without returning to the committee for routine approvals. The annual business plan extends that idea beyond the operating budget to the company's deal pipeline, staffing intentions, capital deployment targets, investor outreach, and strategic priorities.

When a development company's annual business plan has been reviewed, debated, and formally approved by the management committee, the managing partner's authority to execute on it derives from the approval itself. The managing partner does not need a separate committee vote to pursue a deal specifically identified in the approved plan, to hire the analyst position that appears in the

approved staffing budget, or to present the company's platform to the investor segment named in the approved capital strategy. Approval of the plan is the authorization for those activities.

This is the plan's most underappreciated governance value. In a company with a well-run annual plan process, the committee focuses its governance energy on the plan itself, reviewing, debating, and approving the year's strategic priorities and resource allocation, rather than on the individual decisions that carry those priorities out through the year. The result is better governance, since the committee is engaged at the strategic level where its judgment adds the most value while the managing partner is empowered to execute without friction.

The Plan as a Partner Accountability Instrument

The annual business plan is also the primary mechanism through which founding partners are held accountable for their operational commitments. Every partner's role generates commitments that can be measured against actual performance over the year. The plan makes those commitments explicit, sets measurable targets, and creates a shared basis for the year-end performance conversation.

A development company without a formal annual plan process has no shared standard for judging whether a partner has fulfilled their role-specific commitments. If Partner A was supposed to source three new development opportunities and instead sourced one, there is no documented basis for addressing the shortfall unless the target was documented, approved, and understood as a commitment at the start of the year. A formal plan process provides that documentation.

This accountability function connects the plan directly to the equity and compensation arrangements discussed in Chapters 5 through 7. If a partner's vesting schedule includes milestone-based components, a defined deal-sourcing volume, a capital-raising target, a construction performance benchmark, the annual plan is the document in which those milestones are contextualized, tracked, and evaluated. The plan bridges the operating agreement's vesting mechanics and the company's operational reality.

What the Annual Business Plan Must Cover

A plan that serves both the planning and governance functions must be comprehensive enough to meaningfully authorize and constrain the managing partner's activities, and specific enough to create the accountability framework against which actual performance can be measured. The sections below address each primary component the plan must cover.

The Deal Pipeline and Investment Program

The deal pipeline is the operational heart of the annual plan for a development company. It should specify:

- **Active deals under contract or in advanced negotiations.** For each, the plan should include the property address or deal name, the asset class and development strategy, the projected total project cost, the anticipated equity requirement, the development approach (ground-up, value-add, adaptive reuse), the current status and timeline to closing, and the partner primarily responsible for execution.
- **Deals in active pursuit.** For deals being actively evaluated but not yet under contract, the plan should identify the specific sites or opportunities, the anticipated timeline to a binding commitment, the resource requirements (due diligence budget, legal fees, broker relationships), and the probability-weighted capital deployment associated with them.
- **Target deal volume for the year.** The aggregate dollar volume of new project commitments the company intends to make, expressed in total project cost and the company's equity

requirement per deal. This target sets the accountability standard for the deal-sourcing partners.

- **Deal-sourcing activities.** The specific activities through which the company will generate its pipeline: direct landowner outreach, broker relationship cultivation, municipal partnership development, market research, and site identification. These activities are the leading indicators for deal flow; tracking them creates accountability for sourcing performance independent of whether deals actually close, which may depend on market conditions outside any partner's control.

Revenue Projections

The revenue section should specify the company's expected income from each source during the year, with enough specificity to support the operating budget and mid-year variance analysis:

- **Development management fees.** For each active project, the expected fee income based on the fee rate applied to the projected construction cost, the anticipated construction draw schedule, and the milestone payments built into the development management agreement.
- **Acquisition fees.** For each anticipated new project closing, the projected acquisition fee based on the company's standard fee rate applied to the expected acquisition cost.
- **Asset management fees.** For each stabilized or income-producing asset under management, the expected fee income based on the rate applied to the applicable fee base, typically equity invested or gross asset value.
- **Disposition and refinancing fees.** For any project expected to be sold or refinanced during the year, the projected fee income from those events.
- **Contingency.** A downside revenue scenario that reflects the real possibility that some projected fee income does not materialize: a closing is delayed, a disposition is postponed by market conditions, a capital raise takes longer than anticipated.

Revenue projections for a development company are inherently uncertain because they depend on deal closings subject to due diligence outcomes, lender approval, and market conditions. The plan should present both a base case (the most likely outcome given reasonable assumptions) and a downside case (the outcome if two or three material events are delayed or fail to close). The operating budget should be tested against the downside case, not the base case, so the company stays viable if the year does not go exactly as planned.

The Operating Budget

The operating budget is the most mechanically precise section of the plan. It should specify every category of operating expense the management company expects to incur during the year, with monthly or quarterly phasing that reflects when expenditures will actually occur:

- **Personnel costs.** Partner guaranteed payments (by partner); employee salaries and benefits (by position); payroll taxes; and employer contributions to any benefit plans. Personnel is typically the single largest category of operating expense and the one with the least flexibility once commitments are made.
- **Legal and professional fees.** Ongoing securities compliance, deal-level transaction costs (if not charged to the project entity), employment matters, annual entity compliance, and specialized counsel for regulatory or litigation matters.
- **Accounting and tax.** CPA fees for bookkeeping, financial statement preparation, tax return preparation, and any audit or review engagements required by investors or regulators.
- **Insurance.** All coverage lines (directors and officers, errors and omissions, general liability, cyber, workers' compensation), with renewal dates and the premium payment schedule.

- **Technology.** Investor portal, project management software, financial modeling tools, CRM, communications infrastructure, and cybersecurity.
- **Office and facilities.** Rent, utilities, equipment, and any capital expenditures for office infrastructure.
- **Marketing and business development.** Investor relations materials, website maintenance, conference attendance, direct marketing, deal pursuit costs (due diligence on deals that do not close), and broker relationship activities.
- **Contingency.** A defined percentage of total budgeted expenses, typically 10 to 15 percent, set aside for unexpected costs. The contingency should be a real budget line, not a slush fund; its use should trigger a budget variance report to the committee.

The Staffing Plan

The staffing section should specify the company's intended organizational development for the year: which positions are currently filled, which the company intends to fill, the anticipated timing and cost of each planned hire, and the triggering conditions (revenue milestones, deal volume, assets-under-management thresholds) that activate hiring for each position.

Staffing decisions have long-term financial consequences that extend well beyond the current budget year. A hire made in the first quarter creates a compensation obligation that continues into future years regardless of future revenue. The staffing section should therefore address not just the current-year cost but the ongoing run-rate commitment the hire represents and the revenue assumption that makes that commitment sustainable.

The staffing plan should also specify the hiring authority framework: which positions the managing partner can fill within their unilateral authority (typically positions below a defined salary threshold), which require committee majority approval, and which require the committee's specific review and consent regardless of compensation (typically C-suite positions and any hire with direct access to investor funds or regulatory filing obligations).

The Capital Strategy

The capital strategy section addresses the company's plans for raising equity capital for its development projects during the year: from whom, in what amounts, through what regulatory structure, and on what timeline. It is particularly important for companies that raise outside investor capital, because the capital strategy governs the company's securities offering activities, which carry significant compliance implications the committee should review and approve as a whole rather than deal by deal. The section should address:

- The aggregate equity capital the company expects to raise during the year across all deals and funds, as both a base case and a downside case.
- The investor segments the company intends to target: existing investors (repeat commitments from prior deal participants), new investors referred by existing investors, new investors from direct outreach, and any institutional or family office prospects in active engagement.
- The regulatory framework for each anticipated offering: which deals or funds will be offered under Rule 506(b) (no general solicitation, pre-existing relationships required) and which under Rule 506(c) (general solicitation permitted, accredited investor verification required).
- The investor relations activities the company will conduct: events, newsletters, reporting, and personal outreach that maintain and develop the investor network even when no specific offering is active.
- Any planned first-time engagements with institutional capital sources, such as family offices or endowments, and the timeline and prerequisites for those relationships.

The Strategic Review

The final section of the plan should address the company's strategic direction for the coming year and any planned evolution from the prior year. This is the committee's chance to revisit and reaffirm, or deliberately modify, the foundational strategic decisions made at formation:

- **Asset class and development strategy.** Is the company's focus the same as the prior year, or are market conditions or performance results prompting an evolution?
- **Geographic focus.** Is the company deepening its presence in its primary market, or are the conditions for geographic expansion in place, as defined in the formation discussions of Chapter 1?
- **Business model evolution.** Is the company moving from balance sheet development toward a sponsor model, from deal-by-deal syndications toward a fund structure, or from an emerging platform toward an institutional one?
- **Competitive positioning.** What specific advantages is the company developing or reinforcing during the year, and what activities will build them in measurable ways?

The strategic review should be drafted collaboratively by all partners, not just the managing partner, because it addresses questions about the company's fundamental direction that belong to all partners under the operating agreement's governance framework. The plan's other sections, the deal pipeline, the budget, the staffing plan, should flow logically from the strategic review, so the committee's strategic decisions are reflected in the operational and financial detail.

The Business Plan Approval Process

The annual business plan is only as valuable as the process through which it is developed, debated, and approved. A plan the managing partner drafts alone and presents to the committee as a fait accompli is not really a governance document; it is a notice of what the managing partner intends to do regardless of the committee's views. A real governance process requires structured input from all partners, honest debate about strategic and financial priorities, and a formal approval that reflects the committee's considered judgment rather than its passive acceptance of the managing partner's proposal.

The Approval Timeline

The operating agreement should specify the timeline within which the plan must be completed, reviewed, and approved. The calendar below represents best practice for a calendar-year company:

Timing	Activity	Responsible	Deliverable / output
Oct 1 to 15	Prior-year performance review: each partner documents year-to-date results against prior year plan targets	All partners	Written variance analysis per partner
Oct 15 to 31	Strategic review session: the committee discusses market conditions, strategic priorities, and any material changes to the business model for the coming year	Management committee	Meeting minutes; agreed strategic direction memo
Nov 1 to 15	Managing partner drafts the initial plan: deal pipeline, revenue projections, operating budget, staffing plan, capital strategy	Managing partner	Draft plan distributed to all partners
Nov 15 to 30	Partner review and comment: each partner reviews the draft and submits written comments, questions, and proposed modifications	All partners	Written comments from each partner
Dec 1 to 10	Business plan workshop: the committee meets to review and debate the draft, address comments, and reach alignment on the final plan	Management committee	Revised draft incorporating the workshop outcomes

Timing	Activity	Responsible	Deliverable / output
Dec 10 to 20	Final review and approval vote: the committee reviews the final draft, votes to approve, and documents approval in the minutes	Management committee	Approved annual business plan; signed committee resolution
Dec 21 to 31	Plan distribution and briefing: the approved plan goes to everyone who must execute on it; the managing partner briefs employees with plan-specific responsibilities	Managing partner	Distributed plan; employee briefing record
Jan 1	Plan takes effect: the managing partner operates within the approved parameters; budget authorizations active	Managing partner	First monthly operating report due at month-end

This timeline provides roughly a 90-day runway from the start of the planning process to the start of the plan year, which is enough for a company with a clear strategic direction and partners prepared to engage. Companies whose partners are spread across multiple geographies, or who have limited bandwidth in the fourth quarter because of active deal closings, may need to start earlier or compress specific stages.

The Required Approval Threshold

The operating agreement should specify the threshold required to formally adopt the plan. Common approaches:

- **Majority approval.** The plan is adopted by a majority of the committee. This is the most operationally efficient threshold, preventing a single dissenting partner from blocking the company's operational framework for the entire year, but it may not be protective enough in a company where all partners must participate in execution.
- **Supermajority approval.** The plan is adopted by a defined supermajority (typically 66.7 percent or 75 percent). This gives stronger protection against a plan adopted over significant minority opposition while still preventing a single partner from exercising a veto over the company's operational direction.
- **Unanimous approval.** The plan is adopted by unanimous committee consent. This is the most protective threshold but creates the greatest risk of gridlock if partners cannot agree. It suits a two-partner company, where one partner's withholding of consent effectively functions as a veto regardless of the stated threshold, or companies with strong partnership cultures where unanimous commitment is seen as essential to execution.

The approval threshold for the plan need not match the threshold for other significant decisions. The plan is a comprehensive operational commitment that affects all partners' roles and compensation, which may argue for a higher threshold than routine committee decisions. But it is not a permanent governance change like an operating agreement amendment, which argues for a threshold below the unanimous consent reserved for those fundamental decisions.

Interim Approval and the Amendment Process

The plan is approved at the beginning of the year on the best available information. As the year unfolds, events occur that the plan did not anticipate: a deal falls through or closes earlier than projected, a key hire's start date moves, a market opportunity emerges that was not in the pipeline, or a regulatory change requires a modification to the capital strategy. The operating agreement should specify a process for amending the approved plan during the year without repeating the full approval process. Common approaches:

- **Material modifications require committee approval at the same threshold as the original plan.** A material change to the deal pipeline, the operating budget, or the capital strategy requires a formal committee vote. Non-material adjustments, such as routine timing changes or minor budget reallocation within categories, fall within the managing partner's discretion.

- **Quarterly plan reviews with rolling update authority.** The committee conducts a quarterly review at which it formally updates the plan to reflect actual performance and adjusts forward projections. This institutionalizes the amendment process and keeps the plan a living document rather than a January artifact that grows steadily less relevant.
- **Emergency amendment process.** For situations needing immediate action, such as an unexpected deal opportunity that cannot wait for the next scheduled meeting or a sudden change in the company's financial position, the operating agreement should specify expedited committee action by written consent or emergency teleconference.

Operating Within the Approved Budget

An approved budget that exists only as a document, without enforcement mechanisms, does not function as a governance tool. The operating agreement and the plan process must address how the company operates within the approved budget: what authority exists to deviate from it, what triggers an escalation to the committee, and what consequences attach to material departures from the approved plan.

The Managing Partner's Budget Authority

Once the plan is approved, the managing partner's operational authority should extend to all decisions that execute on it within the approved budget parameters. Specifically:

- All expenditures within approved budget line items are pre-authorized and need no separate committee approval, even when they exceed the managing partner's general unilateral authority threshold. An approved personnel budget that includes a $180,000 senior hire authorizes that hire, even if the managing partner's unilateral authority threshold is $75,000.
- Expenditures that change the category allocation of the budget, moving funds from the marketing line to the personnel line, for example, require the managing partner to notify the committee but may not require formal approval if the reallocation is below a defined materiality threshold, commonly 10 percent of the affected line item or 5 percent of the total operating budget.
- Expenditures that exceed an approved budget line item by more than the defined materiality threshold require committee approval for a budget amendment before the expenditure is committed.

Variance Reporting

The managing partner should provide the committee with regular variance reports, comparisons of actual results against the approved plan, at a frequency set in the operating agreement. Monthly reports suit a company with active operations; quarterly may be acceptable for an earlier-stage company with limited operational activity. A meaningful variance report should include:

- **Revenue.** Actual against planned revenue for the period and year-to-date, by category, with explanations for any variance above a defined materiality threshold.
- **Operating expenses.** Actual against budgeted expenses for each line item, with explanations for over-budget categories.
- **Deal pipeline.** Current status of each deal in the approved plan against the planned timeline, and an update on any new pursuits not in the original plan.
- **Capital deployment.** Actual equity raised against the capital strategy targets, with explanations of timing differences and any material change in the investor pipeline.

- **Staffing.** Actual headcount against the approved staffing plan, with updates on any pending hires or departures.

A variance report is not an admission of failure when actuals diverge from the plan. Every financial plan diverges from reality; that is the nature of forecasting. The report's governance function is to keep the committee informed of those divergences promptly, so it can judge whether adjustments are needed and decide on current rather than plan-vintage information.

When the Budget Runs Out

The operating agreement should specifically address what happens when the company exhausts the approved budget before year-end, a scenario more common than founding teams typically expect, particularly when the deal pipeline is more active than projected or when the ramp-up period runs longer than the planning assumptions.

When budget exhaustion appears imminent, the managing partner should notify the committee immediately and present a proposed amendment that addresses the shortfall: additional capital from a partner loan or capital call, a reduction in planned expenditures to fit within existing resources, or an acceleration of projected revenue through earlier-than-planned closings. The notice and proposed amendment should come before the exhaustion, not after. A managing partner who keeps spending after the budget is exhausted without committee authorization is acting outside their governance authority, however reasonable each individual expenditure may be.

Connecting the Business Plan to Partner Compensation

The annual business plan and the partner compensation arrangements set in the operating agreement are closely related but often treated in isolation. When the connection is made explicit, in both the plan and the operating agreement, the plan becomes a stronger accountability and incentive tool.

Guaranteed Payment Adjustments Tied to Plan Performance

As discussed in Chapter 7, the operating agreement should specify a mechanism for adjusting partner guaranteed payments as the company's financial position changes. The annual plan process is the natural home for that mechanism: as part of plan approval, the committee reviews and confirms each partner's guaranteed payment for the coming year, with adjustments based on projected revenue and cash flow. A plan-tied compensation review has several advantages over ad hoc negotiation:

- It creates a predictable process for compensation decisions rather than letting them arise unplanned whenever a specific partner raises the issue.
- It grounds the decision in the company's actual financial situation as reflected in the plan, rather than in each partner's own assessment of their performance.
- It lets the committee make compensation and budget decisions together, ensuring the approved guaranteed payments are actually funded by the approved revenue projections.
- It creates a shared, documented basis for the decision that all partners can refer to if it is later questioned.

Milestone Vesting and Plan Targets

For partners whose equity includes a milestone vesting component, as discussed in Chapter 5, the annual plan is the right place to establish the specific deliverables that will be evaluated as milestones for the coming year. A partner whose vesting is tied to deal-sourcing volume should

have the current year's sourcing target documented in the approved plan. A partner whose vesting is tied to investor capital raised should have the current year's fundraising target documented in it.

This connection between the plan and vesting milestones aligns the company's operational goals with each partner's individual equity incentives. The partners who most need to perform to earn their equity are working toward targets that also serve the company's broader strategy, because the same targets appear in both the vesting schedule and the approved plan.

Performance Conversations and the Plan

The plan creates the basis for year-end performance conversations grounded in documented commitments rather than subjective impressions. When the committee reviews the year against the plan in October or November, each partner's contributions can be assessed against the specific targets they agreed to at the start of the year.

That grounding changes the character of the conversation. It shifts from "did you contribute enough to the company this year," a question that turns entirely on the evaluator's subjective sense of what enough looks like, to "did you achieve the specific targets you and your partners agreed were the right goals for this year." The second question still calls for judgment in its application, but it rests on an agreed standard that both the evaluator and the person being evaluated accepted at the outset.

Capital Deployment Commitments and Investment Program Governance

For companies that raise outside investor capital, or that deploy their own capital across multiple projects, the annual plan must address how capital deployment decisions are governed through the year. The approved plan creates a framework for the company's investment activities; the governance framework specifies how individual investment decisions within that framework are approved.

The Plan as Investment Program Authorization

When the plan specifically identifies development projects the company intends to pursue, and the committee approves the plan with those projects included, that approval constitutes authorization to keep pursuing those specific projects through the commitment stages described in the Decision Authority Matrix.

This does not mean plan approval eliminates the need for deal-level committee approvals at the thresholds in the matrix. A project in the approved plan still requires committee majority approval for a letter of intent and supermajority approval for a purchase and sale agreement, as specified in the Decision Authority Matrix. The plan's authorization is authorization to pursue; the matrix's approval requirements govern each stage of that pursuit.

For projects not identified in the approved plan, new opportunities that emerge during the year, the managing partner must seek committee approval at the appropriate threshold before committing the company's resources or relationships to the pursuit. A new deal opportunity is not pre-authorized by the plan; it requires specific authorization under the Decision Authority Matrix's provisions for deal evaluation and commitment.

Co-Investment and Capital Commitment Governance

When a specific deal requires the company to commit capital, whether from its own balance sheet or from the partners' personal co-investment, the plan and the Decision Authority Matrix work together to govern the decision. The plan establishes the aggregate co-investment capacity the company has budgeted for the year; the matrix specifies the approval level required to commit that capacity to a specific deal.

For deals that require partner personal co-investment, the capital strategy section should specify each partner's anticipated co-investment commitment for the year, the conditions under which those commitments will be called, and the process for a partner to decline a specific co-investment without triggering the capital call consequences that apply to mandatory contributions. The distinction between mandatory capital calls and voluntary co-investment opportunities must be documented clearly in both the operating agreement and the plan, to avoid disputes when a partner declines to co-invest in a deal that others wish to pursue.

The Strategic Review: How Often and How Deep

The annual plan process addresses the coming year's operational commitments. But the questions that most affect a development company's long-term trajectory, whether the business model is working, whether the competitive positioning is sound, whether the partners remain aligned on the company's direction, should be addressed more deliberately and less frequently than the annual operating cycle.

The Annual Strategic Review Session

Embedded within the annual plan process, typically at the start of the planning cycle, before the managing partner drafts the operational components, should be a dedicated strategic review session. This is not a planning session; it does not produce a budget or a deal pipeline. It produces a shared strategic direction memo that guides all the operational planning that follows. The session should address:

- **Performance against the prior year's strategic goals.** Did the company achieve the objectives it identified twelve months ago? If not, why not, and what does the answer reveal about the strategy itself as opposed to execution?
- **Market assessment.** What has changed in the company's primary market since the prior review: new competitors, shifting capital availability, changes in demand for the asset classes the company develops, regulatory changes affecting the entitlement environment?
- **Partner alignment check.** Do all partners remain aligned on the company's fundamental direction, the business model, the geographic focus, the investor segment, the long-term exit ambition? Has anything changed in a partner's personal circumstances or professional ambitions that affects that alignment?
- **Competitive positioning.** What is the company measurably better at than its competitors in the target market? Has that advantage grown, shrunk, or shifted in character over the past year?
- **Strategic options for the coming year.** What material strategic choices does the company face that represent real alternatives rather than obvious next steps?

The Multi-Year Strategic Review

Every three to five years, the committee should conduct a more comprehensive strategic review that goes beyond the annual cycle to reassess the company's fundamental positioning and direction. The multi-year review is the right moment for the partner alignment conversations described in Chapter 1, about the long-term exit vision, the destination model, and whether each partner's personal ambitions remain aligned with the company's direction.

It is also the right moment to assess whether the company's current operating agreement still reflects the parties' actual intentions. As described in Chapter 4, the operating agreement is a living document that should be revisited when circumstances change materially. The multi-year strategic review is a natural catalyst for that assessment: if the company has grown significantly, if new

partners have been admitted, or if the business model has evolved, the operating agreement may need updating to reflect those changes.

Connecting the Business Plan to the Operating Agreement: What the Agreement Must Specify

The operating agreement's governance provisions should address the annual business plan process with the same specificity as the other governance mechanisms. The minimum required provisions:

1. The obligation to prepare an annual business plan covering the required content areas, and the deadline for completing the planning process (no later than December 31 of the prior year, for a calendar-year company).
2. The process for preparing the plan: who prepares the initial draft, the partner comment period, the workshop session, and the final approval vote.
3. The approval threshold required to adopt the plan, and whether an unapproved plan carries any default authority for the managing partner (typically the prior year's plan continues on a rolling basis pending approval of the new plan, with certain protective modifications).
4. The managing partner's authority to act within the approved plan and budget without additional committee approval, and the conditions under which that authority requires supplemental approval (material budget variances, new deals not in the plan, personnel decisions above defined thresholds).
5. The frequency and format of variance reports, and the materiality thresholds that trigger a required committee notification or budget amendment request.
6. The process for amending an approved plan during the year: what constitutes a material modification requiring committee approval, and the emergency amendment process for time-sensitive decisions.

The Business Plan as an Investor Relations Tool

For a development company that manages capital for outside investors, the annual plan has an additional dimension: it informs the investor relations activities and communications the company conducts through the year. The plan itself may not be distributed to investors, since it contains confidential operating information and strategic direction not appropriate for general distribution, but the investor-facing communications the company produces should be consistent with the approved plan and reflect its key targets and commitments.

Investor Reporting and the Plan

The quarterly investor reports the company provides to its deal-level investors should be grounded in the approved plan's projections. When actual performance diverges materially from projected performance, a closing is delayed, a construction timeline extends, a market condition changes the projected return, the investor report should acknowledge the variance, explain its cause, and describe what the company is doing to address it.

This connection between the approved plan and investor reporting creates an important discipline: the company's investor communications must be consistent with the internal targets the committee has approved. A company that tells its committee that projected returns on a deal have declined

materially but continues to present prior projections to investors in its quarterly reports has created a serious disclosure problem. The annual plan process, properly integrated with investor reporting, helps prevent that by creating a single source of truth for the company's performance expectations.

Capital Raising and Plan Commitments

When a development company is in the market raising investor capital for a new project or fund, it is making representations to investors about its strategy, pipeline, track record, and management team. Those representations must be consistent with the approved annual plan and with the company's actual performance relative to its prior plans.

Investors, particularly institutional investors conducting detailed due diligence, will ask to review the company's internal planning process as part of their diligence. A company with a rigorous annual plan process, documented approval procedures, and regular variance reporting demonstrates an organizational maturity that gives investors confidence in its ability to manage their capital responsibly. A company with no formal planning process, or with plans that are routinely ignored or never tracked against actual performance, raises serious governance concerns in diligence.

CHAPTER 9: KEY TAKEAWAYS

1. The annual business plan is a governance document, not a marketing document. Its primary governance functions are providing the managing partner with standing authorization to act within its parameters without constant committee approval-seeking, and creating the accountability framework against which each partner's performance can be evaluated at year-end.
2. A complete plan covers six components: the deal pipeline and investment program (active deals, deals in pursuit, and target volume); revenue projections (by source, with base and downside scenarios); the operating budget (by category, with monthly phasing and a meaningful contingency); the staffing plan (positions, timing, cost, and the revenue conditions that justify each hire); the capital strategy (target capital volume, investor segments, regulatory framework, and investor relations activities); and the strategic review (direction, competitive positioning, and planned evolution from the prior year).
3. The approval process should run on a defined timeline of roughly 90 days, beginning in October with the prior-year performance review and ending December 31 with the formally approved plan for the coming year. The approval threshold, majority, supermajority, or unanimous, should be specified in the operating agreement and calibrated to the founding team's governance philosophy.
4. Once approved, the plan authorizes the managing partner to execute on its contents within the approved budget without returning to the committee for routine approvals. Variance reporting, monthly for active companies and quarterly for earlier-stage ones, keeps the committee informed of deviations before they become material problems. Material budget variances require committee notification and, above a defined threshold, formal approval of a budget amendment.
5. The plan and partner compensation are closely connected. The plan approval process is the natural home for the annual guaranteed payment review: compensation decisions should be made together with the budget, so that approved compensation is funded by approved revenue projections. For partners with milestone-based vesting, the plan should document the specific deliverables that will be evaluated as milestones for the coming year.

6. Every three to five years, the committee should conduct a multi-year strategic review that goes beyond the annual cycle to reassess fundamental positioning, partner alignment, and whether the operating agreement still reflects the parties' actual intentions. This deeper review is the right moment to revisit the Chapter 1 conversations about long-term exit vision and business model in light of the company's actual experience.
7. For companies that manage outside investor capital, the plan creates a single source of truth for performance expectations that must be reflected consistently in investor communications. A rigorous planning process with documented approval procedures and regular variance reporting demonstrates the organizational maturity institutional investors specifically look for in due diligence.

WHAT COMES NEXT

The rest of Part IV turns to the company's economics: the full spectrum of fees a real estate development and sponsor company can earn (Chapter 10), how development profits and the project promote are structured (Chapter 11), and how to build the team that makes the company function, with hiring, compensation, and equity participation for key employees (Chapter 12). These chapters build on the governance and financial frameworks established so far to address the specific revenue and compensation structures that define the development company's economics.

See also: *Appendix D (Decision Authority Matrix: governs the approval levels for deal-level decisions within the approved plan) • Appendix G (Regulatory Compliance Calendar: coordinates the business plan's timeline with regulatory filing obligations) • Appendix J (Glossary: annual business plan, budget variance, material modification, rolling authorization)*

CH. 10

PART IV: OPERATIONS, FEES & HUMAN CAPITAL

The Fee Architecture of a *Development and Sponsor Company*

The full spectrum of fees a real estate development and sponsor company can earn, how to structure them to be commercially reasonable and investor-defensible, and how to allocate them internally among the founding partners.

Real estate development companies earn money in more ways than most investors fully grasp, and in more ways than many founders appreciate when they structure their first deal. The fee structure of a development and sponsor company is more than a simple schedule of percentages applied to deal sizes. It is a designed compensation architecture that has to be commercially reasonable, internally logical, consistently disclosed to investors, and explicitly governed by the company's internal agreements.

This chapter covers the full spectrum of fees available to a development and sponsor company, the market standards that govern each fee type, the licensing requirements and regulatory implications attached to earning certain fees, and the internal allocation decisions that determine how fee income is divided among the founding partners. The fee architecture is as much a legal and compliance matter as a business development one.

Why Fee Architecture Matters

The fee architecture of a development company is among its most sensitive legal and commercial design choices. Every fee the company charges is at once a statement about what services the company provides, a disclosure obligation in its investor documents, a potential regulatory trigger depending on how it is earned and by whom, and an economic arrangement that must be justified to investors who have alternative uses for their capital. Four reasons the founding team must understand before any fee structure is set:

- **Investor relations.** Sophisticated investors, particularly family offices and institutional LPs, scrutinize fee structures during due diligence with considerable care. They are evaluating not just the rates but the logical relationship between the fees charged and the services actually provided. A fee schedule that is internally inconsistent, that charges for services the company does not actually provide, or that creates perverse incentives is a red flag in due diligence that can delay or derail a capital raise.
- **Securities law compliance.** When a development company manages investments for outside investors, fees charged to those investors must be disclosed in the private placement memorandum (PPM) with enough specificity and accuracy that an investor could make an informed decision about whether the fee structure is acceptable. Inadequate fee disclosure is among the most common bases for securities anti-fraud enforcement actions against private real estate sponsors.
- **Regulatory compliance.** Certain fee types, including equity placement fees, loan origination fees, and investment advisory fees, may require licensure under federal or state law before they can be earned. Earning fees without the required license is both a regulatory violation and a personal legal risk to the company and its principals.
- **Internal governance.** How fee income is divided among the founding partners is an economic decision that must be documented in the operating agreement with the same

precision as equity allocation and compensation. Fee income the operating agreement does not address will be divided by the default rules, typically pro-rata to equity ownership, which may or may not reflect the founding team's actual intentions.

The Acquisition Fee

The acquisition fee is earned when a development property is purchased, calculated as a percentage of the total acquisition cost. It compensates the sponsor for the deal-sourcing, underwriting, negotiation, due diligence management, and closing coordination required to identify and execute the acquisition. From an investor's perspective, it represents compensation for the work done to find and secure the opportunity they have been invited to invest in.

Market Rate and Basis

The market rate for acquisition fees in private real estate transactions is generally 0.5 to 1.5 percent of the total acquisition cost. The appropriate rate within that range depends on several factors:

- **Deal size.** Larger acquisitions typically support lower percentage rates because the absolute fee amount grows even as the percentage declines. A 1 percent acquisition fee on a $2 million land purchase is $20,000; the same 1 percent on a $40 million stabilized asset is $400,000. Institutional investors applying due diligence to a large deal will scrutinize whether a 1 percent fee is reasonable given the total amount.
- **Competitive dynamics.** In markets where multiple sponsors compete for the same investor capital, fee rates tend to compress. An emerging sponsor without a strong track record has less leverage to sustain a 1.5 percent acquisition fee than an established sponsor with a documented history of deal delivery.
- **Off-market versus marketed deals.** An off-market acquisition the company sourced through proprietary relationships, a landowner who called the company directly or a site identified through the company's own research, arguably justifies a higher acquisition fee than a brokered deal where the company was one of several bidders and the broker is charging a commission.

Institutional Investor Considerations

Institutional LPs frequently negotiate acquisition fees in ways emerging sponsors should understand before entering a capital raise. Common institutional positions:

- **Fee reduction.** Institutional LPs may negotiate a reduced acquisition fee, often 0.5 percent rather than 1.0 or 1.5 percent, particularly for larger deals where the absolute amount is already meaningful.
- **Subordination to the preferred return.** Some institutional LPs require the acquisition fee to be subordinated to the investors' preferred return in the waterfall. Under this structure the fee is not earned at closing but is paid, with or without interest accrual, only when and if the waterfall reaches the point where the sponsor would otherwise be entitled to a distribution. It is LP-protective but significantly reduces the cash flow value of the fee to the sponsor.
- **Offset against the promote.** Some LPs require acquisition fees to be credited against the promote at disposition, effectively treating the acquisition fee as an advance on the promoted interest rather than a separate fee. This is even more LP-favorable and is relatively uncommon outside institutional co-investment relationships.

Internal Allocation

The acquisition fee is typically allocated among the founding partners based on each partner's contribution to the specific acquisition. Common approaches:

- **Equal split.** All founding partners share the acquisition fee equally. Simple to administer, but it does not distinguish between a partner who sourced the deal through a proprietary landowner relationship and one who learned about it from a broker who had already shopped it to several other developers.
- **Deal-sourcing credit.** The partner who originated the deal, the first point of contact with the seller or the principal whose relationship made the acquisition possible, receives an enhanced share (often 50 to 60 percent), with the remainder divided among the other partners. This reflects the real economic value of deal origination.
- **Role-based allocation.** If the company has a defined role structure, the fee is divided among the roles that contributed to the acquisition, with sourcing, underwriting, and closing each receiving a defined percentage.

Whatever method the partners choose, it must be documented in the GP entity's operating agreement and applied consistently across deals, to prevent disputes about whether a specific deal's sourcing should entitle one partner to a larger share.

The Development Management Fee

The development management fee is the most central fee in a development company's revenue architecture. It compensates the sponsor for overseeing every aspect of the development process, from entitlement and design through permitting, construction management, cost control, lender reporting, and delivery. Unlike the acquisition fee, a one-time payment at a single transaction event, the development management fee is earned over the life of the construction process and represents ongoing operational compensation for the work of actually building the project.

Market Rate and Structure

The market rate for development management fees is generally 3 to 5 percent of total project costs, with the specific rate depending on project complexity, the services included, and the competitive dynamics of the sponsor's capital-raising environment. The fee basis, whether total project costs, hard costs only, or total development budget including soft costs, can significantly affect the fee amount and should be specified precisely in the development management agreement.

For a development project with $15,000,000 in total project costs (hard costs plus soft costs plus land), a 4 percent development management fee generates $600,000. For the same project measured on $10,000,000 in hard construction costs only, a 4 percent fee generates $400,000. That $200,000 difference illustrates why the definition of the fee basis is a commercially significant negotiating point.

The payment structure should be tied to construction milestones rather than paid in a lump sum. Common structures:

- **Monthly draws based on percentage of completion.** The fee accrues as a percentage of total projected fee income and is paid monthly as that percentage is achieved. Straightforward to administer and provides regular cash flow to the management company during construction.
- **Milestone payments tied to construction benchmarks.** Defined percentages of the total fee are paid when the project reaches specific milestones, for example 20 percent at permit issuance, 30 percent at foundation completion, 30 percent at framing completion, and 20

percent at certificate of occupancy. This ties payment to actual construction progress and rewards on-schedule completion.

- **Holdback at completion.** A defined portion, often 10 to 15 percent of the development management fee, is withheld until final certificate of occupancy and resolution of all material construction deficiencies. This aligns the fee with completion quality and is increasingly requested by lenders and institutional LPs.

What the Development Management Fee Must Cover

The development management agreement, the contract between the project entity (the deal-level SPE) and the management company specifying the services rendered for the fee, should specify the included services with enough precision to make them defensible in investor due diligence and any regulatory review. The fee typically covers:

- **Entitlement and pre-development.** Managing the entitlement process, coordinating with municipal staff, attending public hearings, managing the design and engineering team, and overseeing all pre-construction activities through permit issuance.
- **Contractor procurement.** Preparing and distributing the request for proposals, evaluating bids, recommending the general contractor, and negotiating the construction contract.
- **Construction oversight.** Regular site visits, the owner's representative function during construction, review and approval of pay applications, management of schedule and budget, and coordination with lenders and their inspectors.
- **Lender reporting.** Preparation of monthly or quarterly draw requests, coordination with the construction lender's inspector, maintenance of the project budget and cost report, and management of the lender's conditions to each draw.
- **Investor reporting during construction.** Periodic construction update reports to the project's LP investors, including the cost report, schedule update, and photographs.

Services typically excluded from the development management fee and addressed through separate arrangements: general contracting (if the company acts as its own GC, which requires a separate contractor's license and a separate contract); property management after stabilization (addressed through the property management agreement); and investment advisory services (if the company is a registered investment adviser, addressed through the advisory agreement).

The Licensing Question

A development management fee earned for overseeing the construction of a project the company is developing for itself, as the owner or sponsor, generally does not require a contractor's license. The company is an owner paying itself for management services, not a contractor performing work for a third party.

The analysis changes if the company begins offering development management services to third parties, managing the development of a project owned by someone else for a fee, without holding a meaningful equity stake. In that context the company may be operating as a professional project manager or developer-for-hire, which can trigger contractor licensing requirements in some states and construction management licensing requirements in others. The founding team should obtain legal advice about the licensing requirements in their operating states before expanding into third-party development management.

The Asset Management Fee

The asset management fee is earned during the hold period of a completed, stabilized development project. It compensates the sponsor for ongoing portfolio oversight: monitoring the investment, managing the lender relationship, overseeing property management, communicating with investors, and making strategic decisions about the asset's operation and eventual disposition.

It is an important fee for a development company that holds completed projects for extended periods rather than selling immediately upon completion. Without it, the company has no compensation for the ongoing work of portfolio management between the end of construction and the eventual disposition, which may span several years in a value-add or core-plus strategy.

Market Rate and Basis Options

The asset management fee is calculated on one of two primary bases:

- **Equity-based.** A percentage, typically 0.5 to 2.0 percent, of the LP equity invested in the project or fund. This approach stays constant as the asset's value changes, because the fee is calculated on the amount investors committed rather than a mark-to-market valuation. It is most common for development projects and value-add strategies, where the project's value during the development phase may be volatile or hard to appraise.
- **Gross asset value basis.** A percentage, typically 0.25 to 1.0 percent, of the gross value of the assets under management, based on an annual appraisal or an agreed valuation methodology. The gross asset value approach aligns fee income with the value the sponsor has created, since the fee rises with the asset's value, but it requires an annual valuation process that adds administrative cost and complexity.

For a development company managing a $10 million equity raise on a project appraised at $25 million upon completion, the difference is significant: a 1 percent equity-based fee generates $100,000 per year, while a 0.5 percent gross-asset-value fee on $25 million generates $125,000. The right basis depends on the investment strategy, the investor base's expectations, and the company's administrative capacity.

Investment Adviser Implications

The asset management fee is the fee most likely to trigger investment adviser registration requirements under the Investment Advisers Act of 1940. A company that manages assets for compensation, which is precisely what an asset management fee represents, may qualify as an investment adviser under the federal definition, subject to specific exemptions and safe harbors.

Chapter 20 addresses the investment adviser regulatory framework in detail. The key point at the fee architecture level is that the asset management fee should not be established without a concurrent review of the company's adviser registration obligations. A company earning asset management fees from a portfolio of investments held for outside investors is a candidate for Exempt Reporting Adviser status at a minimum, and for full Registered Investment Adviser status if its assets under management exceed the applicable thresholds.

Property Management Fees and the Self-Management Decision

The property management fee compensates whoever manages the day-to-day operations of a completed, income-producing property. When a development company self-manages its completed projects, handling tenant relations, maintenance, lease renewals, vendor contracts, and operating expense management, it can earn a property management fee that provides ongoing revenue and keeps the property management economics within the company rather than paying them to a third party.

The decision to self-manage is not only an economic one. It requires the company to build and maintain a property management operation with all the associated infrastructure, personnel, and licensing. The founding team must evaluate whether self-management is appropriate given the company's portfolio size, asset class, and organizational capacity.

Market Rate and Fee Structure

The market rate for property management fees is 3 to 8 percent of effective gross income, the total rental income collected after adjusting for vacancies and concessions but before deducting operating expenses. The rate varies significantly by asset class:

- **Multifamily residential.** Typically 5 to 8 percent of effective gross income, reflecting the high tenant turnover, maintenance intensity, and customer service demands of residential management.
- **Commercial (office, retail, industrial).** Typically 3 to 5 percent of effective gross income for properties with fewer tenants and longer lease terms, reflecting lower transaction intensity relative to residential.
- **Mixed-use.** Rates vary by the proportionate composition of residential and commercial space, typically blended between the applicable residential and commercial rates.

The property management fee is above-the-line: it is an operating expense of the property, deducted before net operating income is calculated. This differs from development management fees and asset management fees, which are typically below-the-line, paid from distributable cash flow. The above-the-line treatment means the property management fee directly reduces net operating income, and therefore the property's value, which is why institutional investors and lenders scrutinize it carefully during underwriting.

Licensing Requirements

Property management is a licensed activity in most states. The specific requirements vary by jurisdiction, but most states require:

- **A licensed real estate broker, or a designated broker affiliated with the property management company.** The person responsible for the property management operation must typically hold an active real estate broker's license in the state where the property is located.
- **A property management license.** Some states, California among them, have a distinct property management license, separate from the broker's license, that must be held by the individual overseeing property management activities.
- **Trust account management.** Property managers are typically required to maintain separate, licensed trust accounts for tenant security deposits and prepaid rents, subject to specific bookkeeping and disbursement requirements.

A development company that earns property management fees without the required licenses is engaging in unlicensed real estate activity in most states, a regulatory violation that can result in fines, license suspension for the principals who hold individual licenses, and civil liability to tenants and property owners. The founding team should obtain legal advice about the specific requirements in each state where the company intends to manage properties before structuring any property management fee arrangement.

Self-Management Versus Third-Party Management

For an emerging development company, the decision to self-manage completed projects should be made deliberately against several criteria:

- **Portfolio size.** Self-management becomes operationally efficient only when the company has enough units or square footage to justify dedicated property management personnel. A development company with a single 80-unit apartment building may find a third-party property manager more cost-effective than maintaining the infrastructure to self-manage.
- **Asset class expertise.** Residential property management requires specific tenant relations, maintenance, and leasing expertise that may not be the development team's primary competency. Outsourcing to a specialist may produce better operational outcomes even at a higher fee cost.
- **Investor expectations.** Institutional LPs may require third-party property management for portfolio assets, viewing self-management as a governance risk, the sponsor managing its own investments without independent oversight, unless the company has a demonstrably qualified and operationally separate property management team.
- **Licensing and compliance.** A company building its development pipeline while also managing properties must maintain two distinct operational disciplines with different regulatory obligations, which can dilute the founding team's focus during a period when focused execution is essential.

Disposition Fees, Refinancing Fees, and the Fee Stacking Problem

Disposition and refinancing fees compensate the sponsor for executing a property sale or refinancing: preparing the offering memorandum or refinancing package, managing the broker or lender selection process, negotiating the transaction, and coordinating the closing. Both are transactional, earned at a specific liquidity event rather than accruing during the hold period.

Disposition Fees

The market rate for a disposition fee is 0.5 to 1.5 percent of the gross sale price. It is distinct from the real estate commission paid to the listing broker: the broker's commission compensates the licensed agent who markets the property and procures the buyer, while the disposition fee compensates the sponsor for the asset management and transaction oversight work involved in executing the sale.

The disposition fee meets significant institutional resistance. Most sophisticated LPs take the position that the asset management fee they already pay should be enough to compensate the sponsor for overseeing the disposition. Adding a separate disposition fee on top is viewed as double-dipping, charging twice for essentially the same oversight function. Sponsors who can show that the disposition genuinely requires work materially beyond what the asset management fee contemplates, a complex ground lease transaction, a portfolio sale requiring independent analysis of multiple assets, or a UPREIT transaction with unusual tax structuring, may be able to justify a disposition fee in institutional contexts. In most straightforward dispositions, it is better to omit it and compete on the quality of the deal economics.

Refinancing Fees

The refinancing fee compensates the sponsor for managing a construction or bridge loan refinancing, a capital event often as complex and time-consuming as the original financing. The market rate is 0.25 to 1.0 percent of the new loan amount.

The institutional view of refinancing fees mirrors the view of disposition fees: if the company is already earning an asset management fee for ongoing portfolio oversight, the refinancing work should be included in that function. Where refinancing fees are accepted, they are typically required to be disclosed in the PPM's fee schedule and are subject to a reasonableness requirement,

meaning the fee must be consistent with what an independent third party would charge for the same services.

Fee Stacking: What It Is and Why It Matters

Fee stacking is the practice of charging multiple fees at different stages of a real estate investment, an acquisition fee when the deal closes, a development management fee during construction, an asset management fee during the hold period, a property management fee during operations, a disposition fee at sale, in a way that, viewed in aggregate, represents compensation disproportionate to the services actually provided and the returns actually delivered to investors.

The concern is not merely reputational; it is a securities law issue. The PPM must disclose all fees charged to investors, and if the aggregate disclosure suggests that a sponsor could earn substantial fees even on a losing investment, an acquisition fee at closing, a development management fee during construction, an asset management fee during the hold, whether or not the project succeeds, sophisticated investors and potentially regulators will question whether the fee structure is aligned with investor interests or primarily built to ensure sponsor compensation regardless of performance. The appropriate response is not to eliminate fees but to:

- Ensure that every fee charged corresponds to a real service the company actually provides and that is not duplicated by another fee in the same schedule.
- Structure at least a portion of compensation as performance-based, the promoted interest, so the sponsor's primary reward depends on investor returns.
- Disclose all fees clearly and completely in the PPM, including the dollar amounts or range that investors can expect in each fee category for a typical project.
- Be prepared to explain and justify each fee in investor due diligence, with specificity about the services it covers and the market comparables that support the rate.

Construction Management and Owner's Representative Fees

When a development company provides real construction oversight services, acting as the owner's representative during construction, managing the GC relationship, reviewing and approving pay applications, monitoring the schedule, and coordinating the lender's inspection process, it may earn a construction management or owner's representative fee separate from the development management fee.

The critical question is whether the construction management function is truly separate from the development management fee or is already included in that fee's scope of services. Charging both a development management fee and a construction management fee for the same project, when the construction management work is part of what the development management fee is supposed to cover, is a fee stacking problem. The fee schedule should be internally consistent: if the development management fee includes construction oversight, as it typically should, then a separate construction management fee is duplicative.

Construction management fees are most legitimately charged when the development management arrangement is structured to cover entitlement, design, and project coordination, and a separate, qualified individual or team provides dedicated, full-time construction supervision that goes beyond the development management scope. In that structure the construction management fee compensates an operationally distinct service provided by a distinct person or group.

The licensing consideration is similar to development management: an owner managing its own project's construction generally does not need a contractor's license, while a company providing construction management as a service to third parties for a fee may need one in the relevant

jurisdiction. The analysis should be done state by state, since licensing requirements vary considerably.

Loan Origination, Placement Fees, and the Broker-Dealer Problem

Of all the fees in a development company's architecture, the loan origination fee and the equity placement fee carry the most significant regulatory risk for the uninformed. Earning these fees, particularly the equity placement fee, without the appropriate license or registration can expose the company and its principals to serious securities regulatory liability, civil suits by investors, and, in egregious cases, criminal enforcement.

Loan Origination and Placement Fees

A loan origination fee is earned when the company arranges or facilitates third-party debt financing for a development project, identifying the lender, preparing the loan package, negotiating the terms, and managing the lender's due diligence and closing. The market rate is typically 0.5 to 2.0 percent of the loan amount, depending on the complexity of the financing and the difficulty of the placement. The licensing requirement depends on the nature of the financing:

- **Commercial real estate loans (construction, bridge, and permanent loans on income-producing commercial properties).** Most states do not require a mortgage broker's license for arranging commercial real estate loans. The exemptions are state-specific and fact-dependent, however, and the founding team should obtain legal advice about the requirements in each state where the company intends to arrange financing for a fee.
- **Residential mortgage loans (one-to-four-family residential properties).** Federal law, the Secure and Fair Enforcement for Mortgage Licensing Act (the SAFE Act), generally requires individual mortgage loan originators to be licensed in states where they originate mortgage loans for one-to-four-family residential properties. In some states the requirement applies even when the developer is arranging construction financing for its own residential development project.

The Equity Placement Fee and the Broker-Dealer Problem

An equity placement fee is earned when the company raises equity capital from investors for a specific deal or fund, essentially acting as the placement agent for the investment opportunity. Receiving transaction-based compensation for raising securities is, in the eyes of federal securities law, the core activity of a broker-dealer registered with FINRA under Section 15(a) of the Securities Exchange Act of 1934.

The regulatory risk is severe: a person or entity that raises securities from investors and receives compensation tied to the success of the raise, a percentage of capital raised, as an equity placement fee would be structured, may be required to register as a broker-dealer or to use a registered broker-dealer as an intermediary. Operating as an unregistered broker-dealer is a federal securities violation that carries significant penalties, including the right of investors to rescind their investments.

The most common structure development companies use to earn placement-style compensation without triggering broker-dealer registration rests on the distinction between the company acting as the issuer of the securities, which does not require registration, and acting as an agent for a third party, which does. A development company that raises equity for its own deals, where the company or its principals sell interests in a project they own and operate, is acting as the issuer rather than a broker and generally does not trigger broker-dealer registration under the issuer exemption.

The broker-dealer problem arises when the company begins earning equity placement fees from third parties, raising capital for projects owned by someone else in exchange for a transaction-based fee. Conducted regularly as a business, that is broker-dealer activity requiring registration or the engagement of a registered broker-dealer as the intermediary.

The Unlicensed Broker-Dealer: A Significant and Common Regulatory Trap

Many development companies, as they grow, begin to earn placement-style fees from transactions where they are helping other developers or sponsors raise capital. The compensation is structured as a percentage of capital raised, which feels to them like a straightforward business development arrangement. To the SEC, it looks like unregistered broker-dealer activity.

The consequences of operating as an unregistered broker-dealer include SEC enforcement action (disgorgement of fees earned, civil penalties, and injunctive relief); investor rescission rights (investors may demand the return of their investment if they discover that the company that facilitated the offering was an unregistered broker-dealer); civil liability to investors who suffer losses; and, in egregious cases, criminal prosecution.

The founding team must draw a clear line. Raising equity for the company's own deals is permissible without broker-dealer registration, subject to the applicable securities offering exemptions discussed in Chapter 19. Raising equity for other people's deals, in exchange for transaction-based compensation that depends on the success of the raise, is broker-dealer activity that requires either FINRA registration or the engagement of a registered broker-dealer. When in doubt, consult securities counsel before the fee arrangement is established.

Offering Cost Reimbursement and Organization Expenses

When a development company raises investor capital for a deal or fund, it incurs legal, accounting, and administrative costs in preparing and conducting the offering: the PPM, the operating agreement or LPA, subscription documents, investor know-your-customer and accredited investor verification, SEC and state blue sky filings, and the accounting and audit work associated with the offering itself. The company may seek reimbursement of these costs from the project or fund entity rather than absorbing them as management company overhead. Reimbursement is generally accepted by investors when:

- It is limited to actual, documented costs incurred in connection with the specific offering, not a fixed percentage of capital raised that bears no relationship to actual costs.
- It is capped as a percentage of total equity raised (commonly 2 to 3 percent) to keep reimbursement from becoming disproportionate to the offering's scale.
- It is fully disclosed in the PPM with enough specificity that investors can evaluate what they are being asked to reimburse.
- Amounts above the cap are explicitly the company's obligation, not an additional cost to investors.

For tax purposes, organization and offering costs must be treated carefully. Organization costs (costs incurred to form the fund or project entity) must generally be amortized over 180 months rather than deducted in the year incurred. Offering costs (costs incurred to offer and sell the interests) generally cannot be deducted and must be charged against capital raised. The

company's CPA should be consulted on the specific treatment of each category before the reimbursement provision is included in the offering documents.

Internal Fee Allocation Among Founding Partners

Fee income earned by the management company from its development and investment activities is income of the company, not of the individual partners. Its distribution follows the operating company's distribution provisions, which, absent a specific fee allocation provision, default to pro-rata distribution based on equity ownership.

For a company where all partners contribute equally to all deals, the pro-rata default may be appropriate. For a company where specific partners play distinct roles on specific deals, one sources and closes the acquisition, another manages construction, a third manages investor relations, a role-based fee allocation that distributes fee income by each partner's contribution to the deal that generated it will produce a more equitable outcome over time.

Allocation Methodologies

The same four methodologies applicable to promoted interest allocation, equal, equity-proportional, role-based, and hybrid, apply to fee income. The right methodology for fee income may differ from the one used for the promoted interest, because the contributions that generate fee income are more transaction-specific than the platform-level contributions that justify the promoted interest:

- The acquisition fee is most logically allocated with a deal-sourcing credit for the partner who originated the deal, with the remainder split equally or proportionally.
- The development management fee is most logically allocated with a construction management credit for the partner who oversees construction, with the remainder split among all partners.
- The asset management fee is most logically allocated with a capital-raising credit for the partner who raised the investor equity, with the remainder split among all partners.
- The property management fee, if the company self-manages, is most logically allocated entirely or primarily to the operations partner who manages the property management function.

Whatever methodology the partners choose must be documented in the GP entity's operating agreement with enough specificity to govern actual distributions. Vague provisions, such as fees will be allocated based on each partner's contribution to the deal, do not prevent disputes; they create them.

Related-Party Fee Approval Requirements

A fee earned by the management company is earned at the company level and distributed to the partners through the operating agreement's distribution provisions. But some fee arrangements create related-party transaction concerns that require specific governance oversight.

The most common arises when a founding partner has an interest in an entity performing services for which the company earns a fee. If a partner owns a 40 percent interest in a general contracting company and that GC is selected to build the company's projects, the GC's contract is a related-party transaction. The fact that the management company is earning a development management fee for overseeing the GC's work does not eliminate the conflict; it compounds it. The related-party transaction policy addressed in Chapter 13 applies: the GC contract must be approved by the disinterested partners at committee level, must be on arm's-length terms, and must be disclosed to investors in the PPM.

Similarly, if a partner earns a real estate commission on an acquisition where the management company also earns an acquisition fee, the double compensation, from both the management company and the partner's brokerage relationship, is a related-party transaction that must be disclosed and approved. The principle is not that the partner cannot earn the commission, but that investors and co-partners must be informed of and consent to the arrangement.

The Complete Fee Schedule Reference

The master fee schedule below consolidates all the fee types addressed in this chapter, presenting each fee's market rate range, calculation basis, payment timing, institutional negotiation points, internal allocation approach, and licensing or disclosure considerations. It is designed to be adapted by the founding team as the basis for the fee disclosure section of their offering documents.

Fee type	Market rate range	Calculation basis	When paid	Institutional negotiation	Internal allocation approach	Licensing and disclosure notes
Acquisition fee	0.5 to 1.5% of purchase price	Applied to total acquisition cost at closing	At closing of the acquisition; sometimes earned at LOI execution with a refund if the deal falls through	Often reduced or subordinated to the preferred return by institutional LPs; 1% is the market ceiling for most institutional deals	Equal split, or the deal-sourcing partner receives an enhanced share (for example 60/40 if one partner sourced the deal)	No license for the company's own acquisitions; a broker license may be required in some states if the fee is earned for representing others
Development management fee	3 to 5% of total project cost (hard plus soft costs)	Applied to total project cost, sometimes hard costs only; payable via monthly or milestone draws during construction	Monthly or quarterly during construction; final installment at certificate of occupancy	Negotiated heavily; institutional JV partners often require subordination or deferral; some cap at 4% of hard costs only	Managing partner receives an oversight premium; the construction partner receives a construction management share; split documented in the GP operating agreement	No state license for the company's own projects; a contractor license is required if the company acts as general contractor
Asset management fee	0.5 to 2.0% of equity invested, or 0.25 to 1.0% of gross asset value	Equity-based: percentage of LP equity invested. GAV-based: percentage of appraised or cost value of assets managed	Monthly or quarterly during the hold period; typically continues through stabilization and disposition	Institutional LPs negotiate the rate, the basis (equity or GAV), and whether the fee is subordinated to preferred return distributions	Capital-raising partner often receives an enhanced share; the operations partner receives a base allocation; split by source of assets under management	Investment adviser registration may be required if the fee is charged for managing a fund or discretionary vehicle (see Chapter 20)
Property management fee	3 to 8% of effective gross income	Percentage of collected rents and other income from managed properties; an above-the-line operating expense	Monthly from operating income; senior to preferred return distributions	Institutional partners typically accept self-management only if the company has a licensed, staffed property management operation	Operations partner manages; fee earned at the operating company level (if the company self-manages) and shared among partners	A state property management license is required in most jurisdictions; requires a licensed designated real estate broker or property manager in most states
Disposition fee	0.5 to 1.5% of gross sales price	Applied to total gross sales proceeds before payoff of debt or return of equity	At closing of the property disposition	Often negotiated out or subordinated; most institutional LPs resist disposition fees absent demonstrated marketing value	Deal-sourcing or asset management partner typically receives an enhanced share; documented in the GP operating agreement	A real estate broker license is required in most states if the company markets the property to buyers; some states exempt a sale to a single identified purchaser
Refinancing fee	0.25 to 1.0% of loan amount	Applied to total new loan proceeds at close of refinancing	At closing of the refinancing transaction	Often omitted from institutional structures; limited acceptance where the company already earns an asset management fee on the asset	Finance partner typically receives an enhanced share; split documented in the GP operating agreement	A mortgage broker license is required in most states if the fee is earned for originating or arranging third-party financing; exemptions vary significantly
Construction management or owner's representative fee	1 to 3% of hard construction costs	Applied to total hard costs, sometimes to total project cost; paid monthly via construction draw	Monthly during the construction period	Accepted where the company provides real owner's representative services; scrutinized alongside the development management fee for combined fee stacking	Construction partner receives the primary allocation; split with other partners per the GP operating agreement	A general contractor license is required if the company acts as GC; no license for the owner's representative role in most states

Fee type	Market rate range	Calculation basis	When paid	Institutional negotiation	Internal allocation approach	Licensing and disclosure notes
Loan origination or placement fee	0.5 to 1.0% of equity raised (equity placement); 0.5 to 2.0% of loan amount (debt placement)	Applied to total capital raised or total loan amount arranged	At closing of the capital raise or financing; sometimes split between an initial draw and final closing	Equity placement fees are particularly scrutinized; institutional LPs often prohibit or limit fees paid to an affiliated placement agent	Capital-raising partner receives the primary allocation; split documented in the GP operating agreement	A securities broker-dealer license (FINRA member) is required if the company raises equity from investors for transaction-based compensation as a regular business; serious exposure for unlicensed placement activity
Organization and offering cost reimbursement	Actual costs; commonly 2 to 3% of total capital raised, capped	Reimbursement of actual legal, accounting, marketing, and formation costs incurred in connection with the offering; not a fee as such	At fund closing or first investor close; sometimes spread across multiple closings	A cap on reimbursement (often 2% of total equity raised) is required by institutional LPs; amounts above the cap are the GP's obligation	Shared by all partners as a company expense; no specific allocation beyond the normal operating company distribution	Must be specifically disclosed in the PPM; excessive reimbursement may trigger SEC scrutiny; organization expenses must be amortized over 180 months for tax purposes

The schedule above addresses the most common fee types in development company practice. The founding team should review each line item with legal counsel, specifically on the licensing and disclosure columns, and with their financial advisor on the market rate and institutional negotiation columns, before finalizing the fee schedule for any offering. The schedule must then be included in the PPM with full disclosure of all terms, conditions, and related-party implications.

Fee Disclosure in Investor Documents

Every fee described in this chapter must be disclosed in the offering documents, the private placement memorandum, with enough specificity to let an investor make an informed decision about whether the fee structure is acceptable. This is not merely a best practice; it is a federal anti-fraud obligation under Rule 10b-5 and the general anti-fraud provisions of the Securities Act.

What the PPM Must Disclose

The PPM's fee disclosure section should include:

- The name and description of each fee type that can be charged to the project entity or the investors in connection with the offering.
- The rate or amount of each fee, expressed as a specific percentage or dollar range rather than a vague reference to customary fees or market rates.
- The basis on which each fee is calculated, whether purchase price, project cost, equity invested, gross asset value, or collected rents, with enough specificity for the investor to estimate the dollar amount.
- The timing of each fee payment: at closing, monthly during construction, annually during the hold, or at disposition.
- Any related-party implications: whether the fee is paid to the management company (itself a related party to the GP), to a partner's affiliated entity, or to a third party.
- Any subordination provisions: whether the fee is senior or subordinate to investor distributions, the preferred return, or other priorities in the waterfall.
- The cumulative impact of all fees charged to a typical deal, expressed as a percentage of total investor equity or total project cost, so investors can assess the total fee load.

The Full and Fair Disclosure Standard

The securities anti-fraud standard that applies to fee disclosures in private placement memoranda requires full and fair disclosure of all material facts a reasonable investor would want to know. Applied to fees, the standard means the PPM must disclose not just the existence of each fee but its likely magnitude, the circumstances under which it will be earned, and any conflicts of interest the fee arrangement creates.

A disclosure that says the sponsor may earn acquisition fees in connection with property acquisitions, without specifying the rate, basis, or expected magnitude, is not adequate. An investor reading it has not been given the information needed to evaluate whether the acquisition fee is reasonable or to model its impact on projected returns. Vague disclosures that technically acknowledge fees without providing actionable information are a meaningful regulatory risk.

The standard also applies to the relationship between the fee structure and the incentives it creates. If a fee is structured so that it creates an incentive for the sponsor to make decisions that benefit the sponsor at investors' expense, an acquisition fee that rewards buying assets whether or not they represent the best opportunities, for example, that conflict must be disclosed clearly in the PPM's risk factors, alongside the affirmative fee disclosure.

CHAPTER 10: KEY TAKEAWAYS

1. Fee architecture matters for four reasons: investor relations (fee structures are scrutinized in due diligence), securities law compliance (inadequate fee disclosure is among the most common enforcement bases against private sponsors), regulatory compliance (specific fees trigger licensing requirements), and internal governance (fee allocation must be documented in the operating agreement with the same precision as equity and compensation).
2. The development management fee (3 to 5 percent of total project costs) is the central fee in a development company's revenue architecture. It should be tied to construction milestones, specify the services included with enough precision to be defensible in investor due diligence, and address the holdback-at-completion structure increasingly requested by institutional lenders and LPs.
3. The asset management fee (0.5 to 2.0 percent of equity, or 0.25 to 1.0 percent of gross asset value) is the fee most likely to trigger investment adviser registration analysis. Any company earning asset management fees from a portfolio held for outside investors should assess its Exempt Reporting Adviser or Registered Investment Adviser obligations under Chapter 20 before establishing the fee.
4. Property management fees require state-specific real estate licensing in most jurisdictions. A company that earns them without the required broker's license is engaging in unlicensed real estate activity. The self-management decision should be weighed against portfolio size, asset class expertise, investor expectations, and licensing compliance capacity.
5. The equity placement fee, transaction-based compensation for raising equity from investors, may require broker-dealer registration under federal securities law when earned for raising capital for third parties. Raising capital for the company's own deals under the issuer exemption is permissible; regularly earning transaction-based fees for raising capital for other people's deals is broker-dealer activity. The distinction is critical and the consequences of crossing it are severe.
6. Fee stacking, the accumulation of multiple fees at different stages of a single investment, is viewed negatively by sophisticated investors and is a disclosure obligation under the securities anti-fraud rules. Every fee must correspond to a real

service, must not duplicate another fee in the schedule, and must be justified in due diligence with specificity about the services it covers and the market comparables that support the rate.

7. Fee disclosure in the PPM must meet the full and fair disclosure standard: every fee disclosed with its specific rate, calculation basis, timing, related-party implications, and cumulative impact on investor returns. Vague disclosures that acknowledge fees without providing actionable information are inadequate and create regulatory risk. The complete fee schedule earlier in this chapter provides the framework for a comprehensive PPM disclosure.

WHAT COMES NEXT

Chapter 11 takes up development profits and the project promote structure: how the company structures its economic participation in development projects beyond fee income, how the promote waterfall works in a development context, and how the founding partners divide those promoted economics internally. Where this chapter addressed the fee income that sustains the management company during the development period, Chapter 11 addresses the performance-based economics that represent the primary source of wealth creation for the company's founders over time.

See also: *Chapter 19 (Securities Law Compliance: full treatment of PPM disclosure obligations) • Chapter 20 (Investment Adviser Obligations: asset management fee implications) • Appendix F (Securities Law Compliance Checklist: includes fee disclosure requirements) • Appendix J (Glossary: acquisition fee, development management fee, asset management fee, broker-dealer, placement agent, fee stacking)*

CH. 11

PART IV: OPERATIONS, FEES & HUMAN CAPITAL

Development Profits

and the Project Promote Structure

How the company structures its economic participation in development projects, whether investing its own capital, managing projects for outside investors, or both, and how development profits are divided among the founding partners.

Fee income keeps the company alive; development profits make it worth building. That distinction separates the financial architecture of the previous chapter from this one. The acquisition fees, development management fees, and asset management fees of Chapter 10 are the revenue that funds operations in the years before any project generates a significant return. Development profits, the promoted interest earned from performing above the investors' preferred return and the equity appreciation captured by the company's own balance sheet investment, are the compounding, capital-gains-taxed wealth that motivates a career in real estate development.

This chapter addresses how development profits are structured, how the project promote works in a development context, how balance sheet development creates equity directly without a promoted interest structure, how co-GP arrangements let the company partner with other sponsors on deal economics, and how all of these arrangements must be documented at the company level before the first investor dollar is committed.

The Difference Between Fee Income and Development Profit

The distinction between fee income and development profit is not only a matter of when the money arrives. It reflects different economic relationships between the company and the projects it executes.

Fee income is compensation for services rendered. The development management fee is earned because the company managed the construction process. The asset management fee is earned because the company oversaw the portfolio. The fees are earned whether or not the project performs well, whether or not investors receive their preferred return, whether or not the project is sold at a profit. Fee income is relatively predictable, relatively early in the investment cycle, and taxed as ordinary income.

Development profit is the return on the company's economic position in the project itself: the equity it invested, the promoted interest it holds as sponsor, or both. It is contingent, existing only if the project generates a return above the thresholds the investment structure defines, and it arrives at disposition, potentially years after the project was acquired and developed. But when it comes, it comes in larger amounts and, in most cases, at the more favorable tax treatment of long-term capital gains.

This distinction matters for how the founding partners design both the project economics and the company's financial plan. A company that earns fees but no promoted interest is being compensated for its time and expertise but is not building wealth proportionate to the risk it bears. A company that earns a meaningful promoted interest on performing investments is building the compounding wealth base that justifies the financial and personal risk of the development business.

The Three Paths to Development Profit

A real estate development company can participate in development profits through three structural paths, each creating a different risk profile, return potential, and set of legal and governance requirements. The founding partners must be clear about which path, or combination of paths, the company intends to pursue, because the answer shapes the entity structure, the securities compliance obligations, the capital requirements, and the partner contribution framework.

Path One: Balance Sheet Development

In a balance sheet development model, the company invests its own capital, or its principals' capital held in the project entity, alongside or in place of outside investor equity. When the project is sold or refinanced, the company captures the appreciation directly as an equity return, not through a promoted interest structure. There is no preferred return to satisfy before profits flow to the company; the company is simply an equity owner in a project that has increased in value.

Balance sheet development produces the cleanest economics: the company owns a percentage of the project and receives that percentage of the net sale proceeds after debt is repaid. But it requires the company, or its principals, to commit actual capital, capital that is at risk for the duration of the development and hold period, that cannot be recovered until the project is sold or refinanced, and that bears the full loss if the project underperforms. The balance sheet model is capital-intensive and carries a different risk profile than the promoted interest model precisely because the company's equity is subject to the same downside risk as any outside investor's equity.

Path Two: The Promoted Interest in a Development Syndication

In the sponsored development model, the company raises equity from outside investors for a specific development project. The company serves as the general partner or managing member of the deal-level entity, contributing development expertise, deal sourcing, and project management rather than, or in addition to, significant equity capital. The outside investors contribute most or all of the equity. At disposition, the proceeds flow through a waterfall that first returns investor capital and the preferred return, then allocates a promoted interest, a disproportionate share of the remaining profits, to the GP or sponsor.

This is the model most people mean when they talk about a real estate sponsor or developer. The promoted interest is the sponsor's primary economic reward for the risk of development, the work of execution, and the investment of its reputation in the project. It requires relatively less company capital than balance sheet development, since the sponsor may contribute 5 to 15 percent of the equity in many structures, but it is contingent on performance in a way that balance sheet equity is not.

Path Three: Co-Investment and Hybrid Structures

The most common structure for an established development company is a hybrid: the company earns a promoted interest as the sponsor while also co-investing its own capital alongside the outside investors. The co-investment serves several functions. It demonstrates alignment with investors (the sponsor has capital at risk), it provides additional equity capital that may reduce the need for outside equity, and it gives the company a direct equity return on top of the promoted interest.

A co-investment stake means the company holds two distinct economic positions at once: a promoted interest, earned through the waterfall as the sponsor, and a co-investment interest, a direct equity stake that participates in distributions pro-rata to its ownership percentage, like any other investor. The co-investment typically sits alongside the LP investors in the capital stack,

subject to the same waterfall mechanics as the LPs' equity. The promoted interest is additional to the co-investment, not a substitute for it.

The Development Promote: Mechanics in a Development Context

The promoted interest in a development project works through the same waterfall mechanics introduced in Chapter 6, but the development context adds specific timing and structuring considerations distinct from the fund management context. The development promote is earned at disposition, typically the sale of the completed, stabilized project, after investors have received their full capital return and preferred return. The development timeline means the gap between when investor capital is committed and when the promote is earned can span three to seven years, during which the company must sustain itself on fee income alone.

The Standard Development Waterfall

The distribution waterfall in a development syndication typically follows the four-tier structure introduced in Chapter 6, adapted for the development timeline:

TIER 1

Return of Capital: 100% to LP Investors

All distributable proceeds from the project disposition flow first to the LP investors until their full contributed equity has been returned. In a development syndication this is the investors' original equity contribution, not including any development management fees or other distributions made during the hold period.

▼

TIER 2

Preferred Return: 100% to LP Investors

After full return of capital, distributions continue 100% to LP investors until the cumulative preferred return is satisfied. The preferred return accrues from the date of each investor's capital contribution, compounded annually at the agreed rate (typically 6 to 8 percent for a development project). Because development timelines are long and cash distributions during construction are typically zero, the preferred return accrual at disposition can be substantial.

▼

TIER 3

GP Catch-Up: 100% to GP and Sponsor

After the LP preferred return is fully satisfied, 100% of distributions flow to the GP until the GP has received an amount equal to the agreed promote percentage applied to the combined total of Tiers 2 and 3. This uses the gross-up calculation: if the LP received a given amount in preferred return and the promote is 20%, the catch-up is that amount divided by 0.80 and multiplied by 0.20, bringing the GP to 20% of the combined Tier 2 and Tier 3 distributions.

▼

TIER 4

Promote Split: Negotiated LP and GP Division

All remaining proceeds are split between LP investors and the GP at the agreed promote percentage. The most common split is 80% to LP investors and 20% to the GP, though development deals with higher risk profiles or stronger sponsor track records may negotiate 75/25 or 70/30 splits in favor of the GP on returns above a second IRR hurdle.

A Worked Development Waterfall Example

The following example illustrates the complete development waterfall for a ground-up multifamily project. The facts reflect typical development economics, including the long hold period that lets the preferred return compound significantly before disposition.

Example Project Facts

- Total equity raised from LP investors: $8,000,000
- GP co-investment (alongside LP investors): $500,000 (approximately 5.9 percent of total equity)
- Total project cost: $28,000,000 (funded by $8.5M equity plus $19.5M construction loan)
- Development period (land through certificate of occupancy): 30 months
- Stabilization and hold period after certificate of occupancy: 18 months
- Total hold period: 48 months (4 years)
- Gross sale proceeds at disposition: $36,000,000
- Outstanding loan balance at sale: $19,000,000
- Net sale proceeds after loan payoff: $17,000,000
- Preferred return: 7 percent per annum, compounded annually
- Promote: 20 percent GP / 80 percent LP
- Operating distributions during stabilization: $120,000 total, split pro-rata to equity (approximately $112,941 to LP investors and $7,059 to the GP co-investor); no operating distributions during construction

Step 1: Calculate the cumulative LP preferred return

The LP investors contributed $8,000,000. The preferred return compounds annually at 7 percent over the full 48-month hold, from capital contribution to disposition:

Period	Beginning balance	7% annual accrual	Ending balance
Year 1	$8,000,000	$560,000	$8,560,000
Year 2	$8,560,000	$599,200	$9,159,200
Year 3	$9,159,200	$641,144	$9,800,344
Year 4	$9,800,344	$686,024	$10,486,368
Cumulative preferred return accrued			**$2,486,368**

At disposition the LP investors are owed $8,000,000 in return of capital plus $2,486,368 in cumulative preferred return. The $112,941 in operating distributions the LP investors received during stabilization is credited against the preferred return, reducing the remaining preferred obligation at disposition to approximately $2,373,427.

Step 2: Apply the waterfall to net sale proceeds

Net sale proceeds after loan payoff are $17,000,000. Prior operating distributions of $120,000 ($112,941 to LP investors pro-rata, $7,059 to the GP co-investor) were made during the hold period and are accounted for above.

Tier	Distribution rule	To LP	To GP	Cumulative LP	Cumulative GP
1. Return of capital	100% to LP until $8M is returned; the GP receives its $500,000 co-investment capital alongside	$8,000,000	$500,000	$8,000,000	$500,000
2. Preferred return	100% to LP until the remaining $2,373,427 preferred return is satisfied (net of the $112,941 in prior operating distributions)	$2,373,427	$0	$10,373,427	$500,000
3. GP catch-up	100% to GP; grossed up: $2,373,427 / 80% × 20% = $593,357	$0	$593,357	$10,373,427	$1,093,357
4. Promote split	80% LP / 20% GP of the remaining $5,533,216	$4,426,573	$1,106,643	$14,800,000	$2,200,000
Total	**$17,000,000 fully distributed (plus $120,000 in prior operating distributions)**	**$14,800,000**	**$2,200,000**	**87.1% of net**	**12.9% of net**

Reading the results: the GP entity earns $1,700,000 in promoted interest (the $593,357 catch-up plus the $1,106,643 promote split) on the $8,500,000 total equity commitment, in addition to the return of its $500,000 co-investment. The LP investors receive approximately $14,800,000 on their $8,000,000 investment over four years, about a 1.85x equity multiple and roughly a 16.5 percent IRR after the preferred return and promote are applied. The promote is earned entirely from the project's performance above the preferred return threshold.

The GP Co-Investment: Aligning Economics With Risk

The GP's co-investment in a development deal, the sponsor's own equity invested alongside the LP investors in the project entity, has become increasingly important to institutional investor due diligence. It is no longer enough for a sponsor to argue that capital at risk is provided by the company's reputational exposure; institutional LPs require a meaningful financial stake that aligns the sponsor's personal economic interests with their own.

The Market Standard for GP Co-Investment

The typical GP co-investment is 5 to 20 percent of the total project equity, with the appropriate level depending on deal size, the company's financial capacity, and the investor base's expectations. Smaller deals with high-net-worth individual investors may accept a lower co-investment percentage; institutional co-investment partners and family offices typically expect a minimum of 10 percent GP co-investment as a condition of the relationship.

For a development company in its early years with limited balance sheet capital, the co-investment requirement can create a capital planning challenge. A company managing three projects at once, each requiring 10 percent GP co-investment, may need $1 million to $3 million in committed co-investment capital across its portfolio at any given time. That is capital that cannot be deployed elsewhere, is illiquid for the duration of each project, and is at full risk alongside the LPs' equity.

The founding partners' ability to fund the company's co-investment obligations, whether from the management company's retained earnings, from personal capital, or from a dedicated co-investment vehicle funded by the partners, is a material financial planning consideration that should be addressed in the annual business plan and in the operating agreement's capital call provisions.

Individual Partner Co-Investment Versus Company Co-Investment

When a deal requires GP co-investment, the operating agreement must specify whether that investment is made by the management company (whose assets are shared among all founding partners in proportion to their ownership) or by the individual founding partners in their personal capacity. The distinction has significant governance and economic consequences:

- **Company co-investment.** The management company contributes the co-investment amount to the project entity from its own funds. All founding partners benefit from the co-investment's returns in proportion to their equity ownership in the management company. No individual partner bears more co-investment risk than their equity ownership percentage would suggest.
- **Individual partner co-investment.** Each founding partner contributes directly to the project entity in proportion to their ownership, or some other agreed allocation. Each partner holds a personal co-investment interest, receives personal distributions from the project entity, and reports the project entity's K-1 on their personal tax return. The returns flow to the partners individually rather than through the management company.

Individual partner co-investment is more common when the founders prefer to hold direct equity ownership in individual projects rather than through the management company. It is also more common when the management company lacks sufficient retained earnings to fund the co-investment and the partners must invest from personal resources. The governance framework must address which approach applies to each deal and whether any partner can decline a specific co-investment opportunity without consequences.

Co-GP Arrangements: Sharing the Promote With Another Sponsor

As development companies mature, they increasingly encounter opportunities where a joint venture with another sponsor makes strategic sense: a deal larger than the company can execute alone, a market where a local partner's relationships are essential, or an asset class expertise that complements the company's own. In these situations the company may enter a co-GP arrangement, a partnership with another development company at the sponsor level, above the deal-level entity.

How Co-GP Arrangements Work

In a co-GP structure, two or more development companies share the general partner or managing member position in a deal-level entity. The co-GPs together face the LP investors as a unified sponsor, but their internal relationship, how the GP economics are divided, how decisions are made, how expenses are allocated, is governed by a separate co-GP joint venture agreement to which the LP investors are typically not party. That agreement addresses:

- **Promote allocation.** How the total promoted interest earned by the GP entity is divided between the co-GPs. The allocation typically reflects each co-GP's specific contribution to the deal: the co-GP who sourced the deal may receive a larger share of the acquisition fee and a promote bonus, the co-GP who manages construction may receive the development management fee, and the co-GP who raised the investor capital may receive the asset management fee.
- **Decision authority.** Which co-GP has day-to-day operational authority over the project, and which decisions require joint approval. The governance framework for a co-GP arrangement follows the same principles as the internal governance framework discussed in Chapter 8: define who decides what, and at what threshold.
- **Capital obligations.** Whether the co-GPs share the co-investment obligation equally or in proportion to their promote allocation, and what happens if one co-GP cannot fund its portion of the required co-investment.

- **Fee allocation.** How the fees earned by the GP entity (acquisition, development management, asset management) are divided between the co-GPs, and whether each co-GP's share reflects its specific operational contribution.
- **Exit provisions.** What happens if one co-GP wants to exit the arrangement, how the departing co-GP's promote and fee interests are valued, and who has the right to assume full control of the project.

Disclosure Obligations in Co-GP Arrangements

The co-GP arrangement is a related-party relationship from the perspective of the LP investors, who have committed capital to a GP entity whose internal economics are governed by an agreement they have not seen. The PPM must disclose the existence of the co-GP arrangement, identify the co-GP parties, and describe in general terms how the GP economics are divided between them.

The disclosure obligation does not require the co-GP joint venture agreement to be provided to investors in full. But the general structure of the arrangement, the fact that two separate companies share the GP economics, the identity of those companies, and the general allocation of roles and responsibilities, is material information a reasonable investor would want before committing capital. Failing to disclose a co-GP arrangement is an omission of material fact in violation of the securities anti-fraud rules.

Internal Documentation of Development Profit Allocation

The development profit allocation among the founding partners is governed by the GP entity's operating agreement, not the fund's LPA, not the project entity's operating agreement, and not a verbal understanding from a partnership dinner. The founding partners must agree on and document the allocation before the first deal closes. The consequences of failing to do so were described in Chapter 6, but they bear repeating in the development context, because the amounts at stake are typically larger and the disputes harder to resolve.

Development Profit and Promoted Interest: A Clarification

In the balance sheet development context, development profit refers to the equity return the company earns on its own invested capital, the appreciation above cost that the company captures when a project it owns is sold. This profit flows through the operating company's own accounts and is distributed to the founding partners under the operating company's distribution provisions.

In the sponsored development context, the term refers to the promoted interest, the GP's performance-based share of the deal's profits above the LP preferred return. This profit flows through the GP entity and is then allocated among the founding partners under the GP entity's operating agreement.

The founding team must be clear, in both operating agreements, which profits are governed by which document. The operating company's operating agreement governs the distribution of the management company's own profits, including income from balance sheet investments held directly by the operating company. The GP entity's operating agreement governs the distribution of promoted interests received by the GP entity from deal-level vehicles in which outside investors participate.

What the GP Entity Operating Agreement Must Specify

As discussed in Chapter 6, the GP entity's operating agreement must address the following promoted interest allocation questions with specificity before any deal closes:

- The percentage of the total promoted interest received by the GP entity that is allocated to each founding partner, by specific dollar percentage, not by vague reference to contribution or role.
- Whether the allocation is uniform across all deals the GP manages or varies by deal based on each partner's specific contribution to that deal (deal sourcing, capital raising, construction management).
- The conditions under which a partner's promote participation is forfeited or reduced upon departure, and whether any vested promote participation follows the partner after departure.
- The clawback allocation: how each partner's obligation to return promoted interest in a clawback scenario is calculated, and whether a carry escrow or holdback is maintained as a reserve.
- The process for modifying the allocation for future deals: what approval is required, and whether changes affect deals already in progress.

Tax Treatment of Development Profits in Different Structures

The tax treatment of development profits varies significantly with the structure through which they are earned, the holding period of the underlying assets, and the character of the income at the project level. The founding partners must understand these distinctions to anticipate their individual tax obligations and to structure transactions for tax efficiency within the constraints of applicable law.

Balance Sheet Development Profits

When a development company sells a project it owns on its own balance sheet, the profit is characterized based on the nature of the company's activities and its intent with respect to the property:

- **Long-term capital gain.** If the property has been held more than one year (for assets other than carried interests, which have their own holding period rules) and the company is not classified as a dealer, the gain is a long-term capital gain taxed at preferential rates, currently a maximum of 20 percent at the federal level, plus the 3.8 percent net investment income tax for high-income taxpayers.
- **Ordinary income (dealer status).** If the company's primary business involves buying and selling real estate as inventory, a homebuilder, a land flipper, or a developer whose primary strategy is rapid development and disposition, the IRS may classify the company as a dealer, which would cause gains on the sale of development properties to be taxed as ordinary income rather than capital gain. Dealer status is a facts-and-circumstances determination that depends on the frequency and nature of transactions, the company's intent at acquisition, and the relationship between its development and holding activities.
- **Section 1231 gain.** For property held in a trade or business for more than one year, gain on sale is typically treated as Section 1231 gain, which receives capital gain treatment if total Section 1231 gains exceed Section 1231 losses for the year. Section 1231 treatment is generally available to a development company that is not classified as a dealer.

Depreciation recapture is particularly important for development companies. When a completed project is sold, the depreciation taken during the hold period is recaptured at disposition, but not uniformly. Depreciation on the real property itself is taxed as unrecaptured Section 1250 gain at a maximum federal rate of 25 percent, while the accelerated depreciation on the shorter-life personal property components identified in a cost segregation study is recaptured as ordinary income under

Section 1245. The portion taxed as ordinary income, rather than at the lower capital gains or 25 percent rates, can be meaningful for projects with aggressive cost segregation studies.

Promoted Interest Tax Treatment

The promoted interest earned by the GP entity in a development syndication is a partnership interest held for services. As discussed in Chapter 6, the tax treatment of carried interest was significantly changed by the Tax Cuts and Jobs Act of 2017 through Section 1061 of the Internal Revenue Code. For development projects:

- **Assets held more than three years.** The GP's promoted interest share of the gain from the sale of a development project held more than three years qualifies for long-term capital gains treatment, provided the interest is an applicable partnership interest as defined under Section 1061.
- **Assets held between one and three years.** If the underlying real estate was held more than one year but less than three years, Section 1061 recharacterization applies, converting what would otherwise be long-term capital gain into short-term capital gain taxed at ordinary income rates. For development companies whose projects take 24 to 36 months from acquisition through disposition, common for value-add repositioning strategies, this distinction can significantly affect the after-tax economics of the promote.
- **Assets held less than one year.** Gain from the sale of assets held less than one year is always short-term capital gain, at ordinary income rates, for the promoted interest, regardless of Section 1061.

The Holding Period Strategy

Section 1061's three-year holding period requirement is not always within the company's control; market conditions, lender requirements, and investor timelines all influence when a project is disposed. But the founding team should understand how the holding period affects the tax treatment of the promoted interest and build that understanding into the deal underwriting and hold strategy. In practical terms:

- **Ground-up development projects** typically run well past the three-year mark by the time they are sold. The full timeline from acquisition through construction, stabilization, and disposition commonly exceeds three years; the worked example earlier in this chapter, with a 30-month development period and an 18-month stabilization and hold, runs 48 months from acquisition to sale and clears the three-year requirement comfortably. The three-year clock runs from the date the project entity acquires the underlying property, or, in some interpretations, the date the property is contributed to the project entity.
- **Value-add acquisitions** with a targeted 18-to-24-month exit timeline will typically not meet the three-year holding period, resulting in ordinary income tax rates on the GP's promoted interest share of the gain. The underwriting for these deals should reflect the higher effective tax rate on the promote, which reduces the after-tax economics compared to a projection that assumes capital gains rates.
- **Deals approaching the three-year mark** should be evaluated with particular care: the economic benefit of holding six months longer to qualify for the capital gains rate may be substantial, particularly on a large promoted interest.

Development Profits and the Company's Financial Plan

Development profits, the promoted interest and balance sheet equity returns, are the economic engine that ultimately justifies building a real estate development company. But they are also the

most deferred component of the company's revenue and the component most subject to market risk. The founding team's financial plan must treat development profits with realism about timing, conditionality, and the tax cost of realization.

The Timing Reality

A development company that closes its first project in Year 1 will not earn promoted interest from that project until it is sold, which may be Year 5, Year 6, or later depending on the development timeline, the stabilization period, and the state of the disposition market at sale. For the first four to six years, the founding partners must sustain themselves and the company on fee income alone while the promoted interest builds up in the development pipeline. This timing reality has several implications:

- The 24-month operating budget developed in Chapter 2 must be adequate to sustain the company through the period before development profits begin to materialize. A budget that assumes development profits by Year 2 or Year 3 is almost certainly unrealistic for a ground-up development company.
- The partners' personal financial plans must accommodate the deferred nature of development profits. Founding partners who depend on development profit distributions for their personal needs during the company's early years are building on an unstable foundation.
- The annual business plan should model the promoted interest pipeline separately from fee income, tracking each active project's projected promote, the probability of achieving the required return thresholds, and the anticipated distribution date, so the management committee understands the company's medium-term financial trajectory even when near-term fee income is the primary revenue source.

Modeling Promoted Interest in the Annual Business Plan

The annual business plan's revenue section should include a promoted interest pipeline table that tracks each active project's projected promote through the life of the investment:

- Project name, acquisition date, and projected disposition date.
- Total LP equity invested and projected LP preferred return at the anticipated disposition date.
- Projected gross sale proceeds and loan payoff.
- The waterfall calculation: projected LP return of capital, preferred return, GP catch-up, and promote split at the projected disposition date.
- The GP entity's projected promoted interest from the project, and the timing and amount of the anticipated distribution.
- Each founding partner's share of the projected promoted interest based on the GP entity's internal allocation.
- A probability-weighted projection: what probability does the management committee assign to achieving the projected promote on this project?

This pipeline table gives the management committee a realistic forward-looking view of the company's economic trajectory beyond the current year's fee income. It also creates a governance tool: the committee can review each project's promote trajectory annually and identify early whether a project is on track to generate its projected promote or whether performance is diverging from the original underwriting.

Reinvesting Development Profits: Building the Company's Balance Sheet

One of the most important financial decisions a development company makes during its early profitable years is what to do with development profits when they arrive. The instinct is often to distribute them: the partners have been deferring full market-rate compensation while the company built its portfolio, and a significant promote distribution feels like a well-earned reward for years of discipline.

The strategic alternative, retaining a meaningful portion of early development profits in the company, is worth weighing carefully. The reasons to reinvest:

- **Building co-investment capital.** Each deal the company pursues will require GP co-investment. A company with $2 million to $5 million in retained earnings can fund its co-investment obligations from internal resources rather than requiring personal contributions from the partners for every deal. That operational flexibility is valuable and differentiating in a competitive deal environment.
- **Funding the ramp-up for new deals.** Ground-up development requires significant pre-development investment before construction financing is available. Legal fees, design costs, entitlement expenses, and earnest money deposits can run $500,000 or more on a significant project before a single construction loan dollar is available. A company that distributes all of its profits must fund these costs from partner contributions or bridge financing; one that retains earnings can fund them internally.
- **Absorbing the risk of a difficult deal.** Development companies occasionally encounter projects that need additional capital beyond the original underwriting, from cost overruns, entitlement delays, or market softening during construction. A company with a balance sheet reserve can absorb these costs without a crisis; one that distributed all available capital cannot.
- **Building institutional credibility.** Institutional co-investment partners and senior lenders pay attention to the management company's financial strength. A company with meaningful retained earnings and a track record of reinvesting in its own business looks different to an institutional counterparty than one that distributes everything and operates on a thin margin.

How much of development profits to distribute and how much to retain should be addressed explicitly in the annual business plan, with the management committee making a deliberate choice rather than defaulting to full distribution because that is the most immediately satisfying option.

CHAPTER 11: KEY TAKEAWAYS

1. Development profits and fee income are different economic instruments. Fee income compensates the company for services rendered and is earned whether or not projects perform. Development profit, whether through balance sheet equity returns or promoted interests, is contingent on performance, arrives at disposition, and is taxed at more favorable capital gains rates. The distinction matters for financial planning, compensation design, and the governance of distribution decisions.
2. Development companies access development profits through three structural paths: balance sheet development (direct equity ownership, no preferred return to satisfy), sponsored development with a promoted interest (performance-based compensation above the LP preferred return), and hybrid co-investment structures (the GP holds both a promoted interest and a direct equity stake alongside LP investors). Most established development companies operate in hybrid structures.

3. The development waterfall follows the same four-tier structure as any promote structure (return of capital, preferred return, GP catch-up, promote split), but the development context creates specific timing dynamics: the long hold period means preferred returns compound significantly before disposition, the GP catch-up is calculated using the gross-up method (LP preferred return divided by the LP's percentage equals the combined Tier 2 and Tier 3 distributions), and the promote is realized entirely at disposition rather than during the development period.
4. GP co-investment, the sponsor's own equity invested alongside LP investors, has become increasingly important to institutional due diligence. The typical co-investment is 5 to 20 percent of total project equity. The operating agreement must address whether the co-investment is made by the management company or by individual founding partners, and what happens if one partner cannot fund their share of the obligation.
5. Co-GP arrangements, partnerships between two development companies at the sponsor level, must be documented in a co-GP joint venture agreement addressing promote allocation, decision authority, capital obligations, fee allocation, and exit provisions. The existence of the co-GP arrangement must be disclosed to LP investors in the PPM; the specific terms need not be provided, but the general structure must be disclosed.
6. Section 1061's three-year holding period requirement affects the tax treatment of the promoted interest on development projects. Projects held more than three years qualify for long-term capital gains treatment on the GP's promote. Projects held one to three years are subject to Section 1061 recharacterization to ordinary income, which can significantly reduce the after-tax economics of value-add strategies with 18-to-24-month exit timelines.
7. The timing reality of development profits must be built into the company's financial plan: promoted interest from a project closed in Year 1 may not be received until Year 5 or later. The company must sustain itself on fee income during this period, and the partners must plan their personal finances accordingly. Annual business plan modeling of the promoted interest pipeline, tracking each project's projected promote through the life of the investment with probability weighting, gives the management committee a realistic forward-looking economic picture.

WHAT COMES NEXT

Chapter 12 takes up human capital, how to build the team that makes the company function. It covers the organizational build-out timeline, the employee versus independent contractor classification analysis, compensation philosophy (market-rate versus below-market plus equity upside), profits interests for key employees, employment agreements, non-compete and non-solicitation provisions, and the HR compliance obligations that attach from the first hire. The chapter bridges the fee and development-profit architecture of this part of the handbook with the people-management practices that determine whether the company can execute on its strategic plan.

See also: *Chapter 6 (Profits Interests: the Section 1061 three-year holding period) • Chapter 19 (Securities Law Compliance: PPM disclosure of co-GP arrangements) • Appendix D (Decision Authority Matrix: co-investment and JV approval thresholds) • Appendix J (Glossary: promoted interest, GP catch-up, co-investment, co-GP, dealer status, Section 1231, Section 1061)*

CH. 12

PART IV: OPERATIONS, FEES & HUMAN CAPITAL

Human Capital

Employees, Compensation, and Equity Participation

Building the team that makes the company function: how to hire, compensate, and retain the right people while managing the legal and financial obligations that come with employment.

A real estate development company is only as good as the people who run it. The founding partners bring vision, relationships, and initial execution capacity. Beyond the founders, the company's ability to scale, to pursue more deals at once, to manage construction more efficiently, to build deeper investor relationships, and to maintain the financial and compliance infrastructure a growing portfolio requires, depends on bringing in the right people at the right time, paying them appropriately, and structuring their participation in the company's success so their interests align with the founders' own.

This chapter addresses every part of building that team: when to hire and when to outsource, what positions the company needs at each stage of growth, how to structure compensation for employees who are not founding partners, how to use profits interests to create real equity alignment without diluting the founders' ownership of current value, the legal compliance obligations that attach from the first hire, and the non-compete and non-solicitation framework that protects the company's investment in its people.

The Organizational Build-Out Timeline

The most common hiring mistake early-stage development companies make is hiring too fast, and the wrong people, driven by ambition about the company's near-term trajectory rather than an honest assessment of what the company can actually support and what it actually needs to function. Hiring creates fixed obligations, salaries, benefits, payroll taxes, that continue whether or not revenue materializes on schedule. The right question is not what team a successful development company needs, but what team this company needs right now, given its current deal volume, revenue, and capital, and what it will need at the next stage of growth.

The organizational build-out timeline should be tied to the company's deal volume and revenue milestones, not to an aspirational organizational chart. The table below presents the typical hiring sequence for a development company growing from formation through an established portfolio, with the triggers that justify each position and the cost implications of each hire.

Position	Primary function	Hire trigger	Approximate annual cost (salary plus benefits)
Project Coordinator / Analyst	Deal underwriting support, due diligence coordination, lender reporting, construction draw administration	First deal under construction; managing partner spending more than 30 percent of time on administrative project tasks	$65,000 to $95,000
Asset Manager / Development Associate	Active project management, GC coordination, budget tracking, investor reporting for individual deals	Two or more active construction projects at once; managing partner cannot adequately oversee all projects	$90,000 to $135,000
Controller / Senior Accountant	Management company accounting, financial statement preparation, deal-level bookkeeping, K-1 coordination with the CPA firm	Three or more active projects, each with separate entity accounting; investor reporting requires monthly financials; outsourced bookkeeping cost exceeds an internal hire	$85,000 to $120,000

Position	Primary function	Hire trigger	Approximate annual cost (salary plus benefits)
Investor Relations Associate	LP communications, investor portal management, subscription document processing, investor data management	Active capital raises across two or more concurrent deals; managing partner spending significant time on investor administration rather than deal execution	$70,000 to $100,000
Senior Development Manager	Lead project management on specific deals; GC relationship management; entitlement and permitting oversight; budget and schedule management	Five or more active or pipeline deals; senior project capacity insufficient to manage all projects; desire to build internal leadership depth	$120,000 to $175,000
Director of Capital Markets / VP Investor Relations	Institutional investor relationships, fund-raise management, PPM and offering document coordination, LP reporting oversight	Transition from individual investor raises to institutional LP relationships; capital raising requires dedicated senior relationship management	$150,000 to $220,000
Chief Financial Officer	Financial strategy and reporting, banking relationships, audit management, tax planning coordination, investor financial reporting oversight	Significant assets under management (generally $50M and up); audited financial statements required; fund and project accounting complexity exceeds controller capacity	$175,000 to $280,000
In-House General Counsel	Contract management, compliance oversight, securities law coordination, employment law, lender negotiations	Deal volume and legal complexity make outside counsel costs consistently exceed an in-house hire; typically $100M and up in assets under management, or 10 or more active projects	$200,000 to $325,000

These ranges reflect total cash compensation (salary plus target bonus) and do not include employer-side payroll taxes, health insurance, retirement plan contributions, or other benefits, which typically add 20 to 30 percent to the base compensation cost. The hire trigger column matters as much as the compensation range: the question is not whether a position would be useful, but whether the company's deal volume, complexity, and financial capacity justify the ongoing commitment.

Employee or Independent Contractor: The Classification Decision

Before the company engages anyone to perform regular, ongoing work, whether called an employee, a consultant, a contractor, or anything else, the founding partners must understand and apply the legal framework for worker classification. The classification is not determined by what the contract calls the relationship; it is determined by the economic and behavioral reality of how the relationship actually functions.

Misclassifying an employee as an independent contractor is one of the most common and most consequential compliance failures early-stage development companies make. The cost of correction almost always exceeds the short-term savings from avoiding payroll taxes and benefits obligations.

The IRS Economic Reality Test

The IRS uses a multi-factor test to determine whether a worker is an employee or an independent contractor. No single factor is determinative; the analysis looks at the totality of the relationship across three broad categories:

- **Behavioral control.** Does the company control, or have the right to control, what the worker does and how they do their job? Factors include whether the company gives specific instructions about how work is performed, whether it provides training, and whether the worker personally performs the services or can hire others. A worker who follows the company's specific direction on how to perform the job, uses the company's systems and

tools, and is expected to perform the work personally looks like an employee regardless of how the contract describes the relationship.

- **Financial control.** Does the company control the business aspects of the worker's work? Factors include whether the worker has a significant investment in their own equipment or facilities, whether the worker serves multiple unrelated clients, whether the worker advertises to the general public, and whether the worker has a real opportunity for profit or loss. A worker who works exclusively for one company, uses that company's equipment, and has no meaningful alternative income source is financially dependent on the company in the way an employee is.
- **Type of relationship.** What kind of relationship do the parties perceive themselves to have? Factors include whether there are written contracts describing the relationship, whether the worker receives employee-type benefits, whether the relationship is expected to be permanent, and whether the services are a key aspect of the regular business of the company. An asset manager who has worked for the company for two years performing the same ongoing portfolio oversight central to the company's operations has a relationship that looks permanent and integrated, the defining characteristics of employment.

The Consequences of Misclassification

The consequences of misclassifying an employee as an independent contractor are specific, substantial, and cumulative:

- **Back payroll taxes.** The company must pay both the employer and employee portions of Social Security and Medicare taxes for all misclassified periods, plus the federal and state income tax withholding that should have been deducted from wages. These amounts typically carry interest and penalties that can substantially exceed the original tax liability.
- **Workers' compensation.** Misclassified workers who suffer job-related injuries may file workers' compensation claims. If the company carried no workers' compensation insurance, which it was not required to carry if it had no employees, it is uninsured for those claims and personally liable.
- **Employment benefit claims.** If the company provides benefits to employees but denied them to misclassified workers, those workers may claim the benefits they should have received.
- **State enforcement actions.** Most states have independent enforcement authority over worker classification, and state penalties are often more severe than federal penalties. California, Massachusetts, and New York have particularly aggressive enforcement programs with significant personal liability for the company's principals.
- **Private lawsuits.** Misclassified workers have a private right of action under the FLSA and various state laws to recover unpaid wages, overtime, and benefits, plus attorney's fees.

When Contractor Status Is and Is Not Appropriate

Independent contractor status is appropriate for workers who provide specialized professional services: the CPA firm preparing the company's annual tax returns, the attorney handling deal-level transaction work, the engineer providing a specific feasibility study, the graphic designer creating a one-time branding deliverable, the consultant reviewing a market analysis. These workers maintain their own businesses, serve multiple clients, hold their own professional credentials, and are engaged for specific limited projects.

It is not appropriate for workers who perform ongoing, regular work central to the company's operations, who work under the company's direction and control, and who have no meaningful alternative client base. An asset manager who shows up at the office five days a week, uses the company's systems, takes daily direction from the managing partner, and has worked exclusively for the company for eighteen months is an employee by any objective test, regardless of what the contract calls them.

When in doubt, classify as an employee. The cost of proper employment, payroll infrastructure, workers' compensation insurance, and employment tax withholding, is a manageable, predictable cost. The cost of defending a misclassification claim, including back taxes, interest, penalties, and legal fees, is neither manageable nor predictable.

Employment Agreements for Key Personnel

Most development company employees do not need written employment agreements. The at-will employment relationship, under which either party can end the relationship at any time, for any reason, without breach of contract, is the legal default in every U.S. state except Montana, and it suits the majority of the company's workforce. An employee handbook, a compensation letter, and a standard offer letter are sufficient documentation for most positions.

Written employment agreements are appropriate for a narrower category of key personnel, where the company needs contractual protections the at-will default does not provide and the employee's importance justifies the additional formality:

- **Senior leaders with significant operational authority.** A Director of Development, Chief Financial Officer, or Head of Capital Markets who will have access to confidential deal information, investor relationships, and financial systems needs a written agreement specifying their confidentiality and non-solicitation obligations, their equity participation terms, and the consequences of departure in a way a generic offer letter cannot.
- **Employees who receive meaningful equity participation.** Anyone who receives a profits interest grant should have a written employment agreement, or at minimum a written grant agreement, specifying the terms of the grant, the vesting schedule, the departure mechanics, and the Section 83(b) election process.
- **Employees the company needs to retain for a defined period.** If the company hires a senior construction manager to oversee a specific 24-month project, a written agreement specifying a 24-month term with early termination consequences gives the company contractual certainty that the manager will see the project through.

Key Employment Agreement Provisions

A well-drafted employment agreement for a key employee of a development company addresses:

- **Title, duties, and reporting structure.** The specific position, its primary responsibilities, and the manager to whom the employee reports. The duties description should be general enough to accommodate the company's evolution without requiring amendments, but specific enough to establish the scope the non-compete provisions, if any, are designed to protect.
- **Compensation.** The base salary and the terms of any bonus, including the calculation formula, the payment timing, and the conditions the employee must satisfy to earn it (typically including continued employment through the payment date).

- **Equity participation.** If the employee receives a profits interest, the grant agreement (or a specific section of the employment agreement) must address the terms described in Chapter 6: threshold value, vesting schedule, departure mechanics, and the Section 83(b) election.
- **Term and termination.** Whether employment is at-will or for a defined term; the notice required for voluntary resignation; the consequences of termination with and without cause; the definition of cause (which must be specific and objective, for the same reasons discussed in the context of partner departure in Chapter 5); and the severance, if any, payable on termination without cause.
- **Confidentiality.** A broad obligation to maintain the confidentiality of the company's proprietary information, investor data, deal pipeline, financial information, and trade secrets, extending beyond the end of the employment relationship.
- **Non-solicitation of investors and employees.** A time-limited obligation (typically one to two years after departure) not to solicit the company's investors for competing investment opportunities and not to recruit the company's employees to competing ventures.
- **Intellectual property assignment.** A specific assignment to the company of all work product, inventions, analyses, models, processes, and other intellectual property created by the employee in the course of employment.
- **Non-compete.** Where the company seeks to restrict the employee's post-departure activities in the real estate development business, a non-compete with specific scope (asset class, geography, duration) drafted to be enforceable in the relevant jurisdiction.

Non-Compete and Non-Solicitation Provisions: A State-by-State View

Non-compete and non-solicitation agreements are among the most jurisdiction-sensitive provisions in employment law. Their enforceability varies dramatically by state, and a non-compete drafted for enforcement in one state may be entirely unenforceable in another. A development company that operates in multiple states, or hires employees who may work from different locations, must address the applicable law question carefully in each employment agreement.

The analysis below addresses the five states most relevant to development company practice, California, Texas, New York, Florida, and Illinois, along with the general framework applicable in the remaining states.

California: Near-Total Ban

California prohibits non-compete agreements in employment by statute, with extremely limited exceptions. California Business and Professions Code Section 16600 voids every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind. The prohibition is broadly interpreted and applies regardless of where the agreement was signed or whether it purports to be governed by another state's law.

A California-based development company, or any development company hiring employees who will work primarily in California, cannot enforce a non-compete against those employees. The company's practical protections are limited to the non-solicitation covenant (California law is somewhat more receptive to non-solicitation of investors and clients, though even these provisions face scrutiny) and the confidentiality and IP assignment obligations that survive the employment relationship.

California's 2024 enforcement expansion, which required employers to notify employees that existing non-competes are void and prohibited providing employees with contracts that include void non-compete provisions, with civil penalties for violations, further strengthened the state's already

formidable posture. Companies with California employees should assume non-compete provisions will not be enforced and design their confidentiality and non-solicitation provisions to provide the maximum permissible protection within that constraint.

Texas: Enforceability with Reasonableness Requirements

Texas enforces non-compete agreements under the Texas Covenants Not to Compete Act, which requires that the covenant be ancillary to or part of an otherwise enforceable agreement, that it contain reasonable limitations as to time, geographic area, and scope of activity, and that those limitations be consistent with the consideration given.

In practice, Texas courts have been reasonably hospitable to non-competes in professional employment. Reasonable time restrictions (generally one to two years) and geographic limits tied to the markets where the employee worked are likely to be enforced. A non-compete barring an asset manager from working for any real estate company anywhere in the United States for five years would not survive scrutiny; one barring the same asset manager from managing similar commercial assets in the Dallas-Fort Worth metropolitan area for two years is likely enforceable.

Texas non-solicitation of investors provisions are generally enforced where the investor relationships are legitimate trade secrets of the employer and the scope and duration are reasonable. A provision prohibiting solicitation of the company's specific investor list for two years after departure is well-supported under Texas law.

New York: A Shifting Landscape

New York has historically been a moderate non-compete jurisdiction, enforcing reasonable restrictions under a balancing test that asks whether the restriction protects a legitimate employer interest, is reasonably limited in scope and duration, and is not unduly harsh or oppressive to the employee. Courts have enforced non-competes for employees with access to confidential client relationships and specialized know-how, while striking down provisions that are overbroad in geographic scope or duration.

The New York Legislature passed a broad non-compete ban in 2023, but Governor Hochul declined to sign it without a salary threshold, having sought to exempt employees earning above roughly $250,000, and the bill was not enacted. New York has continued to weigh non-compete legislation since, but as of this writing no statewide ban has become law, and the pre-existing case-by-case reasonableness standard still governs New York non-competes. Development company counsel should monitor New York legislative developments closely, as the policy environment is shifting and new legislation remains likely.

New York non-solicitation provisions targeting customer and client relationships are generally enforceable where the employer can show a protectable proprietary relationship with the client. For a development company, the investor relationship database constitutes this protectable interest, and a well-drafted non-solicitation covenant targeting those specific relationships is supported by New York precedent.

Florida: Employer-Favorable

Florida is among the most employer-favorable non-compete states in the country. Florida Statute Section 542.335 specifically authorizes enforcement of non-compete agreements and provides that courts shall not consider the hardship to the employee in determining enforceability. The statute creates a presumption that restrictions within stated durations (two years or less for non-solicitation of clients and for non-competition) are reasonable, and that longer ones are not.

A Florida development company can generally enforce non-compete provisions that comply with the statute, including a reasonable geographic scope and a two-year or shorter duration. The courts will reform (blue-pencil) an overbroad provision to make it enforceable rather than voiding it entirely,

which gives Florida employers additional protection against the risk that a court finds a provision unenforceable.

Non-solicitation of investors is strongly supported under Florida law where the investor relationships constitute the employer's legitimate business interest, which, for a development company whose investor database represents years of relationship-building, they clearly do.

The General Framework for Other States

For development companies operating in states not specifically analyzed above, the general enforceability framework:

- **Most states enforce reasonable non-compete and non-solicitation agreements in employment.** The definition of reasonable varies, but generally encompasses a duration of two years or less for non-competes, a geographic scope limited to the markets where the employee actually worked, and a scope of prohibited activity limited to the same or similar business as the employer's operations.
- **States with recent anti-non-compete legislation require special attention.** Minnesota banned non-competes in 2023; Oklahoma and North Dakota have longstanding near-bans. The trend in state legislation has been toward restricting rather than expanding non-compete enforcement, and the landscape continues to evolve.
- **Federal attention to non-competes continues even without a federal rule.** The FTC's 2024 rule that would have broadly banned non-compete agreements nationwide was vacated by a federal court and has since been abandoned by the agency, which dropped its appeals and removed the rule from its regulations. The Commission has signaled it will instead challenge overbroad non-competes case by case under Section 5 of the FTC Act. Development company counsel should monitor federal developments that may affect the national framework.
- **Confidentiality and investor non-solicitation hold up almost everywhere.** Regardless of a state's treatment of non-competes, confidentiality provisions and non-solicitation of specific investor relationships are generally enforceable across jurisdictions as protections of legitimate business interests and trade secrets.

Compensation Philosophy: Market-Rate Cash or Equity Upside

Every development company that hires beyond the founding team faces a compensation philosophy choice: compete on cash compensation at or above market rates, or offer below-market cash combined with meaningful equity upside through profits interests. The answer is not the same for every role or every stage of growth, and getting it wrong in either direction has predictable consequences.

The Case for Market-Rate Cash

Market-rate cash compensation attracts the widest pool of qualified candidates, creates fewer complexities around employee expectations about equity value, and avoids the legal and administrative demands of profits interest grants. An employee paid market-rate cash knows exactly what they are receiving, does not need to understand the company's distribution waterfall or vesting mechanics, and is not dependent on the company's long-term success for a meaningful portion of their total compensation.

Market-rate cash is the right approach for most non-senior positions, project coordinators, financial analysts, administrative staff, and other roles that are important to operations but where the company's long-term equity appreciation is not the appropriate compensation vehicle. It is also

appropriate for roles with high turnover expectation, where the administrative overhead of profits interest grants is not justified by the expected tenure of the employee.

The Case for Below-Market Cash Plus Equity Upside

Below-market cash combined with meaningful profits interest participation makes sense for senior-level employees who are:

- Truly important to the company's long-term success, not just the current deal or the current year, but the company's ability to build a durable, scalable platform.
- Motivated by the prospect of significant equity upside and willing to accept lower current cash in exchange for a share of the company's long-term appreciation.
- Expected to stay for a multi-year period that justifies the vesting schedule and the legal and administrative overhead of a profits interest grant.
- In a role where their specific contributions to the company's long-term value can be reasonably attributed, making the equity upside feel truly contingent on their contribution rather than a deferred compensation arrangement.

The practical challenge is expectation management: employees who accept below-market cash in exchange for equity upside are making a financial bet on the company's long-term success. If that success does not materialize, or materializes more slowly than expected, the below-market cash breeds resentment. The company must be honest with prospective employees about the risks and uncertainties of the equity upside, not just the potential rewards.

The Compensation Approval Authority

The compensation of all employees, both initial compensation at hire and any later adjustments, must be governed by the approval authority framework established in the Decision Authority Matrix (Chapter 8). Specific governance provisions the operating agreement and the matrix should address:

- The managing partner or designated officer can hire employees up to a defined compensation threshold without committee approval. This threshold should reflect the company's scale and deal volume, typically $75,000 to $120,000 in total annual compensation for an emerging company.
- Employees above the compensation threshold, or in positions with significant operational authority (asset manager, controller, head of investor relations), require committee majority approval.
- C-suite hires and any hire with equity participation (a profits interest grant) require committee supermajority or unanimous approval, regardless of compensation level.
- Annual compensation adjustments for all employees are approved as part of the annual business plan's budget process, with the managing partner having delegated authority to implement approved adjustments without further committee action.

Profits Interests for Key Employees: The Practical Grant Framework

As discussed in Chapter 6, profits interests are the preferred vehicle for granting meaningful equity participation to key employees without requiring them to purchase the company's current value and without generating immediate income tax at the time of grant. This section addresses the practical process for granting profits interests to employees, with attention to the employment-context considerations that distinguish employee grants from founding partner grants.

Grant Size Ranges

Appropriate profits interest grant sizes for key employees vary by seniority, role, and the company's stage. The ranges below reflect market practice for development platforms at the emerging-to-established stage:

Position level	Typical grant range	Key considerations
Partner-Track Senior Leader	0.5% to 3.0%	Employees on an explicit or implicit partner track expected to eventually become full economic participants; grant size reflects the path to partnership and is often supplemented by additional grants over time
Senior Director / VP Level	0.25% to 1.5%	Key senior contributors critical to specific functions (capital markets, development management, finance) who may not be on a direct partner track; the grant reflects contribution without creating an expectation of partnership
Director / Manager Level	0.1% to 0.5%	Experienced mid-level contributors the company wants to retain long-term and align with performance; meaningful but not disruptive to the founding partners' economics
Analyst / Associate Level	0.0% to 0.1%	Typically not appropriate for profits interests at this level; if granted, very small amounts to create basic alignment and retention without significant dilution or administrative overhead
Transformative Senior Hire (C-Suite)	1.0% to 5.0% and up	Executives whose specific skills materially change the company's trajectory (for example, a Head of Capital Markets who opens institutional LP relationships the founders could not access independently); grant size reflects the transformative nature of the contribution

These ranges are starting points, not mandates. The appropriate grant for a specific employee depends on the company's total equity pool, the number of employees who have already received grants, the employee's specific contribution to the company's value, and the founding partners' judgment about what level of equity participation is fair and motivating for the role.

Vesting for Employee Grants

Employee profits interests should be subject to a vesting schedule that creates a real retention incentive. The same principles that apply to founding partner vesting, time-based cliff vesting, milestone-based vesting, or a hybrid, apply to employee grants, with some employment-specific modifications:

- **Vesting period.** Four years with a one-year cliff is standard for senior employees. Some companies use a shorter period (two to three years) for employees hired at a later stage, recognizing that their contributions generate value immediately and that an excessively long cliff may deter acceptance or breed resentment if the employee leaves before the cliff.
- **Performance milestones.** For senior employees whose deliverables are measurable, a hybrid structure (for example, 70 percent time-based and 30 percent performance-based) creates stronger accountability than pure time-based vesting. The performance component should be tied to deliverables the employee controls, not market-dependent outcomes.
- **Good leaver and bad leaver.** The same framework discussed for founding partner departures applies to employee departures, adapted for the employment context. Involuntary termination without cause is always treated as a good leaver departure; voluntary resignation before the cliff is typically treated as bad leaver.
- **Accelerated vesting on change of control.** A standard double-trigger acceleration provision (vesting accelerates only if there is both a change of control and the employee is terminated without cause within a defined period) suits employees who made meaningful commitments based on the expectation of long-term participation. Single-trigger acceleration for employees is less common and should be approached carefully, given its impact on an acquirer's ability to retain the management team.

The Section 83(b) Election for Employees

The same 30-day filing deadline applies to employee profits interest grants as to founding partner grants. The company's onboarding process must include a specific step at the time of any profits interest grant:

- The employee is given written notice of the Section 83(b) election when the grant agreement is executed. The notice must explain what the election is, the deadline for filing (30 days from the grant date), the tax consequences of filing versus not filing, and the recommendation to consult a personal tax advisor before the deadline.
- The employee signs a written acknowledgment confirming receipt of the notice and their understanding of the deadline. This documentation protects the company against a later claim that the employee was not properly informed.
- The company's legal counsel or the employee's personal tax advisor prepares the Section 83(b) election statement (filed with the IRS service center for the employee's filing location). The election must include the property description, the fair market value (zero or nominal for a new company), the amount paid for the property (typically zero), and the tax year.
- A copy of the filed election is retained in the company's records and in the employee's personnel file.

The 30-day deadline cannot be extended. If an employee receives a profits interest on January 5 and misses the deadline of February 4, the election is permanently unavailable for that grant. The company's obligation is to inform and advise; the decision whether to file belongs to the employee and their personal tax advisor.

Employee Benefits: What the Company Must Provide and What It Should

Benefits are a meaningful component of total employee compensation and a significant cost to the development company. The distinction between what the company is legally required to provide and what it should provide as a matter of competitive compensation practice matters for financial planning.

Legally Required Benefits

The following benefits are legally required for employers in the United States, with specific requirements varying by state:

- **Workers' compensation insurance.** Mandatory in virtually every state for any employer with even a single employee. It provides benefits to employees who suffer work-related injuries or illness, and the employer pays the premiums. Rates vary by job classification and claims history. For office-based employees, rates are relatively modest; they increase for employees who regularly visit active construction sites.
- **Unemployment insurance.** Employers must pay federal and state unemployment insurance taxes based on each employee's wages, up to an annual wage base. These taxes fund state unemployment benefit programs and are entirely an employer cost, not a deduction from employee wages.
- **FICA employer match.** Employers must pay a matching share of Social Security and Medicare taxes equal to 7.65 percent of each employee's wages up to the annual Social Security wage base (and 1.45 percent above the base for Medicare only). This is one of the most significant mandatory benefits costs for a small employer.
- **Mandatory leave.** The Family and Medical Leave Act requires employers with 50 or more employees to provide up to 12 weeks of unpaid, job-protected leave for qualifying family and medical events. Many states impose broader leave requirements, including paid family leave,

that apply to smaller employers. Compliance with applicable leave laws is mandatory and state-specific.

Competitive Benefits the Company Should Consider

Beyond the legal minimums, the following are important components of competitive compensation packages for a development company recruiting senior talent:

- **Health insurance.** An employer-sponsored health plan is expected by virtually all full-time professional employees. The Affordable Care Act requires employers with 50 or more full-time employees to offer health coverage; for smaller employers it remains optional, but offering it is essential to recruiting quality talent. Group health premiums for a small employer typically run $500 to $800 per month per employee for individual coverage, with the employer typically covering 50 to 100 percent of the premium.
- **Retirement plan.** A 401(k) plan or SIMPLE IRA lets employees save for retirement through pre-tax payroll deductions, which many employees value highly. An employer match (commonly 50 to 100 percent of employee contributions up to 3 to 6 percent of salary) is a competitive incentive that also provides a tax benefit to the employer.
- **Paid time off.** A structured policy covering vacation, personal days, and sick leave is standard for professional employment. Most professional roles receive a minimum of two weeks of vacation, with escalating entitlement for tenure. Some companies use a flexible policy that does not accrue or cap; others use a traditional accrual system. The choice affects both employee satisfaction and the company's financial reporting.
- **Disability insurance.** Disability coverage replaces a portion of an employee's income if they become unable to work due to illness or injury. Short-term disability (typically 60 to 70 percent of wages for up to 26 weeks) is commonly provided as an employer-sponsored group benefit. Long-term disability is important for senior employees whose continued participation is critical to operations.
- **Professional development.** Supporting employees' professional education, conference attendance, continuing education, professional association dues, and industry certifications, builds capability and signals the company's investment in its people. A defined annual budget per employee (typically $1,000 to $5,000) is a low-cost, high-value benefit.

The Total Cost of Employment

Founders often underestimate the true cost of an employee by focusing on the stated salary without accounting for the full employer cost. For planning purposes, the total employer cost of a $100,000 salaried employee is approximately:

Total Employment Cost Illustration

Base salary: $100,000

Employer FICA (Social Security 6.2 percent plus Medicare 1.45 percent): $7,650

Federal and state unemployment insurance: approximately $500 to $1,500 (varies by state)

Workers' compensation insurance: approximately $500 to $2,000 (varies by classification)

Health insurance employer contribution (50 percent of a family plan): approximately $7,000 to $12,000

401(k) employer match (50 percent match up to 6 percent of salary): $3,000

Paid time off cost (two weeks): approximately $3,850 (2/52 of $100,000)

Total employer cost: approximately $122,500 to $130,000

Effective cost multiplier: approximately 1.22x to 1.30x base salary

For planning purposes, use 1.25x to 1.30x base salary as the total employment cost for office-based professional employees, and adjust upward for higher-cost benefits plans or states with additional mandatory employer contributions.

HR Compliance: The Legal Framework That Applies From Day One

The moment a development company hires its first employee, it enters a dense and often surprising body of employment law that applies regardless of the company's size, revenue, or organizational sophistication. Founding teams with no prior experience as employers frequently discover this framework for the first time when a compliance issue arises, which is the most expensive possible time to learn about it. The sections below address the most critical HR compliance obligations that apply from the first hire.

I-9 Employment Eligibility Verification

The Immigration Reform and Control Act of 1986 requires all employers to verify the identity and employment authorization of every employee hired in the United States. Verification is accomplished through Form I-9, which must be completed by both the employee and the employer within three days of the employee's first day of work. The employer must physically examine the original documents that establish identity and employment authorization, record the document information on the I-9, and retain the form for three years after the date of hire or one year after the date of termination, whichever is longer.

Penalties for I-9 violations range from $288 to $2,861 per violation for paperwork errors, and up to $28,619 per unauthorized employee for knowingly hiring or continuing to employ unauthorized workers. These are per-violation fines that accumulate quickly across a workforce. A development company with ten employees that never completed I-9s is exposed to $2,880 to $28,610 in potential penalties for paperwork violations alone, and federal enforcement of these requirements has intensified, with several categories of error that were once treated as correctable now treated as immediately fineable.

The I-9 compliance process must be built into the new employee onboarding procedure before the first hire. The form, instructions, and list of acceptable documents are available from the USCIS website. Many companies use an HR software platform that automates I-9 completion and retention, which is appropriate for any company with more than a handful of employees.

Anti-Harassment and Anti-Discrimination Policy

Federal law, through Title VII of the Civil Rights Act, the Age Discrimination in Employment Act, the Americans with Disabilities Act, and other statutes, prohibits employment discrimination and harassment based on protected characteristics including race, color, religion, sex, national origin, age, and disability. Most states have parallel laws with broader protected classes and, in some cases, more stringent requirements. From the first hire, the company must:

- Have a written anti-harassment and anti-discrimination policy that clearly prohibits harassment based on all protected characteristics, defines prohibited conduct, establishes a procedure for reporting and investigating complaints, and prohibits retaliation against employees who make good-faith complaints.
- Distribute the policy to all employees at the time of hire and annually thereafter.

- Conduct anti-harassment training. Several states (California, New York, Connecticut, Delaware, Illinois, and others) mandate employer-provided anti-harassment training for employees and supervisors, with specific minimum requirements. Even where training is not mandatory, providing it is an important defense against liability.
- Investigate complaints promptly and document the investigation and its outcome.

Wage and Hour Compliance

The Fair Labor Standards Act establishes minimum wage requirements, overtime pay obligations, and record-keeping requirements for most employers. The most common FLSA compliance failures in development companies:

- **Overtime exemption misclassification.** The FLSA requires employers to pay overtime (1.5 times the regular rate) to non-exempt employees who work more than 40 hours in a week. Certain categories, executives, administrators, professionals, and computer employees, are exempt if they meet specific salary and duties tests. A development company that classifies its analyst as exempt based solely on job title, without verifying that the employee meets both the salary threshold (currently $684 per week) and the duties test, is exposed to overtime liability.
- **Off-the-clock work.** If a non-exempt employee works beyond 40 hours in a week, checking email after hours, attending a weekend event, responding to construction site calls in the evening, that time is compensable even if the employer did not authorize it. Non-exempt employees must be paid for all time they are suffered or permitted to work.
- **State minimum wage and overtime laws.** Many states have minimum wage rates above the federal minimum and overtime rules more protective than the FLSA. California, for example, requires daily overtime (after 8 hours in a day, not just after 40 hours in a week) and has specific meal and rest break requirements with penalty pay for violations.

The Employee Handbook: A Basic Infrastructure Requirement

A development company with its first employee needs a basic employee handbook before that employee starts work. The handbook does not need to be a comprehensive treatise; for an early-stage company with one to five employees, a focused 15-to-25-page document covering the essential policies is sufficient. At minimum it should address:

- An at-will employment statement confirming that the relationship is at-will and that the handbook is not a contract of employment.
- The anti-harassment and anti-discrimination policy described above.
- Hours of work and attendance expectations: normal business hours, remote work policies, and attendance requirements.
- Compensation and payroll: pay schedule, overtime policy, and expense reimbursement procedure.
- Paid time off: vacation, personal days, sick leave, and holidays.
- Confidentiality and intellectual property: the obligation to maintain the company's confidential information and the assignment of work product to the company.
- Technology use: the company's policy on using company equipment and systems for personal purposes, and the company's right to access company-owned devices and accounts.
- Reporting and complaint procedures: how employees should report concerns about harassment, discrimination, wage and hour violations, or other compliance issues.

- A signed acknowledgment from each employee confirming receipt and review of the handbook.

The handbook should be reviewed by employment counsel before distribution and updated annually or whenever a material change in applicable law or company policy occurs. An outdated or legally deficient handbook can create more liability than no handbook at all if its provisions conflict with current legal requirements.

Managing the Investor Relationship Database as Company Property

For a development company that raises outside investor capital, the investor relationship database, the names, contact information, investment history, relationship notes, and communication records associated with each investor, is among the company's most valuable proprietary assets. It represents years of relationship-building, successful capital deployment, and investor trust. Protecting it from misappropriation by departing employees, and departing partners, is a priority that must be addressed in every employment agreement and every operating agreement.

Data Classification and Access Control

The company should maintain its investor data in a company-managed CRM system with role-based access controls. Every employee with access to investor data should understand:

- The investor data is the company's confidential and proprietary information, not the personal property of any individual employee or partner.
- Access to investor data is granted solely to perform the employee's job duties; using that access for personal purposes or for the benefit of any entity other than the company violates the employment agreement's confidentiality provisions.
- All investor data created, compiled, or modified by the employee in the course of employment belongs to the company, not the employee personally.
- On termination of employment for any reason, the employee must return all copies of investor data (digital and physical), delete all company data from personal devices, and certify compliance with these obligations.

The Non-Solicitation Covenant and the Investor Database

The non-solicitation covenant in the employment agreement should specifically reference the investor database as a protectable company interest. The most effective investor non-solicitation provision:

- Prohibits the former employee from directly or indirectly soliciting any investor who was a client, investor, or active prospect of the company during the last 24 months of the employee's employment, for 18 to 24 months after departure.
- Defines solicitation broadly enough to capture both direct outreach (calling the investor to pitch a new investment) and indirect solicitation (using the investor's name as a reference to attract other investors, or providing the investor's contact information to a competing platform).
- Includes a specific remedy provision: the parties agree that breach would cause irreparable harm for which monetary damages would be inadequate, and the company is entitled to seek injunctive relief in addition to any other available remedy.

The injunctive relief provision matters because non-solicitation violations often require immediate court intervention. Once a departing employee has solicited the company's investors and redirected capital to a competing venture, the damage is done and a damages award may be insufficient to

make the company whole. The agreement's explicit acknowledgment of irreparable harm and entitlement to injunctive relief streamlines the company's ability to seek emergency relief.

CHAPTER 12: KEY TAKEAWAYS

1. The organizational build-out timeline should be tied to deal volume and revenue milestones, not aspirational org charts. Hiring creates fixed obligations that continue whether or not revenue materializes on schedule. The eight key positions addressed in this chapter, from project coordinator through in-house general counsel, have specific hiring triggers and total cost implications that must be built into the annual business plan.
2. Worker classification is determined by economic and behavioral reality, not contract labels. The IRS three-factor test (behavioral control, financial control, type of relationship) governs whether a worker is an employee or an independent contractor. The consequences of misclassification, back payroll taxes, workers' compensation claims, employment benefit claims, state enforcement actions, and private lawsuits, consistently exceed the short-term savings from contractor arrangements. When in doubt, classify as an employee.
3. Written employment agreements are appropriate for key employees with significant operational authority, employees who receive profits interests, and employees the company needs to retain for a defined period. The agreement's non-solicitation of investors and confidentiality provisions provide the company's most reliable long-term protection against the departure of key employees to competitors or independent ventures.
4. Non-compete enforceability varies dramatically by state. California effectively bans non-competes in employment. Texas, New York (under current law), and most other states enforce reasonable restrictions. Florida is employer-favorable with a statutory presumption of reasonableness. The FTC's attempted nationwide ban was vacated and then abandoned, leaving the question to state law. The founding team must obtain state-specific legal advice before including non-compete provisions in any employment agreement, particularly for employees who work remotely or across multiple states.
5. Profits interests are the preferred vehicle for granting equity participation to key employees. Grant sizes range from 0.1 to 0.5 percent for director-level employees to 1.0 to 5.0 percent and up for transformative C-suite hires. The Section 83(b) election, with its 30-day filing deadline, must be built into the onboarding process for every grant. The same good leaver and bad leaver framework that governs founding partner departures should be applied to employee grants with appropriate modifications.
6. The total cost of an employee is approximately 1.25x to 1.30x base salary once employer-side payroll taxes, workers' compensation, health insurance, retirement plan matching, and paid time off are included. This multiplier must be used in budget planning; using base salary alone systematically understates personnel costs.
7. HR compliance obligations apply from the first hire: I-9 employment eligibility verification, an anti-harassment policy, FLSA wage and hour compliance, and a basic employee handbook. A company that does not have these in place before its first employee starts is exposed to compliance liability that is entirely avoidable with basic preparation. The investor relationship database must be classified as company property in every employment agreement and protected through specific non-solicitation provisions and data access controls.

WHAT COMES NEXT

Part V of the handbook turns to protection: how the company and its founding partners are protected against the fiduciary failures, competitive threats, and liability exposures that arise in operating a real estate development and sponsor company. Chapter 13 begins that part with fiduciary duties and conflict-of-interest management: what the managing member and other members owe to the company and to each other, how the corporate opportunity doctrine applies in a real estate context, and the governance framework for managing related-party transactions.

See also: *Chapter 6 (Profits Interests: the Section 83(b) election mechanics and the employment context) • Appendix I (Insurance Coverage Checklist: including employment practices liability coverage for employment-related claims) • Appendix J (Glossary: at-will employment, FLSA, FICA, I-9, non-solicitation, workers' compensation)*

CH. 13

PART V: FIDUCIARY DUTIES, RISK MANAGEMENT & PARTNER PROTECTION

Fiduciary Duties

and Conflict-of-Interest Management

What the managing member and other members owe to the company and to each other, how those duties can be modified in the operating agreement, and how conflicts of interest must be identified, disclosed, and managed.

Fiduciary duty is not a phrase most real estate developers associate with their daily work. It lives in the vocabulary of attorneys and corporate governance specialists, not in the language of deal-making, construction oversight, and investor relations. Yet the fiduciary obligations that arise from running a development company, the duties the managing member owes the partnership, the duties each partner owes the others, and the duties the GP entity owes outside investors, are among the most litigated and most misunderstood areas of real estate partnership law.

Understanding fiduciary duties matters less as preparation for litigation you hope never to face than as a practical framework for operating the company so that the litigation never arises. A founding team that understands what the partners owe each other, and what the company owes its investors, designs its governance and operational practices around those obligations. A team that does not tends to encounter them for the first time in a complaint.

Fiduciary Duties in an LLC: The Default Framework

A fiduciary is someone who holds a position of trust and is legally obligated to act in the interest of the person or entity for whose benefit that trust exists. In a real estate development company organized as an LLC, the fiduciary relationships arise at multiple levels and in multiple directions, creating a network of legal obligations the operating agreement can customize but cannot eliminate entirely.

The Duty of Loyalty

The duty of loyalty requires a manager or member in a fiduciary position to act in the best interest of the company and the other members rather than in their own personal interest when those interests conflict. In the LLC context, the duty of loyalty encompasses several specific obligations:

- **The obligation to avoid self-dealing.** A managing member who uses their position to benefit themselves at the company's expense, by paying themselves excessive compensation, directing business to entities in which they have an undisclosed interest, or acquiring assets at favorable prices the company should have had the chance to acquire, is breaching the duty of loyalty.
- **The corporate opportunity doctrine.** A managing member who learns of a business opportunity through their position with the company, and who appropriates that opportunity for personal benefit without first offering it to the company, may be breaching the duty of loyalty. The application of this doctrine to real estate development is discussed in detail later in this chapter.
- **The obligation to act in good faith.** The duty of loyalty includes a general obligation to deal with the company and the other members honestly, transparently, and in good faith. A

managing member who withholds material information from the other partners, misrepresents the company's financial condition, or takes actions designed to harm the minority partners while appearing to act in the company's interest is breaching this aspect of the duty.

The Duty of Care

The duty of care requires a manager or member in a fiduciary position to exercise the care, diligence, and skill a reasonable person in a similar position would exercise under similar circumstances. In the LLC context, this means making decisions based on reasonable investigation and good-faith business judgment.

The duty of care does not require the managing member to be infallible. Business decisions that turn out badly, a development project that underperforms or a capital allocation decision that proves mistaken, do not automatically constitute a breach. The business judgment rule, which applies in the LLC context in most states, protects a managing member from liability for decisions made in good faith, on an informed basis, and in the honest belief that the decision was in the company's best interest.

The duty of care is breached by gross negligence, willful misconduct, or fraud, not by poor judgment in hindsight. A managing member who fails to conduct any due diligence on a development site, ignores obvious red flags in a contractor's financial condition, or proceeds with a transaction despite clear indications that it will harm the company and the investors may be breaching the duty of care. A managing member who conducts reasonable due diligence and makes a good-faith decision that turns out badly is protected by the business judgment rule.

Manager and Member Duties

In a manager-managed LLC, the distinction between the duties owed by the manager and the duties owed by non-managing members is important and sometimes misunderstood. Under Delaware law and the law of most states:

- **The manager owes full fiduciary duties.** The manager, including the managing member, owes the full duties of loyalty and care to the company and to the members. The position is analogous to that of a corporate director: the manager is entrusted with the company's management and must exercise that trust in the members' collective interest.
- **Non-managing members owe limited duties in their member capacity.** A non-managing member who votes against a management committee proposal, lobbies for a decision that benefits their personal interests more than the company's, or withholds consent to a transaction they would prefer not to proceed with is exercising their governance rights as a member, not breaching a fiduciary duty.
- **The distinction collapses where a member exercises control.** A non-managing member who also serves as the company's CFO, or who has been delegated specific authority over certain company functions, owes fiduciary duties in the exercise of that authority even if they would not as a purely passive member.

The operating agreement can modify the fiduciary duties of both managers and members within the limits state law permits. Delaware's LLC Act is among the most permissive: it allows the operating agreement to restrict or eliminate the duty of loyalty (but not the implied covenant of good faith and fair dealing), to expand the duty of care, and to specify the circumstances under which self-interested transactions are permitted. Other states' LLC statutes vary in how much modification they allow.

Modifying Fiduciary Duties in the Operating Agreement

The ability to modify the default fiduciary duties through the operating agreement is one of the Delaware LLC Act's most significant governance advantages, and one that sophisticated real estate partnerships use regularly to create a more flexible operating environment. But the power to modify fiduciary duties carries the responsibility to use it thoughtfully. An operating agreement that eliminates fiduciary protections without replacing them with alternative safeguards creates governance gaps a self-interested managing member can exploit at the minority partners' expense.

Modifications to the Duty of Loyalty

The most common modification to the default duty of loyalty in a development company operating agreement is permission for specific outside business activities that would otherwise constitute a breach. The default duty of loyalty requires the managing member to devote their best efforts to the company and to avoid competing with it. That default is often too restrictive for a professional real estate partnership where the founding partners may have existing business activities, prior fund management relationships, or other real estate interests that predate the company. Permissible modifications include:

- Specifying that each partner may maintain and continue their existing business activities and investments, subject to disclosure and to the corporate opportunity obligations addressed later in this chapter.
- Permitting each partner to engage in outside real estate activities that do not directly compete with the company's defined investment strategy, with disclosure obligations for any activity that could create a conflict.
- Specifying that certain categories of related-party transactions, such as a partner's brokerage company receiving a commission on a company deal, or a partner's affiliated entity providing services to the company, are permitted with disclosure and disinterested committee approval rather than categorically prohibited.

What cannot be modified: the Delaware LLC Act prohibits eliminating the implied covenant of good faith and fair dealing. Even if the operating agreement extensively modifies the duty of loyalty, the managing member cannot act in a way that fundamentally undermines the reasonable expectations of the minority partners. A managing member who uses cleverly drafted provisions to exploit the minority partners in ways no reasonable party would have agreed to at formation has violated the implied covenant even while technically complying with the operating agreement's letter.

Modifications to the Duty of Care

The default duty of care, the obligation to act with reasonable care and skill, can be modified in the operating agreement to a gross negligence or willful misconduct standard. This modification protects the managing member from liability for honest mistakes, poor decisions, and bad judgment that do not rise to the level of gross negligence or willful misconduct. It is a common provision in real estate operating agreements and is generally viewed as fair and appropriate given the speculative nature of development decisions.

The modification should specify what conduct is and is not protected. A provision that protects the managing member from liability for any decision made in good faith is appropriate. A provision that attempts to protect the managing member from liability for fraud, knowing violation of the operating agreement, or intentional harm to the other partners is not enforceable and reflects the kind of overreaching courts scrutinize carefully when fiduciary duty claims arise.

The Corporate Opportunity Doctrine in Real Estate

The corporate opportunity doctrine is the most practically significant fiduciary duty principle for a real estate development company. It holds that a managing member or other person in a fiduciary position who discovers a business opportunity belonging to the company, because it falls within the company's line of business, because it was discovered using company resources or relationships, or because the company has a specific interest in it, must first offer that opportunity to the company before pursuing it personally.

In real estate development, every significant new deal begins as an opportunity discovered by someone. The doctrine determines whether that someone has a legal obligation to bring the opportunity to the company or is free to pursue it independently. The answer depends on how the opportunity was discovered, what the company's defined business is, and what the operating agreement says about the doctrine's application.

What Constitutes a Corporate Opportunity

A business opportunity constitutes a corporate opportunity for a real estate development company when one or more of the following conditions apply:

- **It was discovered through the managing member's position with the company.** A landowner who contacts the company's office offering to sell a development site is presenting an opportunity to the company, not to the managing member personally. The managing member who diverts that site to a personal LLC without presenting it to the company has taken a corporate opportunity.
- **It falls within the company's defined investment criteria.** If the company's strategy is multifamily development in Dallas, a multifamily development site in Dallas that any partner learns of through any channel is arguably a corporate opportunity, because it falls squarely within what the company is in the business of doing.
- **Company resources were used in identifying or evaluating it.** If the managing member used the company's financial modeling tools, market research, relationship with a specific broker, or professional reputation to identify or evaluate an opportunity, the company has a legitimate interest in it.
- **The company has an existing interest or expectancy in it.** If the company has been negotiating for a specific site and the managing member steps in personally to acquire it under different terms, the company's existing interest in the opportunity is clear.

The Investment Criteria Definition Question

The most practically important drafting decision in the corporate opportunity section of the operating agreement is how broadly or narrowly to define the company's investment criteria for corporate opportunity purposes. This definition sets the scope of the obligation to offer opportunities to the company before pursuing them personally.

A broad definition, such as any real estate development opportunity in Texas, creates a near-total bar on any partner pursuing independent development activities in the state. Every opportunity any partner encounters, regardless of whether the company would actually want it or could realistically pursue it, must first be offered to the company. This is extraordinarily restrictive and will generate resentment and disputes if the founding partners have meaningful pre-existing investment activities in the state.

A narrow definition, such as ground-up multifamily development projects of 100 units or more within the city limits of Dallas with a total project cost exceeding $15,000,000, gives the partners significant room for outside activities that do not compete directly with the company's core business. Opportunities that fall outside this definition are not corporate opportunities and can be pursued independently without disclosure to or approval from the company.

The appropriate definition for any specific partnership reflects the actual scope of the company's investment program and the degree to which the founding partners need flexibility for outside activities. It should be negotiated explicitly during formation, not left for a court to determine in hindsight when a specific opportunity is in dispute.

The Required Process for Declining a Corporate Opportunity

Even where the corporate opportunity doctrine applies, the company may legitimately decline to pursue an opportunity, because it lacks the capital, because the opportunity does not fit the current pipeline, or because the risk profile is outside the company's parameters. Once the company has properly declined an opportunity, the discovering partner is generally free to pursue it personally. The operating agreement should specify the required process:

- The partner who discovered the opportunity must present it to the management committee in writing, with enough detail for the committee to make an informed decision (property description, development concept, pricing, timeline).
- The committee must respond within a defined period, commonly 14 to 30 days, with either an expression of interest (triggering a more detailed evaluation) or a formal declination.
- The formal declination must be documented in writing and signed by the disinterested committee members, meaning members other than the partner who discovered the opportunity, if that partner has a personal interest in pursuing it.
- Once properly declined and documented, the discovering partner is free to pursue the opportunity on terms no more favorable than those presented to the company.

The documentation requirement is critical. A managing member who claims to have mentioned the opportunity in a partner conversation, without a written presentation and a written declination, has not properly discharged the corporate opportunity obligation. Proper compliance requires a paper trail.

Corporate Opportunity Scenarios: A Worked Analysis

The following scenarios illustrate the corporate opportunity analysis in concrete development company contexts.

Scenario A: The Off-Market Site

Facts. A landowner in Dallas calls the development company's main phone line, asks to speak with the developer, and is connected to Partner A. The landowner describes a 3-acre site that fits the company's target development profile. Partner A subsequently acquires the site through a personal LLC without mentioning it to Partners B and C.

Analysis. This is a paradigmatic corporate opportunity violation. The opportunity was presented to the company, through its main phone line, to a partner acting in their company capacity. Partner A had no legitimate basis for treating it as a personal opportunity. The use of the company's professional contact information and name to attract the landowner's call underscores that the opportunity came to the partner through their company role, not independently.

Governing provision. The operating agreement's corporate opportunity provision should specify that opportunities presented to any partner in their capacity as a company representative must be offered to the company before any personal pursuit. The written offer and committee response process provides the documentary record of proper compliance.

Scenario B: The Out-of-Market Opportunity

Facts. Partner B has a long-standing personal relationship with a family in Austin who owns a commercial property. The company's defined investment criteria are limited to Dallas multifamily development. The Austin family approaches Partner B personally, not through the company, to ask whether Partner B would be interested in developing their property into mixed-use retail and residential. The project falls outside the company's defined investment criteria.

Analysis. This is not a corporate opportunity under a properly drafted operating agreement with a specific investment criteria definition. The opportunity was not presented to the company; it came to Partner B personally based on a pre-existing family relationship. The project type (mixed-use, with a commercial component) and geography (Austin, not Dallas) both fall outside the company's defined criteria. Subject to the disclosure obligations in the operating agreement, Partner B may pursue it independently.

Governing provision. The operating agreement's investment criteria definition is determinative. A definition of ground-up multifamily development within Dallas clearly excludes this Austin mixed-use opportunity. Partner B should nonetheless notify the management committee of the opportunity as a disclosure matter, so there is a documented record that the committee concurred with the outside-criteria characterization.

Scenario C: The Opportunity Discovered Using Company Resources

Facts. The managing partner directs an analyst (a company employee) to conduct a market study of underutilized industrial properties in a specific Dallas submarket. The analyst identifies several potential conversion opportunities. The managing partner subsequently purchases one of those properties through a personal investment vehicle, relying on the analyst's work product.

Analysis. This is a corporate opportunity violation, potentially compounded by a related-party transaction problem. The opportunity was identified using company resources, the analyst's time and labor, and the market study was conducted for the company's benefit. The managing partner's personal appropriation of the identified opportunity, without first offering it to the company, is a clear breach of the corporate opportunity doctrine. The use of a company employee's work product for personal financial benefit is also a breach of the duty of loyalty, independent of the corporate opportunity analysis.

Governing provision. The operating agreement's corporate opportunity provision should specifically address that opportunities identified through company resources, including the time and labor of company employees, are corporate opportunities regardless of how the identifying partner became aware of them. The misuse of company employees for personal business purposes should be separately addressed in the company's conflict-of-interest policy.

Related-Party Transactions: The Governance Framework

A related-party transaction is any transaction between the company and a party who has a personal relationship or financial interest in the outcome, typically a founding partner, a partner's affiliated entity, or a person connected to a partner. Real estate development companies encounter related-party transactions regularly: the construction company in which a founding partner has an interest is

selected to bid on the company's project; a founding partner who holds a broker's license earns a commission on a company acquisition; a partner's family member's company provides legal or accounting services.

Related-party transactions are not inherently improper. In many cases, using a related party gives the company pricing advantages, trust-based quality assurance, or access to expertise it would not easily find elsewhere. What is improper is allowing related-party transactions to occur without appropriate disclosure and approval mechanisms, mechanisms that ensure the transaction is on terms at least as favorable to the company as an arm's-length transaction with an unrelated party would be.

The Related-Party Transaction Approval Process

The operating agreement should specify a clear approval process for any transaction between the company and a related party. The process must provide both substantive protection (ensuring the transaction is on market terms) and procedural protection (ensuring a legitimate governance process was followed, which protects the company and the approving partners if the transaction is later challenged).

STEP 1

Identification and Disclosure

The partner with a personal interest in the transaction must disclose that interest to the management committee in writing before any negotiations begin or any preliminary agreement is reached. The disclosure must describe the nature of the relationship (equity ownership, family connection, prior financial arrangement), the specific transaction proposed, and the estimated financial terms.

▼

STEP 2

Disinterested Committee Review

The transaction is reviewed by the management committee members who have no personal interest in the outcome, the disinterested members. The conflicted partner must recuse themselves from the discussion and the vote. The disinterested members evaluate whether the proposed terms are at least as favorable to the company as what could be obtained from an unrelated third party.

▼

STEP 3

Independent Valuation (If Warranted)

For transactions above a defined dollar threshold or involving complex pricing, the disinterested committee should obtain an independent valuation or market comparison before approving the transaction. This might mean obtaining competing bids from unrelated parties, engaging an independent appraiser, or obtaining written documentation of market pricing from the company's outside advisors.

▼

STEP 4

Formal Approval and Documentation

The disinterested committee votes on whether to approve the transaction. The vote and the basis for approval should be documented in the committee's meeting minutes, including a specific finding that the transaction is on terms at least as favorable to the company as an arm's-length transaction.

The approving members must believe this to be true; a rubber-stamp approval without real evaluation does not provide the intended protection.

▼

STEP 5

Investor Disclosure (If Applicable)

If the transaction involves a project in which outside investors participate, the related-party transaction must be disclosed in the offering documents. The disclosure should describe the nature of the relationship, the financial terms, and the process by which the transaction was approved. This investor-facing disclosure is a securities law obligation independent of the internal governance process.

The operating agreement should specify the dollar threshold above which independent valuation is required and the approval threshold of the disinterested committee (a majority or supermajority of disinterested members) needed to authorize a related-party transaction. Transactions that should require independent valuation include any related-party construction contract above a defined amount, any lease of property to or from a related party, any loan between the company and a related party, and any purchase or sale of assets between the company and a related party.

Outside Business Activities: What Is Permissible With Disclosure

The default duty of loyalty requires each partner to devote their full efforts to the company and to avoid competing with it. In practice, that default is almost never appropriate for a founding team of real estate professionals who have existing business activities, prior investment positions, and outside professional commitments that precede and coexist with the new venture.

The operating agreement must affirmatively address outside business activities, specifying what is permitted (with or without disclosure), what is prohibited, and what falls in the middle category of activities that require disclosure and potential committee approval. This framework has three components.

Permitted Without Disclosure

Certain outside activities are so clearly unrelated to the company's business that requiring disclosure would be burdensome without any governance benefit:

- Passive investments in publicly traded securities, mutual funds, or REITs, where the partner has no management role and no ability to direct the investment's decisions.
- Personal residential real estate investments, including the partner's primary residence and vacation properties, where the partner is acting as an individual homeowner rather than as a developer or investor.
- Board service on non-profit organizations, community groups, industry associations, and other non-commercial entities.
- Passive limited partnership or non-managing membership interests in real estate investments made before the company was formed, where the partner holds less than a defined threshold (often 5 percent) of the investment and has no management authority.

Permitted With Disclosure

Activities that have a plausible connection to the company's business, or that could create the appearance of a conflict, should be disclosed to the management committee even where the operating agreement explicitly permits them:

- **Active real estate investments outside the company's defined criteria.** A partner who owns and manages a small portfolio of commercial properties in a different asset class or geography from the company's focus is engaged in an activity that may compete marginally for the partner's time and attention. Disclosure lets the committee monitor the situation and raise concerns if the outside portfolio begins to affect the partner's availability.
- **Board service on a real estate company or real estate-related financial institution.** A partner who serves on the board of a bank that makes construction loans, a real estate data company, or a property technology startup has a relationship that could create conflicts in specific transactions. Disclosure lets the committee identify those conflicts when they arise.
- **Advisory relationships with other real estate developers or investors.** A partner who provides informal advisory services to another developer, reviewing underwriting, discussing deal structures, advising on entitlement strategy, has a relationship that may implicate the company's confidential information if the other developer is pursuing similar opportunities.

Prohibited Without Committee Approval

Certain activities are categorically incompatible with the partner's obligations to the company and should require specific committee approval before being initiated:

- Active management roles at a competing real estate development company. A founding partner simultaneously serving as a managing partner or active development executive at a competitor is in a position of direct, irreconcilable conflict regardless of how carefully the investment criteria are defined.
- Personal pursuit of development opportunities that fall within the company's defined investment criteria, before those opportunities have been offered to and declined by the company as the corporate opportunity provisions require.
- Personal relationships with the company's existing investors that involve soliciting those investors for outside investment opportunities, before the applicable non-solicitation period has expired.
- Use of the company's employees, systems, relationships, or resources for the benefit of an outside business activity.

Conflicts Between Personal Investments and Company Opportunities

One of the most practically difficult fiduciary duty problems a development company encounters is the case where a founding partner has made a personal investment, in a property, a project, or a business relationship, that later creates a conflict with the company's interests. These conflicts are not always foreseeable when the personal investment is made, and they require a thoughtful framework for resolution that is fair to both the individual partner and the company.

Pre-Formation Personal Investments

A partner who made personal real estate investments before the company was formed is not in breach of any fiduciary duty by holding them. The duty arises at formation and does not require the partner to divest prior investments simply because they may now be in the same market or asset class as the company's business. The operating agreement should nonetheless address what happens when a pre-formation investment later presents a conflict:

- **A personal investment in a site adjacent to one the company is evaluating.** The personal investment creates a potential conflict because the company's development decisions may affect the value of the adjacent personal property. The partner must disclose the conflict, and the committee should determine whether the personal interest is material enough to require the partner to recuse themselves from the company's evaluation of the adjacent site.
- **A personal investment involving the same investor as a company investment.** If a founding partner has personally taken an investment from an investor who also participates in the company's deals, the personal investment creates a risk of conflict in how the company manages that investor relationship. The partner must ensure that all investor-facing activities related to the shared investor are conducted through the company rather than personally.

Post-Formation Personal Investments

Post-formation personal investments are subject to the corporate opportunity doctrine: any investment that falls within the company's defined investment criteria must be offered to the company before the partner pursues it personally. If the company declines, the partner may proceed.

For investments outside the defined criteria, the partner may proceed without the corporate opportunity offer, but should disclose the investment to the committee if it is in the same market or asset class as the company's operations, involves the same lenders or brokers as the company's relationships, or could reasonably be seen as competitive with the company's activities.

Fiduciary Obligations to Outside Investors

When a development company raises equity from outside investors, high-net-worth individuals, family offices, or institutional capital sources, the company and its principals take on fiduciary-like obligations to those investors that extend beyond the internal partner obligations discussed in the preceding sections. These obligations are grounded in securities law as well as common-law fiduciary duty, and they shape how the company makes investment decisions, how it communicates with investors, and how it manages conflicts between investor interests and the company's own.

The Sponsor's Duty to Investors

The GP entity's fiduciary obligations to the LP investors arise from the LP agreement or operating agreement that defines the relationship. In a well-drafted agreement, those obligations include:

- **The duty to manage consistent with the stated investment strategy.** The GP entity must pursue the investment objectives described in the offering documents, not substitute different objectives because market conditions have changed or because the GP's personal interests point in a different direction. A GP that pivots from a value-add multifamily strategy to speculative land banking without investor disclosure and consent has abandoned its investment mandate.
- **The duty to make decisions in the investors' best interest when those interests conflict with the GP's own.** The GP's ability to earn fees and promoted interest creates structural incentives that may not always align with the investors' interests. A GP that holds a project longer than optimal because the promoted interest threshold has not yet been reached, or that sells too early because the GP needs current cash flow, is prioritizing its own interests over the investors' best outcome.
- **The duty of transparency.** The GP must provide accurate, complete, and timely information to investors about the investment's performance, the GP's fees, any conflicts of interest, and

any material changes in the investment's situation. Omissions of material facts in investor communications are potential violations of the securities anti-fraud rules as well as breaches of fiduciary duty.

- **The duty to avoid self-dealing.** The GP must not engage in transactions that benefit itself at the investors' expense, including excessive fee extraction, related-party transactions on unfavorable terms, or allocation of deal opportunities in ways that favor the GP's personal account over the investment vehicle.

Conflict Disclosure in the PPM

Every conflict of interest between the GP and the investors, or that is likely to arise in the course of the investment, must be disclosed in the private placement memorandum. The conflict disclosure serves two functions: it gives investors the information they need to make an informed decision, and it provides the GP with a legal defense against investor claims that they were not informed of the conflict. Specific conflicts that must be disclosed in the PPM for a typical development company:

- **Related-party transactions.** Any transaction between the project entity and an affiliated party of the GP, a construction company, a property management company, a brokerage firm, a lending relationship, must be disclosed with a description of the relationship, the financial terms, and the process by which the transaction will be approved.
- **Fee arrangements.** All fees the GP or its affiliates will earn in connection with the investment, including their rates, bases, payment timing, and any conflicts the fee structure creates between the GP's interests and the investors' interests.
- **Outside business activities.** The fact that the GP's principals are engaged in other real estate activities that may compete for the same deal opportunities, investor capital, or management time as the investment vehicle.
- **Track record limitations.** Any material facts about the GP's prior investment performance that a reasonable investor would consider material, including deals that did not perform as projected, prior fund failures, or regulatory actions.

The Conflict-of-Interest Policy: Operationalizing the Framework

The fiduciary duties and conflict management framework described in this chapter must ultimately become an operational policy the company's principals can apply in real situations. An abstract statement of fiduciary principles that lives only in the operating agreement does not manage conflicts; it states a legal standard that gets applied after the fact, once a dispute has arisen. What manages conflicts is an operational policy that addresses specific recurring situations, specifies clear procedures, and builds a habit of disclosure and process compliance.

The Annual Conflicts Disclosure

As part of the annual business plan process described in Chapter 9, the company should include an annual conflicts disclosure review. Each founding partner completes a written disclosure form identifying any outside business activities, personal investments, existing relationships with company counterparties, and other potential conflicts that have arisen or changed since the prior year. The completed forms are reviewed by the management committee and documented in the annual business plan's supporting records. The form should address:

- All business entities in which the partner has a direct or indirect ownership interest of 5 percent or more.
- All advisory relationships with real estate developers, investors, lenders, or operators.

- All personal real estate investments made since the prior year's disclosure, whether or not they were required to be offered to the company as corporate opportunities.
- All relationships with existing or prospective investors in the company's deals that extend beyond the professional relationship (family relationships, personal investment relationships, prior employer relationships).
- Any new contractual restriction, non-compete, non-solicitation, or confidentiality obligation, that could affect the partner's ability to fulfill their company obligations.

Transaction-Level Conflict Screening

For each significant new transaction the company considers, a new development site, a new investor relationship, a new lender engagement, a new contractor or service provider, the managing partner should run a brief conflict screen before the transaction proceeds:

- Does any founding partner have a personal or financial relationship with the counterparty to this transaction?
- Does any founding partner have a personal or financial interest in the outcome, beyond their interest as a company owner, that could influence their judgment about whether and on what terms to proceed?
- Does this transaction involve assets, relationships, or resources previously identified in a partner's annual disclosure as a potential conflict area?

If the answer to any of these questions is yes, the conflict disclosure and approval process described earlier in this chapter must be followed before the transaction proceeds.

Conflict Resolution When Process Is Not Enough

Some conflicts are serious enough that the approval process alone cannot adequately protect the company and its investors. When a founding partner's personal interest in a transaction is so substantial that their judgment cannot be relied on even with recusal, or when the nature of the conflict is so fundamental that disclosure and approval cannot resolve it, the company may need more drastic remedies:

- **Mandatory recusal from all decisions related to the conflict.** The conflicted partner is not merely asked to recuse themselves from the specific vote but is excluded from all discussions and decisions related to the conflicted matter, including access to information about it.
- **Assignment of independent management responsibility.** Another partner or an independent third party is assigned responsibility for managing the specific transaction or investment that gives rise to the conflict, with the conflicted partner excluded from all related decision-making.
- **Buyout of the conflicting interest.** If the conflict arises from the partner's ownership interest in an entity that regularly does business with the company, the company may consider requiring the partner to divest that interest as a condition of the company's continued use of the entity's services.
- **Structural conflict waivers with investor consent.** In some cases a conflict that affects investors in a specific deal may be managed through a specific waiver from those investors, obtained before the conflicted transaction is entered into. The waiver must be fully informed, the investors must understand the nature and potential impact of the conflict, and it must be obtained through a process that gives the investors a real choice to decline.
-

CHAPTER 13: KEY TAKEAWAYS

1. Fiduciary duties in a real estate development company LLC arise at multiple levels: the managing member owes duties of loyalty and care to the company and all members; non-managing members owe limited duties in their governance capacity but full duties in any operational capacity they exercise. The operating agreement can modify, but not entirely eliminate, these duties, including the implied covenant of good faith and fair dealing that survives any modification.
2. The duty of loyalty prohibits self-dealing, misappropriation of corporate opportunities, and acting in one's own interest at the company's expense. The duty of care requires reasonable diligence and skill in decision-making, subject to the business judgment rule that protects good-faith decisions that turn out badly. Both duties can be modified in the operating agreement within the limits state law permits.
3. The corporate opportunity doctrine is the most practically significant fiduciary duty principle for a development company. A managing member who discovers an opportunity through their company role must first offer it to the company before pursuing it personally. The scope of the doctrine depends critically on how the operating agreement defines the company's investment criteria: a broad definition creates a near-total bar on independent activities, while a narrow, specific definition creates meaningful room for outside opportunities.
4. The required process for handling a corporate opportunity, written presentation to the committee, response within a defined period, and formal documented declination by disinterested members, must be followed precisely to establish a clear record of compliance. A managing member who claims to have mentioned an opportunity verbally has not satisfied the obligation.
5. Related-party transactions are permissible with appropriate disclosure and process: written disclosure before negotiations begin, review by disinterested committee members, independent valuation above defined thresholds, formal approval with documented findings of arm's-length equivalence, and investor-facing PPM disclosure when outside investors are involved. The process both substantively protects the company and creates the documentary record needed to defend the transaction if it is later challenged.
6. The sponsor's obligations to outside investors, the duty to manage consistent with the stated strategy, the duty to prioritize investor interests over GP self-interest, the duty of transparency, and the duty to avoid self-dealing, are grounded in both fiduciary duty principles and securities anti-fraud law. Every conflict between the GP and the investors must be disclosed in the PPM, measured by the full and fair disclosure standard: would a reasonable investor consider the omitted information material to their decision?
7. The conflict-of-interest policy must be operationalized through two specific mechanisms: an annual conflicts disclosure by each partner documenting all outside activities, personal investments, and potential conflicts; and a transaction-level conflict screen before each significant new transaction that identifies whether any partner has a personal or financial interest beyond their company ownership. These mechanisms convert abstract fiduciary duty principles into practical governance habits.

WHAT COMES NEXT

Chapter 14 takes up restrictive covenants, the non-compete, non-solicitation, and confidentiality provisions that protect the company's most valuable assets: its investor relationships, its deal flow, and its proprietary information. Where this chapter addressed what partners owe the company and each other during the partnership, Chapter 14 addresses how those obligations extend beyond the partnership's termination to protect the company's long-term competitive position.

See also: *Chapter 4 (The Operating Agreement: fiduciary duty modification provisions) • Chapter 8 (Governance: related-party transaction approval authority in the Decision Authority Matrix) • Chapter 10 (The Fee Architecture: related-party fee disclosure in PPMs) • Appendix J (Glossary: duty of loyalty, duty of care, business judgment rule, corporate opportunity, related-party transaction, arm's-length standard)*

CH. 14

PART V: FIDUCIARY DUTIES, RISK MANAGEMENT & PARTNER PROTECTION

Restrictive Covenants

Non-Compete, Non-Solicitation, and Confidentiality

How to protect the company's most valuable assets, its investor relationships, its people, and its proprietary information, through carefully drafted restrictive covenants that are enforceable, fair, and designed for the specific realities of a real estate development and sponsor company.

The value of a real estate development company lies less in its physical assets than in its relationships: with investors who trust it with capital, with brokers and landowners who bring it deals, with lenders who have extended credit, with contractors who perform, and with the talent that makes the enterprise function. When a founding partner departs under difficult circumstances, or a key employee leaves to build a competing platform, one question determines whether the company survives the departure intact: do the restrictive covenants in place actually protect the assets that make the company what it is?

This chapter addresses three interlocking protective mechanisms: the non-compete, which restricts a departing partner or employee from entering competitive activities; the non-solicitation, which protects the company's investor relationships, deal sources, and employees from being diverted; and confidentiality, which protects the proprietary information and trade secrets that give the company its competitive edge. Each differs in scope and legal basis. Together they form the company's most important legal protection against the competitive threat posed by the people who know it best.

Why Restrictive Covenants Matter for Development Companies

Real estate development companies are unusually vulnerable to competitive harm from departing insiders. Consider the information and relationships a founding partner or senior employee accumulates over two or three years of active participation:

- A complete understanding of the company's investment strategy, underwriting methodology, target return parameters, and deal selection criteria.
- Personal knowledge of every investor relationship the company has cultivated, including each investor's investment capacity, risk tolerance, preferred deal structure, and communication preferences.
- Detailed knowledge of the company's deal pipeline: sites under evaluation, sellers the company has negotiated with, brokers who bring the company off-market deals, and municipalities where the company has relationships.
- Knowledge of the company's key employees, their compensation, their professional ambitions, and the specific capabilities that make them valuable to a competing platform.
- Access to the company's financial models, underwriting templates, investor presentation formats, and the operational systems the company has refined over years.

A departing insider who takes this knowledge to a competing platform, or who builds a directly competing company, carries away a competitive intelligence advantage the company spent years and significant resources accumulating. Restrictive covenants are the legal mechanism that limits

the damage of that departure. Without them, the company has no meaningful recourse when a departing partner immediately begins soliciting its investors for a new competing venture.

The enforceability of each category of restrictive covenant differs significantly by jurisdiction, by the nature of the restriction, and by the quality of the drafting. A covenant that is overbroad, vague, or mismatched to the applicable state's enforceability standards will not protect the company when the protection is needed. The goal of this chapter is to provide the drafting framework for covenants that are both legally robust and practically fair.

Non-Compete Provisions: During and After the Partnership

A non-compete provision restricts the partner or employee from engaging in activities that compete with the company's business. It is the most controversial of the three covenant types because it directly limits the departing party's ability to earn a living in their chosen field. That controversy, and the resulting judicial scrutiny of non-compete provisions in almost every jurisdiction, means the drafting quality of the non-compete matters more than the drafting quality of most other operating agreement provisions.

Non-Compete During Active Partnership

The strictest non-compete in the operating agreement is the one that applies during active partnership, while the partner is a member of the company and receiving its resources, relationships, and reputation. During this period, a full non-compete, requiring the partner to devote their professional efforts exclusively to the company and prohibiting them from engaging in directly competing development activities, is appropriate, standard, and rarely challenged. It should specify:

- The prohibition on engaging in any development, sponsorship, or real estate investment management activities that compete with the company's defined business, without prior committee approval.
- The disclosure requirement for any business activity that could conflict with the company's operations, even if not directly competitive.
- The specific definition of competing activities, in terms that align with the company's actual investment strategy, the same investment criteria definition used for the corporate opportunity analysis in Chapter 13.
- The permitted exceptions: managing pre-formation personal investments within the parameters established in Chapter 13, serving on non-profit boards, and other activities permitted with disclosure under the outside business activities framework.

Post-Departure Non-Compete Provisions

Post-departure non-competes, restrictions on the former partner's competitive activities after they have left the company, are the most legally complex and most jurisdiction-dependent of all the restrictive covenants. Their enforceability depends on the state law governing the agreement, the specific scope and duration of the restriction, and the consideration provided in exchange for it. The fundamental enforceability requirements across most jurisdictions are:

- **A legitimate business interest.** The restriction must protect a legitimate business interest beyond merely keeping the departing partner from using their general skills and experience to compete. A development company has legitimate interests in its confidential information, its investor relationships, its proprietary deal flow, and its trade secrets. A non-compete that protects those specific interests has a stronger basis for enforcement than one that broadly prohibits any competitive real estate activity.

- **Reasonable geographic scope.** A prohibition on all real estate development activity anywhere in the United States is not defensible in most jurisdictions. A prohibition on development activity in the specific metropolitan area where the company operates and where the departing partner had active relationships is more likely to survive scrutiny.
- **Reasonable duration.** One to two years is the standard range for post-departure non-competes in most states. Restrictions of three years or longer face increasing judicial skepticism and are regularly reduced or voided in states that apply a reasonableness standard.
- **Adequate consideration.** For a founding partner, the equity interest received at formation is generally considered adequate consideration. For an employee signing a non-compete after employment has already begun, additional consideration beyond continued employment is required in most jurisdictions.

The Tailored and the Broad Non-Compete

The temptation when drafting non-competes is to make them as broad as possible, covering every form of real estate activity, in every market, for the maximum possible duration. This temptation should be resisted. The broadest possible non-compete is often the least protective in practice, because it is the one most likely to be voided entirely or judicially reduced to a scope the company did not intend.

A tailored non-compete, one that specifically describes the activities that actually compete with the company's business, in the specific markets where the company operates, for a duration calibrated to the protection the company legitimately needs, is more likely to be enforced and to deliver the protection the company actually needs:

- **Scope.** Define competing activities by reference to the company's specific business, ground-up multifamily development projects in the Dallas-Fort Worth metropolitan area rather than any real estate activity. The departing partner can be prohibited from doing what the company does without being prohibited from every career path available to a real estate professional.
- **Duration.** Propose a duration the company can justify by reference to the legitimate interest being protected. If the company's investor relationships are typically developed over 18 to 24 months before becoming active capital sources, a two-year duration can be justified on the basis that it protects the company's recent relationship-development investment. A duration longer than the time needed to re-establish the protected interests is harder to defend.
- **Geographic scope.** Limit the geographic restriction to the specific markets where the company operates and where the departing partner had active relationships, contacts, or responsibility during their tenure. A founding partner who was primarily responsible for the company's Dallas operations should be subject to a Dallas-focused restriction; a national restriction for a company that operates in a single metro is overbroad.

The Graduated Non-Compete: A Balanced Structure

One approach sophisticated development company partnerships use to address the tension between protection and enforceability is the graduated non-compete: a restriction that applies most strictly for the first period after departure and relaxes over time. An example structure for a two-year restriction in a two-partner development company:

During the first 12 months after departure, the departing partner may not engage in any development or sponsorship activities involving multifamily projects of 100 units or more in the Dallas-Fort Worth metropolitan area. During months 13 through 24, the restriction narrows: the departing partner may not engage in development activities involving projects

that were in the company's active pipeline as of the departure date, or that involve sites the company had evaluated or negotiated for during the 12 months preceding departure.

This structure provides the strongest protection during the period of greatest risk, the immediate post-departure period when the departing partner's competitive intelligence is most current, while relaxing over time as that intelligence becomes stale. Courts evaluating this kind of graduated restriction tend to view it more favorably than a flat prohibition, because it demonstrates the drafting party's real effort to calibrate the restriction to the legitimate interest being protected rather than simply seeking to handicap a competitor.

Non-Solicitation Provisions: The Company's Most Important Protection

For most real estate development companies, the non-solicitation provision is more commercially important than the non-compete. The reason is straightforward: the non-compete protects the company against direct competition from the departing partner, while the non-solicitation protects the relationships and people that make the company's business possible. A development company can survive a partner who goes to work for a competitor; it has a harder time surviving a partner who takes its investor base, its key employees, and its deal sources to that competitor at the same time.

Non-Solicitation of Investors

The investor non-solicitation is the single most commercially important restrictive covenant in the operating agreement of a development company that manages outside capital. The company's investor relationships represent years of trust-building, successful capital deployment, and communication investment. Each active investor relationship has a demonstrable economic value: the investor's expected future capital commitment to the company's deals, discounted for the probability that the relationship will continue. A well-drafted investor non-solicitation provision must be specific about three things:

- **Who is covered.** The restriction should cover any investor, prospective investor, or capital source who was an investor in, or an active prospect for, any of the company's deals or investment vehicles during the final 24 months of the departing partner's involvement. Active prospect should be defined to include any investor with whom the company had substantive discussions about participating in a specific deal, not merely any individual who appears in the company's CRM.
- **What is prohibited.** Solicitation should be defined broadly to include any direct or indirect communication that invites, encourages, or facilitates an investor's participation in an investment opportunity outside the company. This covers both direct outreach (I am starting a new company; would you be interested in investing?) and indirect solicitation (providing the investor's name and contact information to a competing platform, using the investor's participation as a reference in connection with a different investment vehicle, or communicating with the investor about any investment opportunity not sponsored by the company).
- **How long the restriction lasts.** 18 to 24 months after the departure date is the standard range for investor non-solicitation provisions in professional development partnerships. This duration is generally supported by courts across most jurisdictions where the company can demonstrate a bona fide investor relationship during the covered period.

The investor non-solicitation should also treat the company's investor data as confidential information: the departing partner must return all investor contact information, relationship notes,

capital commitment history, and other investor data in their possession before departing, and must not retain or use any copy of that information in connection with any post-departure business activities.

Non-Solicitation of Deal Sources and Business Relationships

Beyond investor relationships, the company should consider whether to include non-solicitation provisions covering the brokers, landowners, lenders, and municipal contacts whose relationships generate the company's deal flow. These relationships are proprietary in the sense that the company invested resources in developing them, but they are less clearly owned by the company in the way investor relationships are, because deal source relationships are generally professional rather than contractual and are more openly acknowledged in the industry.

The enforceability of deal source non-solicitation provisions is less predictable than investor non-solicitation provisions, and the drafting team should consider whether the scope of the restriction creates a practical burden on the departing partner that outweighs the protection it provides. A focused restriction, prohibiting solicitation of the specific brokers and landowners from whom the company has received specific deal referrals, is more likely to be enforceable and more relevant to the company's actual interest than a broad prohibition on any contact with any member of the real estate community in the target market.

Non-Solicitation of Employees and Contractors

The employee non-solicitation protects the company against a departing partner who attempts to recruit the company's key personnel to a competing venture. For a small development company where specific individuals carry significant institutional knowledge and client relationships, the loss of a key employee to a directly competing platform causes both direct operational harm and indirect competitive harm. A well-drafted employee non-solicitation provision:

- Covers all employees and key independent contractors of the company, not just those with whom the departing partner had a specific working relationship. A broad provision eliminates the argument that a particular employee was not covered because the departing partner had not directly supervised or interacted with them.
- Prohibits both direct solicitation (approaching an employee with a job offer) and indirect encouragement (suggesting to a third party that a specific company employee would be valuable to their platform, knowing the third party will then make the approach).
- Extends for 12 to 24 months after departure, the standard range for employee non-solicitation provisions in most jurisdictions.
- Applies to passive acceptance as well as active solicitation: the departing partner should not be able to avoid the provision by merely accepting an approach from a company employee, when the departing partner has made their plans visible enough that such an approach was foreseeable.

Confidentiality: Protecting Proprietary Information

Confidentiality obligations protect the company's proprietary information: the specific knowledge, data, systems, and processes that give the company a competitive advantage and that it has invested resources in developing. Unlike the non-compete, which restricts competitive activity, and the non-solicitation, which restricts relationship-based competitive acts, the confidentiality obligation restricts the use of specific information rather than categories of competitive behavior.

What Constitutes Confidential Information

The operating agreement's confidentiality provision should define confidential information broadly enough to capture all truly proprietary information while remaining specific enough to be enforceable. An overly vague definition, all information relating to the company's business, may be challenged as overbroad; an overly specific definition may fail to capture proprietary information the parties did not specifically anticipate. For a development company, the following categories should be expressly included:

- **Investor information.** The identity, contact information, investment history, capital capacity, investment preferences, and relationship notes for every investor and prospective investor in the company's investment vehicles. This is the most sensitive category of information the company holds and the most valuable to a competing platform.
- **Deal pipeline and site information.** The identity and location of development sites the company is evaluating, negotiating, or under contract to acquire; the terms of any letters of intent, purchase agreements, or options; the entitlement status of sites under evaluation; and the company's underwriting assumptions for specific deals.
- **Financial models and underwriting methodology.** The specific financial models, return calculations, sensitivity analyses, and underwriting assumptions the company has developed through experience. These are not merely the general principles of real estate finance; they are the specific, calibrated tools the company uses to evaluate specific deal types in specific markets.
- **Investment strategy and proprietary processes.** The specific investment thesis, market selection criteria, risk assessment framework, and operational processes the company has developed, including any proprietary processes for identifying off-market opportunities, managing entitlement risks, structuring investor communications, or managing construction oversight.
- **Employee and contractor information.** Compensation data, employment terms, professional assessments, and performance information for all current and former employees and contractors.
- **Trade secrets and business methods.** Any information that constitutes a trade secret under the Defend Trade Secrets Act or applicable state law, including proprietary software, data analyses, market research, and operational methodologies that derive economic value from not being generally known.

The Duty of Confidentiality During Partnership

During active partnership, every founding partner and every employee has an obligation to maintain the confidentiality of the company's proprietary information. This obligation arises under three independent sources:

- The operating agreement's confidentiality provision, which creates a contractual obligation.
- The fiduciary duty of loyalty discussed in Chapter 13, which independently prohibits a fiduciary from misusing the principal's proprietary information for personal benefit.
- The Defend Trade Secrets Act and applicable state trade secret law, which independently prohibit the misappropriation of trade secrets regardless of any contractual provision.

The practical implication of these overlapping obligations is that the company has multiple legal theories available when its proprietary information is misappropriated. Even if a court finds the confidentiality provision unenforceable for some reason, the trade secret claim and the fiduciary duty claim may survive independently. This layered protection is one reason the confidentiality obligation should be documented in the operating agreement even though it may exist independently under applicable law.

The Defend Trade Secrets Act

The Defend Trade Secrets Act of 2016 created a federal civil cause of action for trade secret misappropriation, supplementing the state trade secret laws that had previously provided the only civil remedy for trade secret theft. The Act lets a company sue in federal court for misappropriation of its trade secrets, which offers several practical advantages over state court trade secret litigation:

- **Emergency ex parte seizure.** Federal courts can issue emergency seizure orders, without prior notice to the defendant, in extraordinary circumstances to prevent the imminent destruction or dissemination of trade secrets. This remedy is particularly valuable when a departing partner is believed to have taken electronic files and is at risk of sharing or deleting them.
- **Enhanced damages.** The Act allows recovery of actual damages, unjust enrichment, and, in cases of willful and malicious misappropriation, exemplary damages of up to twice the actual damages plus attorney's fees. These remedies create a meaningful financial deterrent against deliberate trade secret theft.
- **Federal venue.** Federal venue gives the company access to a court system experienced in sophisticated commercial disputes, which can be advantageous when the case involves complex financial information or multi-party business relationships.

To preserve this protection, the operating agreement's confidentiality provision must include the Act's required immunity notice: a statement informing signatories that they may disclose trade secrets to government officials or attorneys in connection with reporting potential law violations, or in connection with a lawsuit alleging retaliation, without losing protection under the Act. This notice must be included in any agreement entered into after May 11, 2016 to preserve the right to recover exemplary damages and attorney's fees against a signatory to whom the notice was not given.

Confidentiality After Departure

The confidentiality obligation should extend indefinitely beyond the departure date for information that constitutes a trade secret under applicable law. Trade secret protection persists as long as the information retains its status as a trade secret, meaning as long as it derives economic value from not being generally known and the company takes reasonable steps to maintain its secrecy. A departing partner's obligation to protect the company's trade secrets therefore has no expiration date in most jurisdictions.

For confidential information that does not rise to the level of a trade secret, information generally available in the industry but that the company has combined or organized in a specific way that gives it commercial value, the post-departure confidentiality obligation should extend for a defined period, commonly two to five years, during which the information retains its commercial significance.

The operating agreement should also specify the return-of-information obligation at departure: the departing partner must promptly return all physical and electronic copies of confidential information in their possession, delete all such information from personal devices and storage services, and certify in writing that they have complied. The return obligation should be triggered at the moment of departure, not after a negotiated wind-down period.

Intellectual Property Ownership: What Belongs to the Company

The confidentiality provisions protect information the company generates from being disclosed to outsiders. The intellectual property provisions address a related but distinct question: who owns the information and work product the partners and employees create in the course of their activities with the company?

In most jurisdictions, work product created by an employee in the course of employment belongs to the employer as a work made for hire under the Copyright Act, or as an invention or development made using employer resources. But the work-made-for-hire doctrine has gaps, particularly for independent contractors and for work created partly in a personal and partly in a company context. The operating agreement's intellectual property assignment provision fills those gaps by creating an express, contractual assignment of all relevant IP to the company.

What IP the Company Generates

A real estate development company generates several categories of intellectual property that should be expressly assigned to the company through the IP assignment provisions of the operating agreement and any relevant employment agreements:

- **Financial models and underwriting tools.** The company's development, acquisition, and debt service financial models; sensitivity analysis templates; return calculation methodologies; and the specific assumptions and inputs that calibrate these models to the company's target markets and asset classes.
- **Investor materials.** The company's pitch decks, offering memoranda, investor update reports, financial reporting templates, and the specific design and content that differentiate the company's investor communications.
- **Operating procedures and management systems.** The checklists, protocols, and processes the company has developed for managing development projects, processing investor subscriptions, conducting contractor due diligence, and managing the construction draw process.
- **Branding and marketing materials.** The company's name, logo, website, and all associated brand identity elements that distinguish the company in the market.
- **Deal pipeline data and CRM content.** The organized compilation of deal sources, landowner relationships, broker contacts, and investor information maintained in the company's CRM system. The organization and compilation of this data, even where the underlying information is not individually confidential, may constitute protectable IP.
- **Market research and analysis.** The company's proprietary market research, submarket analyses, competitive studies, and demographic analyses that inform its investment decisions.

Pre-Formation Intellectual Property

A founding partner who brings existing intellectual property to the company, a financial model developed at a prior employer, a market analysis conducted before the company was formed, a brand identity created independently, faces a threshold question the operating agreement must address: does that pre-formation IP transfer to the company as a capital contribution, is it licensed to the company for the company's use, or does it remain the partner's personal property that happens to be used in the company's operations?

The consequences of leaving this unresolved can be significant. A partner who claims that the financial modeling system they use daily at the company was developed personally, and who takes that system when they depart, has created both a dispute about IP ownership and a practical problem for the company's ongoing operations. The operating agreement should specify:

- Which pre-formation IP each partner is specifically contributing to the company as a capital contribution or other consideration, creating company ownership.
- Which pre-formation IP each partner is licensing to the company for its use, creating a license the company can rely on while the partner retains ownership.

- The terms of any license: duration (perpetual or tied to the partnership), revocability, and the conditions under which the license can be terminated.
- The treatment of modifications and improvements to pre-formation IP made by company employees or partners using company resources. Typically, improvements to licensed pre-formation IP made using company resources become company property, even if the original IP remains the partner's.

Social Media and Personal Brand

The intersection of a founding partner's personal brand, their professional profile, their reputation, their social media following, their speaking and writing activities, and the company's brand creates a delicate IP and identity question that most operating agreements do not address with enough specificity.

A founding partner who built a significant personal following in the real estate community before forming the company brings that following as a contribution to the company's brand and marketing reach. But the personal brand is the partner's own, built over their career, and not appropriately treated as company property simply because the partner now operates under the company's name. Conversely, a partner who builds a significant professional following while operating exclusively under the company's banner, using company resources and promoting company deals, has created something that is at least partly company property. The operating agreement should address:

- The extent to which the company's brand identity is distinct from any partner's personal brand, and the obligations each partner has to represent the company's brand consistently in their professional activities.
- The treatment of social media accounts: are professional accounts maintained primarily in connection with the company's activities, and financed or supported by the company, company property, or the individual partner's personal property?
- The post-departure use of the company's name: a departing partner should not represent themselves as affiliated with the company in any professional context after their departure date.

Drafting for Enforceability: The Practical Requirements

A restrictive covenant that is legally sound in concept but unenforceable in practice provides no protection. The following drafting requirements are the practical minimum for covenants the company expects to actually enforce when a departing partner or employee violates them.

Choice of Law and Forum

The operating agreement should specify the governing law for the restrictive covenant provisions and the forum in which disputes will be resolved. The choice of governing law matters enormously for non-compete enforceability: a covenant governed by California law is effectively unenforceable regardless of where the departing partner is located, while a covenant governed by Texas or Florida law has a much stronger enforceability foundation.

The enforceability of a choice of law provision is not absolute. Courts in some states, particularly California, have refused to apply another state's law to employment agreements with California-based employees, finding that California's public policy against non-competes overrides the parties' contractual choice. For operating agreements among founding partners, the choice of law analysis is more nuanced than for employment agreements, and experienced counsel should evaluate the appropriate governing law selection for the specific partnership's circumstances.

For forum, the equitable relief carve-out discussed in Chapter 17 is essential: the arbitration provision that governs ordinary disputes should contain a specific exception allowing either party to seek injunctive relief in a court of competent jurisdiction without prior arbitration. Non-compete and trade secret violations typically require immediate injunctive relief, a court order prohibiting the violation while the underlying dispute is arbitrated, that cannot wait for an arbitration proceeding to conclude.

Adequate Consideration

Restrictive covenants must be supported by adequate consideration to be enforceable. For founding partners, the equity interest received at formation generally constitutes adequate consideration for all restrictive covenants in the operating agreement. The operating agreement should make this relationship explicit: the partners are receiving their equity interests in part in consideration for the restrictive covenants they are accepting.

For restrictive covenants added to an existing operating agreement, when a new partner is admitted or the agreement is amended to add new covenants for existing partners, additional consideration must be provided and documented. A new partner's equity grant is adequate consideration for covenants included in the admission agreement. For existing partners whose covenants are being strengthened, a specific additional benefit, an increase in equity, a new guaranteed payment, or an acceleration of vesting, must be provided in exchange for the expanded restrictions.

Specificity of Scope

Every element of the restrictive covenant's scope must be defined with enough specificity to be applied in a real situation without judicial construction. The most common enforceability failure mode is vagueness: a non-compete that prohibits competitive activity without defining what competitive activity means, in what geography, for how long, is a covenant courts will either void for vagueness or construe narrowly in the departing partner's favor. The provisions should define:

- The specific activities prohibited: by reference to the company's defined investment strategy, not by general reference to real estate or development.
- The specific geographic area covered: by city, metropolitan area, county, or state, not by general reference to the markets where the company operates without specifying what those markets are.
- The specific persons covered by non-solicitation provisions: by reference to the company's investor list and employee roster as of the departure date, with a lookback period that captures relationships cultivated before departure.
- The specific duration of each restriction: by calendar period from the departure date, not by reference to indefinite conditions that make it impossible to know when the restriction expires.

The Injunctive Relief Provision

Every restrictive covenant in the operating agreement should include a specific provision acknowledging that:

- A breach of the covenant would cause irreparable harm to the company for which monetary damages alone would be an inadequate remedy.
- The company is therefore entitled to seek injunctive relief, a court order prohibiting the continuation of the breach, in addition to any other remedy available at law or in equity.
- The partner waives any requirement that the company post a bond as a condition of obtaining a temporary restraining order or preliminary injunction in a court of competent jurisdiction.

These provisions serve two functions. They provide a contractual basis for the company's request for emergency injunctive relief, a step courts evaluate based in part on whether the parties

acknowledged the irreparable harm standard when the agreement was signed. And they speed the court's ability to grant emergency relief by eliminating procedural objections the violating partner might otherwise raise.

State-by-State Enforceability Summary

Chapter 12 addressed the state-by-state enforceability of non-competes in the employment context. For operating agreement non-competes among founding partners, the analysis is somewhat different: founding partners are not employees, and many of the worker-protection statutes that limit employer non-competes do not apply in the same way to equity-holding business partners. The following summary addresses enforceability of operating agreement restrictive covenants specifically in the context of founding partners in a development company LLC.

Jurisdiction	Non-compete (founding partners)	Non-solicitation (investors)	Key drafting considerations
California	Largely unenforceable under Business and Professions Code Section 16600 even for LLC members; narrow exceptions (sale of business, dissolution of partnership) may apply but are litigated frequently	Generally enforceable as protection of trade secret and proprietary investor relationships; not subject to the same Section 16600 prohibition as non-competes	Maximize confidentiality and non-solicitation protections; do not rely on a non-compete as primary protection; structure the investor database as a trade secret; trade secret claims available independently
Texas	Enforceable if ancillary to an otherwise enforceable agreement and reasonable in time, geography, and scope; partnership agreements are generally enforceable business agreements for this purpose	Strongly enforceable; Texas courts recognize investor relationships as legitimate protectable business interests	Limit geography to specific metropolitan areas; duration of 1 to 2 years; define competing activities by specific asset class and deal type; include a blue-pencil provision
New York	Enforceable under a reasonableness standard for partners with access to confidential relationships and specialized know-how; pending legislative activity may tighten standards	Enforceable where the company can show a protectable proprietary relationship with the investor; 18 to 24 months standard	Monitor legislative developments; define the legitimate business interest in terms of investor relationships and confidential information; duration 1 to 2 years; geographic scope tied to actual markets
Florida	Enforceable under Florida Statute Section 542.335; statutory presumption of reasonableness for two-year provisions; courts will reform rather than void	Strongly enforceable; Florida expressly recognizes protectable business interests including client relationships	Most employer-favorable state; two-year restrictions standard; broad geographic scope more likely to survive than in other states; include statutory language tracking Section 542.335
Delaware	Enforceable under a reasonableness standard; Delaware courts respect the contractual freedom of sophisticated parties; partnership agreements treated as negotiated commercial contracts	Enforceable; Delaware's strong contract enforcement philosophy supports well-drafted investor non-solicitation provisions	Delaware formation does not determine governing law; governing law should be specified separately; Delaware courts will enforce sophisticated parties' reasonable non-compete agreements
Other states	Most states enforce reasonable restrictions under a totality test: legitimate interest, reasonable scope, duration, and geography, and not unduly harsh to the individual	Generally enforceable across jurisdictions for specific investor relationships; the strength of protection increases with the specificity of the provision	Consult state-specific counsel before finalizing; include a blue-pencil and reformation clause; consider severability for geographic scope

Enforcement: What Happens When a Covenant Is Violated

The most carefully drafted restrictive covenant provides no protection if the company cannot effectively enforce it when it is violated. Enforcement of restrictive covenants is inherently time-sensitive: the competitive harm caused by a violating former partner who is actively soliciting the company's investors accelerates every day the violation continues. The company's enforcement response must be swift, decisive, and procedurally correct.

Immediate Steps on Discovering a Violation

When the company discovers or suspects a breach of a restrictive covenant, the following steps should be taken immediately and in sequence:

- **Document the evidence.** Preserve all available evidence of the breach before doing anything else: download and save electronic communications, take screenshots of social media activity, preserve voicemails, and collect any written materials. Evidence of a violation can disappear quickly once the violating party becomes aware they are under scrutiny.

- **Engage legal counsel immediately.** Restrictive covenant enforcement involves complex procedural requirements, emergency motion practice, bond requirements, and service of process on an emergency basis, that require experienced counsel. The time between discovery and the filing of an emergency motion for a temporary restraining order is often measured in hours, not days.
- **Send a formal cease-and-desist letter.** Counsel should draft and deliver a formal written demand that the former partner immediately cease the specified activities, preserve all company confidential information in their possession, and return all company property and data. The letter both notifies the violating party and begins building the documentary record that will support emergency court relief.
- **Evaluate the need for emergency injunctive relief.** If the violation involves active solicitation of the company's investors or disclosure of trade secrets to competitors, emergency injunctive relief, a temporary restraining order or preliminary injunction, may be necessary to stop the harm before it becomes irreversible. Counsel should file the emergency motion simultaneously with or immediately after the cease-and-desist letter.

Remedies Available for Covenant Breach

The remedies available for breach of a restrictive covenant depend on the nature of the violation, the governing law, and the specific provisions of the operating agreement:

- **Injunctive relief.** A court order prohibiting the violating party from continuing the breach. Temporary restraining orders can be obtained on an emergency basis, sometimes the same day as filing. Preliminary injunctions, which last through the duration of the litigation, require the company to show a likelihood of success on the merits, irreparable harm, and the balance of equities in its favor.
- **Actual damages.** The provable economic harm caused by the breach: the value of investor capital diverted to competing vehicles, the fees lost from deals sourced through misappropriated deal-source relationships, the cost of replacing employees who were recruited away. Actual damages in restrictive covenant cases can be difficult to prove with specificity, which is one reason injunctive relief is often the primary remedy.
- **Disgorgement of profits.** The violating party may be required to disgorge profits earned from activities that violated the covenant. If a former partner solicited the company's investors for a competing fund and earned a promoted interest from that fund, the disgorgement remedy could require the former partner to turn over a portion of that promoted interest to the company.
- **Attorney's fees.** Many operating agreements include a specific provision requiring the breaching party to pay the company's attorney's fees in connection with enforcing a restrictive covenant. Fee-shifting provisions are enforced in most jurisdictions and create a meaningful additional deterrent against deliberate violations.
- **Trade secret remedies.** For violations that constitute trade secret misappropriation, the Defend Trade Secrets Act provides additional remedies including exemplary damages of up to twice actual damages for willful and malicious misappropriation, plus attorney's fees.

Tolling the Covenant Period

A common drafting provision often omitted from template operating agreements is the tolling provision: a clause specifying that if the former partner violates the covenant and the violation is not immediately enjoined, the covenant period is automatically extended by the period during which the violation occurred. Without a tolling provision, a former partner who violates a two-year non-compete for six months and is not stopped until a court issues an injunction has effectively reduced their covenant period to 18 months of compliance.

The tolling provision ensures the full protective period the parties intended is actually delivered: the former partner must comply with the covenant for the agreed duration, counted from the date the violation ceased rather than the date the covenant began. Courts in most jurisdictions enforce tolling provisions in restrictive covenants between sophisticated parties who bargained for the provision at arm's length.

CHAPTER 14: KEY TAKEAWAYS

1. Restrictive covenants protect the company's most valuable assets: investor relationships, deal flow sources, key employees, and proprietary information. A development company that manages outside capital is uniquely vulnerable to competitive harm from departing insiders, because those insiders carry complete competitive intelligence, every investor relationship, every deal pipeline detail, every financial model and underwriting assumption, when they leave.
2. Post-departure non-competes must be tailored to be enforceable. A broad prohibition on all real estate activity is more likely to be voided than a targeted restriction on the activities that directly compete with the company's specific business, in its specific markets, for a reasonable duration (one to two years in most jurisdictions). The graduated non-compete, strongest immediately after departure and relaxing as competitive intelligence becomes stale, is often more defensible than a flat prohibition.
3. The non-solicitation of investors is the most commercially important restrictive covenant in a development company's operating agreement. It must specifically define who is covered (investors and active prospects in the last 24 months), what is prohibited (direct and indirect solicitation, including providing investor contact information to competing platforms), and how long the restriction lasts (18 to 24 months is the standard range). The investor database should be expressly classified as company confidential information and a trade secret.
4. The confidentiality obligation protects proprietary information, investor data, deal pipeline information, financial models, operational processes, and trade secrets, from being disclosed or misused by departing partners and employees. The Defend Trade Secrets Act provides a federal cause of action for trade secret misappropriation that supplements state law and contractual protections; the operating agreement must include the Act's required immunity notice to preserve exemplary damages and fee-shifting remedies.
5. Intellectual property ownership provisions assign to the company all work product, models, systems, and other IP created in the course of the partnership. Pre-formation IP must be specifically addressed: each partner should document what pre-formation IP they are contributing, what they are licensing, and on what terms. Social media and personal brand usage should be addressed in the operating agreement to avoid ambiguity about what the company owns and what the individual partner retains.
6. Enforceability requires specific drafting choices: governing law and forum that align with the company's enforceability objectives; adequate consideration documented when the covenant is agreed to; scope specificity sufficient to apply without judicial construction; an injunctive relief provision acknowledging irreparable harm; and a tolling provision ensuring the full covenant period is actually delivered even if a violation temporarily goes unenforced.
7. When a covenant is violated, the enforcement response must be immediate: document evidence before taking any other action, engage legal counsel the same day, send a formal cease-and-desist letter, and evaluate the need for emergency injunctive relief.

> The time between discovery and court action is often measured in hours when active investor solicitation is occurring. Delayed enforcement both allows the harm to compound and may be construed as a waiver of the covenant.

WHAT COMES NEXT

Chapter 15 continues Part V by addressing insurance and liability management, the insurance program every development company should maintain, including Directors and Officers coverage, Errors and Omissions coverage, Employment Practices Liability, Cyber Liability, Builders Risk, and Key Person Life Insurance, with attention to how each coverage type interacts with the liability protections built into the company's entity structure and the indemnification provisions in its operating agreement.

See also: *Chapter 13 (Fiduciary Duties: the duty of loyalty basis for trade secret protection independent of contract) • Chapter 17 (Dispute Resolution: the equitable relief carve-out from arbitration for restrictive covenant enforcement) • Appendix J (Glossary: non-compete, non-solicitation, trade secret, Defend Trade Secrets Act, blue-pencil, tolling, injunctive relief)*

CH. 15

PART V: FIDUCIARY DUTIES, RISK MANAGEMENT & PARTNER PROTECTION

Insurance

and Liability Management

The insurance program every real estate development company must maintain, how each coverage type protects the company, how coverages interact with the entity structure's liability protections, and how the indemnification provisions in the operating agreement create the rights that insurance must be capable of funding.

Insurance is not an expense to be minimized so much as the funded backstop for the indemnification obligations, the liability exposures, and the catastrophic risks that the entity structure and the operating agreement create rights against but do not themselves fund. A founding partner who is indemnified by the company against claims arising from their management decisions has meaningful protection only if the company has the financial resources, or the insurance coverage, to actually pay on that indemnification when a claim is made.

This chapter addresses each of the insurance coverages a real estate development and sponsor company should maintain: what each coverage does, what it does not cover, what limits and structures are appropriate for a development company at different stages of growth, and how the various coverages interact with each other and with the liability framework established elsewhere in this handbook.

The Relationship Between Insurance and the Entity Structure

The LLC structure created in Chapter 3 and the indemnification provisions drafted in Chapter 4 establish a legal framework for liability protection. The entity's limited liability insulates the founding partners from personal liability for the company's obligations; the operating agreement's indemnification provisions create a company obligation to defend and indemnify the managing member and other managers against third-party claims arising from their management activities. But neither the entity structure nor the operating agreement generates any actual money. They create rights; insurance funds those rights.

This relationship has three practical implications every founding team must understand:

- **The indemnification provisions are only as strong as the company's ability to fund them.** A company that indemnifies its managing member against claims arising from a management decision but carries no Directors and Officers coverage, and has limited balance sheet assets, is offering an indemnification right that may be unfundable in a serious claim. The D&O policy is the mechanism that converts the operating agreement's indemnification promise into funded protection.
- **The LLC's liability protection does not reach all claims.** Personal guarantees on construction debt, securities fraud claims (which can reach the individual principals through the securities laws' personal liability provisions), and claims alleging that the LLC is the alter ego of the individual principals can all pierce the entity structure. Insurance provides an additional layer of protection for these residual exposures.
- **Required coverages are often imposed externally.** A construction lender's loan agreement, a joint venture partner's co-investment agreement, and an institutional LP's side

letter may each specify required coverages and minimum limits the company must carry as a condition of those relationships, often before the company makes its own coverage decisions.

Directors and Officers / Management Liability Insurance

Directors and Officers (D&O) insurance, more accurately called Management Liability insurance for an LLC, since LLCs have managers and members rather than directors and officers, is the single most important coverage a real estate development company must carry. It protects the company's principals against claims arising from their management decisions: allegations of mismanagement, breach of fiduciary duty, misrepresentation to investors, securities law violations, and similar claims from investors, employees, creditors, and regulators.

A development company that raises capital from outside investors operates in an environment where investor claims are a real and recurring risk. An investor who loses money on a deal will look for any available legal theory to recover that loss. The D&O policy is what stands between that claim and the managing partner's personal assets.

What D&O Insurance Covers

Management Liability / D&O coverage for a private company like a development LLC typically provides three coverage insuring agreements:

- **Side A coverage (individual coverage).** Pays on behalf of the individual principals when the company cannot indemnify them, typically because the company is insolvent, in bankruptcy, or legally prohibited from indemnifying the individual in the specific circumstances. Side A is the personal protection for the founding partners and is often the most important coverage from their individual perspective.
- **Side B coverage (indemnification reimbursement).** Reimburses the company for the cost of indemnifying its managers and officers when the company has actually paid on the indemnification. Side B converts the operating agreement's indemnification promise into a funded obligation by reimbursing the company dollar-for-dollar for indemnification payments.
- **Side C coverage (entity coverage).** Pays on behalf of the company itself when it is named as a defendant in a securities claim. For a development company that raises outside investor capital, Side C protects the company entity against securities-related claims from investors.

Not all D&O policies for private companies include all three insuring agreements. The founding team should confirm with their insurance broker that the policy provides Side A, B, and C coverage, and should understand the interplay between them: the policy's single aggregate limit typically covers all three insuring agreements, meaning a large claim under Side C can erode the coverage available under Side A and B for the same policy period.

What D&O Insurance Does Not Cover

D&O insurance is not a catch-all liability policy. Understanding its exclusions is essential to assessing whether the company has adequate total coverage across all lines:

- **Fraud and intentional misconduct.** D&O policies contain conduct exclusions that eliminate coverage for claims based on actual fraud, deliberate dishonesty, or intentional criminal acts. These exclusions typically apply only after a final court adjudication of fraud, not merely upon an allegation, which means the policy will defend and pay defense costs even for fraud allegations until the claim is finally adjudicated.
- **Prior known claims.** D&O policies are typically written on a claims-made basis, meaning they cover claims made during the policy period. Claims known to the company before the

policy's inception are excluded. A company that purchases D&O coverage after a claim has already been asserted will find that the new policy does not cover that claim.

- **Bodily injury and property damage.** D&O coverage does not extend to claims for physical injury to persons or damage to tangible property. These risks are addressed through the General Commercial Liability policy.
- **Professional services.** Claims arising from the company's provision of professional services as a developer, construction manager, or asset manager may be excluded from the D&O policy and are more appropriately addressed through the Errors and Omissions policy.

Coverage Limits and Structures

For an emerging development company in its first three years, a management liability policy with limits of $1 million to $3 million is a reasonable starting point. As the company grows its assets under management, adds outside investors, and increases its deal volume, coverage limits should be revisited and increased to reflect the growing potential claim size:

- **$1M to $3M.** Appropriate for an emerging company with fewer than five deals under management, primarily high-net-worth individual investors, and limited regulatory exposure.
- **$3M to $10M.** Appropriate for a company with a growing institutional investor base, multiple active deals, and meaningful assets under management ($50 million to $150 million).
- **$10M and up.** Typically required by institutional LP side letters as assets under management grow above $150 million; achieved through primary coverage combined with excess layers.

Annual premiums for private company D&O coverage vary significantly based on the company's revenue, assets under management, claims history, and the specific nature of its investor relationships. A company with $5 million to $25 million in annual fee revenue, a clean claims history, and individual investor relationships might expect to pay $15,000 to $40,000 per year for a $3 million policy. Companies with institutional investors, larger assets under management, or prior claims will pay more.

Errors and Omissions / Professional Liability Insurance

Errors and Omissions (E&O) insurance, also called Professional Liability insurance, covers claims arising from the company's provision of professional services: allegations that the company failed to perform its professional duties with the care and skill a client or investor had a right to expect. Where D&O coverage responds to claims of management misconduct and fiduciary breach, E&O coverage responds to claims of professional failure: inadequate analysis, negligent project management, errors in investor representations, and similar service failures.

When E&O Is Required for a Development Company

E&O coverage is most clearly required when a development company provides professional services to third parties for compensation: acting as a development manager for a project it does not own, providing construction management services to a third-party owner, or acting as an investment adviser for a fee. In these contexts, the company is providing professional services that clients rely on, and a failure of those services creates professional liability exposure the D&O policy does not address.

For a company that develops exclusively on its own balance sheet and manages its own investor relationships, E&O coverage may be less clearly required but remains advisable. Investor claims that the company misrepresented a deal's return projections, failed to disclose material risks, or provided negligently optimistic feasibility analyses can be characterized as professional service claims that E&O coverage addresses.

As a practical matter, many institutional investors and joint venture partners require the development company to carry E&O coverage as a condition of their capital commitment or co-investment relationship, regardless of how the company characterizes its activities. The requirement is best viewed as an appropriate protection rather than an unnecessary burden.

Coverage Limits

E&O coverage for an emerging development company typically starts at $1 million per claim and $2 million aggregate. For companies providing construction management or development management services to third parties at meaningful scale (multiple projects, significant fees), $2 million to $5 million in coverage is more appropriate. Institutional relationships may require higher limits, often matching the required D&O limits.

E&O premiums depend on the scope of professional services provided, the company's revenue from those services, and the complexity of the projects involved. Expect to pay $8,000 to $25,000 per year for a $2 million policy for a development company at the emerging stage, with premiums increasing as the company's service revenue grows.

General Commercial Liability Insurance

General Commercial Liability (CGL) insurance is the foundational coverage for any business with a physical presence: it covers claims for bodily injury and property damage arising from the company's operations, premises, and products. For a development company, CGL coverage addresses the risk of physical harm claims that arise in the course of running the business, a visitor injured at the company's office, damage to a neighboring property caused by the company's operations, or injuries arising from the company's activities at a development site in a management capacity.

Management Company and Project-Level CGL

An important structural distinction for development companies: the management company's CGL policy covers the management company's own operations, its office, its employees' activities in their management capacity, and the professional activities of the company's principals. It does not automatically extend to cover the construction and development activities on specific project sites, which are typically subject to a separate project-level CGL policy carried by or through the general contractor.

The management company's CGL policy should specify that it covers the company's activities as owner's representative and development manager without constituting the company as a contractor subject to contractor-specific exclusions. The interplay between the management company's CGL policy, the project-level general contractor's policy, and the Builder's Risk policy requires careful coordination with the insurance broker to ensure no gaps in coverage exist between these policies.

Appropriate Limits

A standard CGL policy for a development company's management operations provides $1 million per occurrence and $2 million aggregate coverage. This level is the baseline minimum and is typically required by commercial landlords for office leases, by clients under development management agreements, and by lenders as a general condition of doing business.

The CGL policy's per-occurrence limit is combined with the Umbrella / Excess Liability policy to provide the total available coverage. The umbrella policy sits above the CGL (and other primary policies) and provides additional limits for claims that exhaust the primary coverage. A $1 million CGL combined with a $5 million umbrella provides $6 million in combined coverage, a practical minimum for a company managing meaningful real estate assets and investor relationships.

Employment Practices Liability Insurance

Employment Practices Liability (EPLI) insurance covers claims by current, former, and prospective employees alleging employment-related wrongdoing: wrongful termination, discrimination, harassment, retaliation, failure to hire, failure to promote, and related employment law violations. As discussed in Chapter 12, the employment law compliance obligations that attach from the company's first hire are extensive, and the consequences of noncompliance can be severe. EPLI is the insurance backstop for those consequences when a claim arises despite the company's best compliance efforts.

Why EPLI Matters Immediately

Many founding teams defer EPLI coverage until the company has a meaningful number of employees, reasoning that a company with only two or three employees faces minimal employment claims risk. This reasoning underestimates the risk in two specific ways:

- **Employment claims can arise from the earliest hires.** A single employment decision, the first termination, or the first hire where one candidate is selected over another, can generate an EPLI claim. The claim's merit is irrelevant to the cost of defending it: even a meritless employment discrimination claim can cost $50,000 to $150,000 in defense costs before it is resolved.
- **Claims from pre-EPLI employees are not covered by a policy obtained after the claim arises.** Like D&O coverage, EPLI is typically written on a claims-made basis: a claim that arises before the policy is in force is not covered even if the employee files the formal complaint after the policy is obtained. The company that fires its second employee without EPLI in place, and is served with an EEOC charge six months later, will find that the subsequently purchased EPLI policy does not cover the claim.

EPLI coverage should be obtained before the first employee starts work. The cost is modest, $3,000 to $10,000 per year for a small development company with five to ten employees, and the protection is immediate.

Coverage Scope

EPLI covers defense costs, settlements, and judgments arising from employment-related claims. Most EPLI policies also cover third-party harassment claims, harassment of the company's employees by contractors, clients, or investors who are not themselves employees, which is relevant for a development company whose employees interact regularly with construction site personnel and in investor meetings.

EPLI policies do not cover workers' compensation claims (addressed by the workers' compensation policy), intentional acts by the employer, criminal acts, or wage and hour class action claims (often excluded as a separate category requiring a wage and hour endorsement). The founding team should review the policy's exclusions carefully with the insurance broker to ensure the specific employment law risks most relevant to the company's operations are covered.

Builder's Risk and Project-Level Insurance

Builder's Risk insurance (also called Contractors All-Risk or Installation Floater insurance in some contexts) covers physical damage to a structure under construction from causes including fire, wind, theft, vandalism, and certain collapse scenarios. Unlike the management company's CGL policy, Builder's Risk is project-specific: a separate policy is typically placed for each development

project, covering the project from the commencement of construction through substantial completion.

Who Carries Builder's Risk

Builder's Risk can be carried by the property owner (the project entity or deal-level SPE), by the general contractor, or jointly. The typical approach in a development project financed by a construction loan is for the project entity, as the property owner and borrower, to carry the Builder's Risk policy, which is then required by the construction lender as a condition of the loan. The lender is typically named as an additional insured and loss payee on the policy, ensuring that insurance proceeds are applied to the loan before being distributed to the project entity.

Even when the general contractor carries their own Builder's Risk, or is required to carry it under the construction contract, the development company's role as owner's representative means the company should understand the coverage terms, the deductibles, and the coverage gaps that may exist between the general contractor's policy and the project entity's exposures.

Coverage Parameters

Key parameters of a Builder's Risk policy that affect the project entity's coverage:

- **Policy limit.** The policy limit should equal the completed value of the structure, the full replacement cost of the building at completion, not the construction cost at the current stage of completion. A total loss fire on the day before substantial completion should be insured at the building's full completed value, not its value partway through construction.
- **Soft cost coverage.** Standard Builder's Risk policies cover hard costs (the physical structure and its components) but not the soft costs, architect's fees, permit fees, financing costs, and development management fees, that would need to be re-incurred if the project is destroyed and rebuilt. A soft cost endorsement extends coverage to these costs, which can be substantial on a complex development project.
- **Delay in completion / loss of rents.** If the project is damaged and completion is delayed, the project entity loses rental income or other revenue it would have earned had the project been completed on schedule. A delay in completion or business interruption endorsement covers this lost income during the period of restoration.
- **Flood and earthquake exclusions.** Standard Builder's Risk policies exclude losses caused by flood and earthquake. In markets with meaningful flood or seismic exposure, separate flood and earthquake endorsements or separate policies are needed.
- **Deductible.** The project entity typically bears a per-occurrence deductible of $10,000 to $50,000 on Builder's Risk claims. Larger projects with higher risk exposure may carry higher deductibles in exchange for lower premiums.

Umbrella / Excess Liability Insurance

Umbrella and Excess Liability insurance provides additional limits above the primary liability policies, CGL, EPLI, and sometimes D&O and E&O, when a claim exhausts the primary policy's limits. It is the mechanism that turns a $1 million CGL policy into a $6 million total protection package (the CGL primary plus a $5 million umbrella) without paying for $6 million in primary coverage across every policy.

For a development company, the umbrella policy is typically written to sit above the CGL policy and potentially above other underlying primary policies. The umbrella covers the same categories of claims as the underlying policies but provides coverage only after the underlying limits are exhausted. Some umbrella policies also provide broader coverage than the underlying policies for

certain claims, which can be beneficial when a claim falls into a gap between primary policy coverages.

Appropriate Umbrella Limits

The appropriate umbrella limit depends on the company's size, assets under management, investor relationships, and the contractual requirements of its lenders and joint venture partners. Common umbrella limit structures:

- **$5 million umbrella.** Appropriate for an emerging development company with under $50 million in assets under management and individual investor relationships. Provides meaningful additional protection above primary CGL limits at a relatively modest premium.
- **$10 million umbrella.** Appropriate as assets under management grow above $50 million, or when institutional investors or co-investment partners require higher total limits as a contractual condition.
- **$25 million and up.** Required in some institutional LP side letters and co-investment agreements for platforms managing significant assets under management. Achieved through a combination of umbrella and excess layers, each building on the last.

Umbrella premiums are relatively modest compared to primary coverage. A $5 million umbrella above a $1 million CGL might cost $3,000 to $8,000 per year for an emerging development company with a clean claims history. The cost-effectiveness of umbrella coverage makes it among the highest-value insurance investments a development company can make.

Cyber Liability Insurance

Cyber Liability insurance covers losses arising from data breaches, cyber attacks, ransomware, and other digital security incidents. For a real estate development company, the most significant cyber exposure is the investor data it holds: personal and financial information for every individual who has subscribed to one of the company's deals, including names, addresses, Social Security numbers, tax identification numbers, net worth information, and banking details for subscription fund transfers.

This investor data is valuable to cybercriminals, who can use it for identity theft, financial fraud, and targeted phishing attacks. Its loss can also expose the company to regulatory sanctions, investor claims, and reputational damage that extends well beyond the direct cost of the breach.

The Regulatory Context

The SEC's attention to cybersecurity for investment advisers and fund managers has intensified in recent years, and the specific obligations came into sharper focus as the rulemaking settled. The Commission's 2022 proposal that would have required advisers to report significant cybersecurity incidents to the SEC on a dedicated form was withdrawn in 2025 and will not be adopted. What governs today are the amendments to Regulation S-P, adopted in 2024, which apply to SEC-registered investment advisers and phase in across covered institutions through mid-2026. For a covered adviser, those amendments require:

- Written policies and procedures for an incident response program reasonably designed to detect, respond to, and recover from unauthorized access to or use of customer information.
- Notification of affected individuals whose sensitive customer information was, or is reasonably likely to have been, accessed or used without authorization, generally within 30 days of the adviser becoming aware of the incident.

- Oversight of service providers that receive customer information, along with the recordkeeping the amended rule requires.

A development company that is a registered investment adviser is directly subject to these requirements. An Exempt Reporting Adviser should adopt comparable practices, both as a matter of good governance and because state data-breach notification laws apply regardless of federal registration status. Either way, a development company holding sensitive investor data should treat cybersecurity compliance as a regulatory obligation, not merely a business risk management question. Cyber liability insurance supports that framework by funding the incident response, legal notification, credit monitoring, and regulatory cooperation costs that arise when a breach occurs.

What Cyber Liability Insurance Covers

Cyber liability insurance for a development company should address the following categories of loss:

- **First-party data breach costs.** The company's own costs of responding to a data breach, including forensic investigation to identify the scope and source of the breach, legal counsel to advise on notification obligations, notification costs (mailing, website notices, call center), and credit monitoring services for affected individuals.
- **Third-party liability.** Claims from affected investors or other parties whose data was compromised in the breach, alleging that the company failed to adequately protect their information.
- **Business interruption.** Lost income and extra expense during the period when the company's systems are disrupted by a cyber attack or ransomware incident.
- **Ransomware and cyber extortion.** The cost of responding to a ransomware attack, including negotiation costs and, in some cases, the ransom payment itself, subject to applicable legal considerations.
- **Regulatory defense and fines.** Legal costs in connection with regulatory investigations or enforcement actions arising from a data breach, and in some states, coverage for regulatory fines, though coverage of fines varies by jurisdiction and policy.

Coverage limits for an emerging development company typically start at $1 million to $3 million. Annual premiums range from $5,000 to $20,000 depending on the company's assets under management, the sensitivity of the data it holds, its existing cybersecurity controls, and the claims history of the cybersecurity market generally.

Workers' Compensation Insurance

Workers' compensation insurance is legally mandated for any employer with employees in virtually every state. It provides benefits to employees who suffer work-related injuries or illnesses: medical treatment costs, temporary wage replacement during recovery, permanent disability benefits, and, in fatal cases, death benefits to the worker's dependents. The system is no-fault: the employee does not need to prove the employer was negligent; the injury or illness need only be work-related.

In exchange for providing workers' compensation coverage, employers receive immunity from most employee lawsuits for work-related injuries, the workers' compensation claim being the exclusive remedy in most circumstances. This immunity is the quid pro quo for mandatory coverage: the employer accepts a defined, insured liability in exchange for protection against unpredictable tort liability.

Premium Calculation and Classification

Workers' compensation premiums are calculated based on payroll size and the classification codes assigned to each category of employee. Classification codes reflect the risk profile of different types of work: office-based employees, including the company's analysts, financial professionals, and administrative staff, carry very low classification rates, typically $0.10 to $0.50 per $100 of payroll. Employees who regularly visit active construction sites, the managing partner who oversees construction, the project manager who attends weekly owner-architect-contractor meetings, the construction manager who walks the site daily, may be classified at higher rates reflecting their exposure to construction hazards.

The company should work with its workers' compensation carrier and a specialized insurance broker to ensure each employee is correctly classified. Incorrect classification can result in audit-triggered premium adjustments that retroactively increase the company's insurance cost, and in some cases coverage disputes when an incorrectly classified employee makes a claim.

Construction Site Exposure

For a development company whose principals and employees regularly visit active construction sites, a daily reality for most ground-up developers, the workers' compensation analysis must address several specific questions:

- **Are the company's employees covered for injuries on the construction site?** In most states, yes: an employee injured at a project site in the course of their employment is covered by the company's workers' compensation policy regardless of where the injury occurs.
- **Does the general contractor's workers' compensation policy cover the development company's employees?** Generally, no: the general contractor's policy covers its own employees and potentially its subcontractors, but not the development company's employees who are on site in an owner's representative capacity.
- **What if a construction worker employed by the general contractor or a subcontractor is injured due to the development company's negligence?** The injured worker's workers' compensation claim is against their employer (the general contractor or sub), but the general contractor or sub may have a separate claim against the development company for contribution or indemnification if the development company's negligence contributed to the injury. This exposure is addressed by the management company's CGL policy and umbrella coverage.

Key-Person Life Insurance and the Buy-Sell Agreement

Key-person life insurance and the buy-sell agreement it funds address one of the most practically disruptive events a real estate development partnership can face: the unexpected death of a founding partner. Without a funded plan for this scenario, the death of a founding partner creates simultaneous crises. The company loses key personnel, management, and relationships at the worst possible moment, and the partner's estate immediately becomes a significant equity holder with legal rights the surviving partners must navigate while also running the company through a difficult operational transition.

The Death Scenario Without Insurance

When a founding partner dies without a funded buy-sell agreement, the operating agreement's death provisions determine the legal framework but provide no mechanism for actually funding the buyout. The partner's equity passes to their estate. The estate has economic rights, distributions, information rights, and potentially voting rights on certain matters, but the estate's relationship with the surviving partners is fundamentally different from the partner relationship that preceded it.

The estate's executor has fiduciary obligations to maximize the value of the estate's assets. A development company equity interest whose value depends entirely on continued management by the surviving partners is an illiquid, difficult-to-value asset the estate may want to convert to cash as quickly as possible. The surviving partners, who must now buy out the estate, may not have the personal liquidity to do so at fair market value without disrupting the company's operations or taking on debt. Life insurance solves this problem by providing the cash needed to fund the buyout immediately upon the partner's death, without requiring the surviving partners to liquidate personal assets or the company to disrupt its operations.

Buy-Sell Agreement Structures

The buy-sell agreement, which may be incorporated into the operating agreement or drafted separately, specifies the mechanism by which the company or the surviving partners purchase the deceased partner's equity interest. The two primary life insurance funding structures:

- **Entity purchase (redemption) structure.** The company is the owner and beneficiary of the life insurance policies on each partner's life. When a partner dies, the company collects the insurance proceeds and uses them to purchase the deceased partner's equity interest from the estate. The surviving partners' percentage ownership increases proportionally as a result of the redemption.
- **Cross-purchase structure.** Each partner owns life insurance policies on the lives of the other partners. When a partner dies, the surviving partners collect the insurance proceeds and use them personally to purchase the deceased partner's equity interest from the estate. The surviving partners receive an increase in their tax basis in the purchased equity equal to the purchase price, which is advantageous when the equity is eventually sold.

The choice between entity purchase and cross-purchase has important tax implications that should be evaluated with the company's CPA before the structure is implemented. The cross-purchase structure provides a stepped-up tax basis for the surviving partners, which reduces their capital gains exposure when the company is eventually sold. The entity purchase structure is simpler to administer as the company grows (fewer policies required) but does not provide the same basis step-up benefit.

Coverage Amount and Policy Structure

The face amount of each life insurance policy should equal the insured partner's equity interest's fair market value at the time of purchase, or a formula-based equivalent that approximates fair market value. Because the company's value changes over time as the business grows, the coverage amounts should be reviewed and updated periodically, at minimum annually as part of the annual business plan process, to ensure the coverage remains adequate to fund a buyout at current value.

Term life insurance is the simplest and least expensive structure: the policy pays a defined death benefit if the insured dies within the policy term, with no cash value accumulation. A 10-year or 20-year term policy covers the period during which the partnership is most active and the equity interest most valuable. Permanent life insurance (whole life, universal life) builds cash value over time but costs more than term coverage for the same death benefit. The appropriate product depends on the partnership's specific circumstances and the partners' long-term planning objectives.

Long-Term Disability Insurance

Long-term disability insurance deserves consideration alongside life insurance for the same key-person protection rationale. While life insurance addresses the permanent loss of a partner, long-term disability insurance addresses a scenario that may be practically more disruptive: a founding

partner who is seriously injured or ill and cannot work, but remains alive and retains all their equity rights and governance authority.

A founding partner who suffers a long-term disability becomes, in functional terms, a passive equity holder rather than an active operational partner. The operating agreement's disability provisions, addressed in Chapter 16, specify the governance consequences of disability. Long-term disability insurance provides income replacement to the disabled partner, reducing the personal financial pressure that might otherwise lead the disabled partner's family to press for an immediate, distressed buyout of the equity at a disadvantageous time.

For the founding partners personally, disability insurance replacing 60 to 70 percent of their guaranteed payment or compensation during a disability period is a meaningful financial planning benefit. Group long-term disability policies offered through the company benefit from group rates more favorable than individual policies, making them a cost-effective benefit to provide to partners and key employees alike.

The Indemnification Provisions and Their Relationship to Insurance

The operating agreement's indemnification provisions create a framework the insurance program must support. As discussed in Chapter 4, the indemnification provision obligates the company to defend and indemnify the managing member and other managers against third-party claims arising from their management activities, to the fullest extent permitted by state law, except for claims resulting from bad faith, willful misconduct, or fraud.

The D&O policy is the financial mechanism that makes this indemnification promise fundable. But the relationship between the indemnification provisions and the D&O policy requires careful attention in three specific areas:

- **Alignment of scope.** The indemnification provisions must align with the D&O policy's definitions and exclusions. If the operating agreement indemnifies the managing member for a category of claims the D&O policy excludes, the operating agreement creates a company obligation the company must fund from its own assets. Coordinating the indemnification provisions' scope with the D&O policy's coverage scope ensures the indemnification promise is backed by insurance wherever possible.
- **Advancement of defense costs.** When a claim is made, the insured needs access to defense counsel immediately, before the claim's merits are determined. The D&O policy should contain a specific provision requiring the carrier to advance defense costs as they are incurred, subject to the insured's agreement to repay the advances if it is ultimately determined that coverage does not apply. The operating agreement's indemnification provisions should similarly specify that the company will advance defense costs before the final disposition of the claim.
- **The Side A interplay.** The interplay between the individual partners' personal indemnification rights and the company's D&O Side A coverage must be understood. Side A pays when the company cannot indemnify the individual. If the company is solvent and the indemnification provisions apply, the company's Side B coverage (reimbursement of indemnification payments) is the relevant insuring agreement. If the company is insolvent or legally prohibited from indemnifying, the individual's Side A coverage provides direct protection. This sequencing is exactly what makes D&O coverage essential even when the operating agreement's indemnification provisions appear comprehensive.

The Insurance Coverage Checklist

The reference table below summarizes the complete insurance program for a real estate development and sponsor company, organized by coverage type with recommended minimum limits for a company at the emerging-to-established stage ($5M to $50M in deal volume), typical premium ranges, and the policy trigger that determines when coverage applies.

Coverage type	Minimum recommended limits	Approx. annual premium (emerging co.)	Policy form	What triggers coverage
D&O / Management Liability	$2M to $5M (increase as AUM grows)	$15,000 to $45,000	Claims-made	Claim alleging management misconduct, breach of fiduciary duty, securities violation, or misrepresentation to investors
E&O / Professional Liability	$1M to $3M	$8,000 to $25,000	Claims-made	Claim alleging professional negligence, failure to perform services with required skill and care, or errors in representations
General Commercial Liability (CGL)	$1M per occurrence / $2M aggregate	$4,000 to $10,000	Occurrence	Third-party claim for bodily injury or property damage arising from company operations, premises, or products
Employment Practices Liability (EPLI)	$1M per claim / $2M aggregate	$3,000 to $10,000	Claims-made	Employee claim of wrongful termination, discrimination, harassment, retaliation, or other employment violation
Cyber Liability	$1M to $3M	$5,000 to $20,000	Claims-made	Data breach, cyber attack, ransomware, or unauthorized access to or disclosure of company or investor data
Workers' Compensation	Statutory (mandated by state); employer's liability $500K / $500K / $500K	$2,000 to $8,000	Occurrence (statutory)	Work-related employee injury or illness; mandatory for all employees in virtually every state
Builder's Risk (per project)	100% of completed value of structure	$5,000 to $30,000+ per project (varies by size and risk)	Occurrence (project-specific)	Physical damage to a structure under construction from covered perils (fire, wind, theft, vandalism)
Umbrella / Excess Liability	$5M to $10M above primary CGL	$3,000 to $12,000	Follow-form (tracks primary policy)	Any claim that exhausts the underlying primary policy's limits
Key-Person Life Insurance	Equal to each partner's equity interest FMV; minimum $1M per partner	Variable (term life): $2,000 to $8,000 per partner annually	Term or permanent life	Death of an insured founding partner during the policy term; proceeds fund the buy-sell buyout
Long-Term Disability	60 to 70% of each partner's guaranteed payment or compensation	$3,000 to $8,000 per partner annually (group rates)	Disability (elimination period typically 90 to 180 days)	Insured partner unable to perform material duties longer than the elimination period due to injury or illness

These premium ranges are illustrative for a company at the emerging stage with $5 million to $50 million in annual deal volume, office-based operations with regular construction site visits, and individual investor relationships. Premiums will be higher for companies with larger assets under management, institutional investor relationships, prior claims, construction site employment classifications, or an adverse loss history. Engaging a specialized real estate company insurance broker, one who works specifically with development companies and is familiar with the coverage structures described in this chapter, is strongly recommended over using a general commercial insurance broker who may not understand the specific risks and coverage requirements of the development business.

CHAPTER 15: KEY TAKEAWAYS

1. Insurance is the funded backstop for the liability protections and indemnification rights created by the entity structure and the operating agreement. A company that indemnifies its managing member against third-party claims but carries no D&O

coverage has made a promise it may not be able to keep. The D&O policy converts the operating agreement's indemnification promise into funded protection.

2. D&O / Management Liability insurance is the single most important coverage for a development company that manages outside investor capital. Side A coverage protects the individual principals when the company cannot indemnify them; Side B reimburses the company for indemnification payments; Side C protects the company entity in securities claims. The founding team should confirm all three insuring agreements are present in the policy before binding coverage.
3. EPLI coverage must be obtained before the first employee starts work. Employment claims can arise from the earliest hires, and a claims-made policy purchased after a claim arises does not cover that claim. The cost of EPLI for an emerging development company ($3,000 to $10,000 per year) is modest relative to the cost of defending an employment claim ($50,000 to $150,000 in defense costs for even a meritless allegation).
4. Cyber liability insurance addresses the investor data exposure that is unique to a development company managing outside capital: a breach of investor personal and financial information creates regulatory sanctions, investor claims, and reputational damage. The amendments to Regulation S-P, which require a written incident response program and breach notification to affected individuals, make cybersecurity a regulatory obligation for registered advisers, not merely a business risk management question.
5. Key-person life insurance and the buy-sell agreement it funds address the practical disruption caused by an unexpected partner death. Without funded coverage, the surviving partners face a simultaneous operational and financial crisis: the loss of key management and the obligation to buy out an estate with legal rights but no operational role. The entity purchase and cross-purchase structure decision has important tax basis implications that require CPA coordination.
6. The insurance program's scope and limits must be reviewed annually and whenever the company adds investors, increases deal volume, expands geographically, or engages in new activities. Coverage that was adequate at formation may be inadequate after three years of growth. Engaging a specialized real estate company insurance broker who understands development company risks is worth the incremental cost over a general commercial insurance broker.

WHAT COMES NEXT

Chapter 16 completes Part V by addressing transfer restrictions and the complete framework for partner exits under every departure scenario, from voluntary resignation through death, disability, divorce, and termination for cause. Part VI of the handbook then turns to disputes, succession, and long-term planning: Chapter 17 covers dispute resolution and the deadlock mechanisms that let a company survive serious partner disagreements without destroying the business, and Chapter 18 covers succession planning and the eventual wind-down.

See also: *Appendix I (Insurance Coverage Checklist: the complete checklist formatted as a standalone reference document) • Chapter 4 (The Operating Agreement: the indemnification provisions that insurance must fund) • Appendix J (Glossary: D&O, E&O, EPLI, Builder's Risk, claims-made, occurrence, buy-sell agreement, Side A / B / C coverage)*

CH. 16

PART V: FIDUCIARY DUTIES, RISK MANAGEMENT & PARTNER PROTECTION

Transfer Restrictions

and Partner Exit Mechanics

The complete framework governing how membership interests move, what protections prevent unwanted transfers, and how every departure scenario, from voluntary resignation to death, bankruptcy, and termination for cause, is governed by the operating agreement.

Every partnership eventually faces the departure of a partner. The departure may be planned and amicable, a founding partner who retires after fifteen years of contribution. It may be unexpected and wrenching, a key partner who dies at the peak of the company's growth. It may be acrimonious and legally complex, a partner terminated for cause after a relationship that deteriorated over years. What determines whether the company survives the departure intact is not goodwill in the moment of crisis but the quality of the provisions drafted long before the crisis arrived.

This chapter addresses transfer restrictions, the provisions that keep membership interests from moving to unintended parties, and the complete exit mechanics framework: what happens to a partner's equity, governance rights, and economic interests under every departure scenario. The exit mechanics framework completes the vesting and departure analysis begun in Chapter 5, adding the transfer restriction provisions that protect the company from forced inclusion of unwanted new members through involuntary transfers.

Why Transfer Restrictions Are the First Line of Defense

A real estate development company is, at bottom, a people business. The company's value derives from the specific relationships, expertise, and judgment of its founding partners. Those qualities do not automatically transfer to a person who acquires a membership interest through sale, gift, divorce decree, or bankruptcy proceedings. The spouse who receives a membership interest as part of a divorce settlement, the creditor who receives an interest in satisfaction of a debt, and the investor who purchases an interest from a departing partner on the secondary market all have something in common: they have acquired an economic interest in a business that depends on a set of working relationships they had no part in building.

Transfer restrictions are the operating agreement provisions that prevent this without the company's consent. They do not restrict the transferring partner's right to receive the economic value of their interest; they do not prevent the partner from selling their interest or from having it taken by a creditor. What they restrict is the transferee's ability to become a full member with governance rights, and they give the remaining partners and the company the right to purchase the interest before it passes to an outsider.

Failing to include robust transfer restrictions exposes the company to scenarios where people the founding partners never chose become their business associates by operation of law or by transaction. Every operating agreement for a development company must address, at minimum: the prohibition on voluntary transfers without consent; the right of first refusal on proposed voluntary transfers; the consequences of involuntary transfers (bankruptcy, divorce, creditor judgment); drag-along rights that allow the majority to require co-sale; and tag-along rights that protect minority partners against a majority-only sale.

The Lock-Up Period

The lock-up period is the most fundamental transfer restriction: a defined period during which no founding partner may transfer, pledge, assign, or otherwise encumber their membership interest without the unanimous consent of the management committee. Unlike the right of first refusal, which allows transfers subject to the remaining partners' opportunity to purchase, the lock-up is an absolute prohibition that cannot be overridden by any amount of willing-buyer, willing-seller negotiation.

Appropriate Lock-Up Duration

The lock-up period for a founding partner's membership interest should correspond to the minimum service commitment that justifies the partner's founding equity, typically the cliff date in the vesting schedule discussed in Chapter 5. A four-year vesting schedule with a one-year cliff creates a natural lock-up architecture: the one-year cliff is the minimum lock-up, before which no vesting and no transferable economic value has accrued, and the full four years is the maximum period during which the company has the strongest interest in preventing any transfer.

For a company still building its investor relationships and deal pipeline, a two-year lock-up is a reasonable minimum. During this period the company is most fragile: its investor relationships are newly formed, its deal pipeline is thin, and any disruption to the founding team creates a level of operational and reputational risk disproportionate to its direct financial cost. A partner departure during the lock-up period is as much a governance crisis as an economic one.

Permitted Transfers During Lock-Up

Even during the lock-up period, certain transfers should be permissible without committee approval because they do not introduce a new active participant into the partnership:

- Transfers to a revocable living trust established for estate planning purposes, where the founding partner retains full control of the trust and serves as the trustee. The transfer is a change in the legal form of ownership; the beneficial owner remains the same, and the same individual continues to exercise all governance rights.
- Transfers to a wholly owned entity (such as a single-member LLC or family limited partnership) controlled entirely by the founding partner, for tax or estate planning purposes. Again, the transfer is a change in legal form; the beneficial owner and the person exercising governance rights remain the same.
- Transfers by operation of law in connection with the partner's death, not because this is a permitted voluntary transfer, but because the operating agreement's death provisions govern this scenario independently of the transfer restriction framework.

Permitted transfers during the lock-up period should be conditioned on the transferee executing a joinder agreement confirming they are bound by the operating agreement in all respects; the founding partner remaining the beneficial owner with no effective change in control of the transferred interest; and the founding partner remaining personally responsible for any obligations arising from the transferred interest, including any vesting conditions and capital call obligations.

Right of First Refusal

The right of first refusal (ROFR) is the primary transfer restriction mechanism after the lock-up period expires. It gives the company and the remaining partners the right to purchase a transferring

partner's membership interest on the same terms as those offered by the proposed outside transferee, before the outside transferee can complete the purchase.

The ROFR is the operating agreement's answer to the question of what happens if a founding partner receives a bona fide third-party offer for their interest and wants to accept it. The ROFR does not prevent the partner from selling; it gives the company and the partners a first opportunity to purchase the interest at the offered price before it passes to the third party. If the company and the partners exercise the ROFR, the partner receives the agreed price from the company or the partners rather than from the third party. If neither exercises within the defined exercise period, the partner may complete the transfer to the third party, subject to the transferee's agreement to be bound by the operating agreement.

The ROFR Mechanics

The operating agreement should specify the ROFR mechanics with enough precision to make the process work in a real transaction without ambiguity:

- **Notice requirement.** When a partner receives a bona fide offer for their interest and wishes to accept it, they must deliver written notice to the company and all remaining partners specifying the identity of the proposed transferee, the purchase price, the payment terms, and all other material conditions of the proposed transfer.
- **Exercise period.** The company and the remaining partners have a defined period, commonly 30 to 45 days from delivery of the notice, to elect to purchase the interest on the same terms. The election must be delivered in writing within the exercise period.
- **Priority of exercise.** The ROFR should specify who has the first right to exercise: typically the company first, and then the remaining partners pro-rata to their existing ownership percentages if the company does not exercise. This two-tier structure ensures the company always has the first opportunity to repurchase the interest and retire it, with the partners as backup purchasers if the company chooses not to or cannot fund the purchase.
- **Payment matching.** The ROFR requires the company or the partners to match the proposed transfer's price and material terms. If the proposed transfer contemplates deferred payment or non-cash consideration, a portion of the purchase price payable over three years, or a portion payable in an interest in another entity, the ROFR must address how those terms are matched. A common approach: if the proposed consideration includes non-cash components, the ROFR election allows the company or the partners to match with cash equal to the fair market value of the non-cash component.
- **Closing timeline.** If the ROFR is exercised, the closing should occur within 60 to 90 days of the exercise notice. If the exercising party cannot close within the timeline, the right lapses and the transfer to the original third party may proceed.

Valuation Issues in ROFR Transactions

The ROFR is straightforward when the proposed transfer is a cash sale at a fixed price to an identified buyer; the company or the partners simply match that price. The mechanics become more complicated in three specific scenarios:

- **The proposed transfer is a gift.** If a partner proposes to gift their interest to a family member, there is no price to match. The operating agreement should specify that the ROFR applies to gifts at a price equal to the fair market value of the interest on the date of the proposed transfer, determined using the valuation methodology specified for partner buyouts.
- **The proposed transfer is to an entity in which the transferring partner retains an interest.** If a partner transfers their interest to a family limited partnership in which they are a 50 percent limited partner, the transfer is not an arm's-length sale. The ROFR provision should address transfers to entities in which the transferring partner retains an indirect

interest, either by exempting permitted estate planning transfers or by subjecting them to a fair market value ROFR to prevent indirect circumvention of the restriction.

- **The proposed transfer is part of a larger transaction.** If a founding partner proposes to sell their interest as part of a transaction that also involves the sale of other assets or business interests, a sale of their entire portfolio including the development company membership interest, the ROFR applies only to the development company interest, priced at the portion of the total consideration attributable to that interest.

Drag-Along Rights

A drag-along right gives a defined majority of the partners the right to require all remaining partners to sell their interests on the same terms when the majority has agreed to sell the company or all or substantially all of its assets to a third party. Without a drag-along, a single minority partner can block the sale of the company simply by refusing to participate, even when a supermajority of the partners and the company's investors believe the sale is in everyone's best interest.

Why Drag-Along Rights Are Necessary

Most sophisticated acquirers of a professional services business, including a real estate development company, want to acquire 100 percent of the equity, not a majority stake that leaves a minority partner as a continuing co-owner. The reasons are practical: a minority partner who did not want to sell retains all the governance and economic rights of a member, creating ongoing complications for the acquirer. The drag-along provision enables the majority to deliver 100 percent of the equity to an acquirer, ensuring the company can be sold when the majority determines a sale is in the collective interest.

Without a drag-along, a minority partner who objects to a proposed sale has effective veto power over it, regardless of how economically compelling the transaction might be and regardless of what percentage of the partnership agrees. That veto power can be weaponized: a minority partner who knows the majority wants to sell has significant negotiating leverage to extract a premium for their consent, even when the value of that consent is not commensurate with their economic interest.

The Drag-Along Mechanics

A well-drafted drag-along provision specifies:

- **The trigger threshold.** What percentage of the partnership must agree to a sale before the drag-along can be exercised? A majority (greater than 50 percent) is the minimum; many operating agreements require a supermajority (66.7 percent or 75 percent) or a majority plus specific consent from the managing partner, to ensure the drag-along cannot be exercised against the management team's wishes by a coalition of passive minority partners.
- **The notice requirement.** The majority must deliver written notice to the dragged partners specifying the identity of the buyer, the purchase price per unit or ownership percentage, the payment terms, the closing timeline, and any representations or warranties the dragged partners will be required to make.
- **Pro-rata participation.** The dragged partners must receive the same price per unit of ownership (or the same equity multiple on their investment) as the partners who agreed to the sale. The drag-along cannot be used to sell the majority's interest at a premium while the dragged partners receive less for the same economic interest.
- **The representations and warranties requirement.** The dragged partners can be required to make representations and warranties about the ownership of their interests, the absence of liens and encumbrances, and their authority to sell. They generally cannot be required to

make representations and warranties about the company's business, financial condition, or operations; those are the responsibility of the management team.

- **Indemnification obligations.** The dragged partners' indemnification obligations in connection with the sale should be limited to losses arising from the breach of their own representations and warranties, and should be capped at the total consideration received by the dragged partner.

Drag-Along Protections for Minority Partners

The drag-along right can be a powerful tool against minority partners. The following protections are reasonable and should be incorporated into the provision to prevent its abuse:

- **Minimum price protection.** The drag-along cannot be exercised unless the proposed sale price represents a minimum return on each partner's invested capital, for example a minimum 1.0x return of invested capital or a minimum defined IRR. This prevents the majority from dragging minority partners into a fire-sale disposition at below-investment value.
- **Equivalent treatment of economic interests.** The dragged partners must receive the same consideration per unit of economic interest as the dragging partners. If the majority negotiates a premium for their controlling interest, that premium does not justify paying the minority less than a pro-rata equivalent.
- **Reasonable closing conditions.** The drag-along cannot expose the dragged partners to unreasonable conditions, such as uncapped indemnification obligations, escrow holdbacks of more than a reasonable percentage for a reasonable period, or representations the dragged partner cannot make in good faith.

Tag-Along Rights

Tag-along rights are the mirror image of drag-along rights: they protect minority partners by giving them the right to participate in any sale by a majority partner on the same terms as the majority. Without a tag-along, a majority partner could sell their interest to a third party, leaving the minority partners with a new co-owner they did not choose, one who may have fundamentally different objectives and governance expectations from the majority partner they replaced.

The tag-along right says that if the majority wants to sell, the minority gets to come along on the same terms. The minority partner's tag-along is a right, not an obligation: they can choose to participate in the sale or to remain as a continuing minority partner with the new majority owner.

How the Tag-Along Works in Practice

When a majority partner receives a bona fide offer to purchase their interest and proposes to accept it, they must deliver written notice to the minority partners specifying the terms of the proposed sale. The minority partners then have a defined period, typically 20 to 30 days, to elect to participate in the sale on the same terms by delivering a written tag-along notice.

If the minority partners exercise their tag-along right, the majority partner's sale must include the minority partners' interests on the same terms. The total consideration is allocated among all participating sellers pro-rata to their ownership percentages. If the acquirer is unwilling to purchase 100 percent of the company, having originally proposed to purchase only the majority's interest, the majority partner may choose to reduce the size of their sale proportionally to accommodate the tag-along interests, or may need to renegotiate with the acquirer.

The tag-along right should specify that it does not apply to permitted estate planning transfers that do not change the effective beneficial owner; transfers to entities controlled by the transferring

partner; or transfers pursuant to a drag-along (since the drag-along already protects the minority by requiring equal treatment).

Involuntary Transfers: Bankruptcy, Divorce, and Creditor Claims

Some of the most practically important transfer restrictions address involuntary transfers, situations where a partner's membership interest is subject to transfer by operation of law rather than by the partner's choice. Bankruptcy, divorce, and creditor judgment are the three most common involuntary transfer scenarios, and each creates different legal and governance challenges for the development company.

Bankruptcy of a Partner

When a founding partner files for bankruptcy protection, their membership interest becomes property of the bankruptcy estate and is subject to the trustee's authority. The Bankruptcy Code's automatic stay prevents the company from exercising any right that would constitute a transfer of the interest without bankruptcy court approval. This includes the exercise of any right of first refusal, any forced buyout at below-market value, and any forfeiture of the interest. The operating agreement's transfer restrictions can still be enforced in bankruptcy, but they must be structured carefully:

- The Bankruptcy Code prevents enforcement of ipso facto clauses, provisions that trigger adverse consequences for the bankrupt partner based solely on their bankruptcy filing. A provision that automatically terminates a partner's membership interest upon a bankruptcy filing is an ipso facto clause and is not enforceable in bankruptcy.
- The trustee takes the bankrupt partner's interest subject to the operating agreement's restrictions. The trustee cannot transfer the interest to a third party without complying with the ROFR provisions, and steps into the bankrupt partner's shoes for all economic rights but generally cannot force the company to accept the trustee as a full member with governance rights beyond what the operating agreement permits.
- The company should include a specific provision triggering a right of first refusal upon the partner's bankruptcy filing, at a price equal to the fair market value of the interest. The company can petition the bankruptcy court for relief from the automatic stay to exercise this ROFR. Courts generally grant relief in this context when the ROFR is at fair market value and the company's operational stability is at real risk from a third-party trustee exercising governance rights.

Divorce and Community Property

Divorce is a particularly challenging involuntary transfer scenario for development companies because of its intersection with community property law in the nine community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin). In these states, membership interests acquired during the marriage are presumptively community property, which means a divorcing partner's spouse may have a legal claim to half of the interest regardless of the operating agreement's transfer restrictions. The operating agreement should address the divorce scenario specifically:

- The transfer restriction provisions should state explicitly that any transfer of a membership interest pursuant to a divorce decree is subject to the ROFR and is not a permitted transfer without committee consent. The non-member spouse may receive a property settlement in the divorce, but the settlement should be funded by the divorcing partner (who keeps the full membership interest) paying the non-member spouse their share of the interest's value from personal funds, rather than by an actual transfer of the membership interest to the spouse.

- The non-member spouse's potential claim to the membership interest should be addressed through a spousal consent to the operating agreement's transfer restrictions, executed at formation by the spouse of each married founding partner. This consent acknowledges the non-member spouse's awareness of the restriction and their agreement that any community property interest in the membership interest is subject to the operating agreement's terms.
- If the non-member spouse actually receives a transfer of the membership interest pursuant to a divorce decree notwithstanding the transfer restrictions, the operating agreement should provide that the transferee spouse receives economic rights only (as an assignee, not a full member) and that the company has the right to purchase the interest from the spouse at fair market value within a defined period following the transfer.

Creditor Claims and Charging Orders

A charging order is the exclusive remedy available to a creditor of an LLC member who has obtained a judgment against the member personally. Unlike a seizure of the member's personal property, a charging order does not transfer the membership interest to the creditor; it creates a lien on the member's distributions from the LLC until the judgment is satisfied. The creditor with a charging order is entitled to receive distributions that would otherwise go to the debtor-member, but has no right to vote, manage, or demand any distributions from the LLC.

The charging order limitation is one of the most significant structural advantages of the LLC form for real estate professionals: a creditor who obtains a judgment against a founding partner cannot use that judgment to force their way into the development company or to demand a liquidating distribution. The creditor must wait for distributions the company chooses to make. The operating agreement should address the charging order scenario:

- **The restriction on transfers to charging order creditors.** The charging order creates a lien on distributions but does not transfer membership rights. The operating agreement should specify that the charging order creditor receives no governance rights, no information rights, and no ability to demand distributions the company is not otherwise making.
- **The company's purchase right.** The operating agreement may give the company the right (but not the obligation) to purchase the charged member's interest at fair market value at any time after a charging order has been entered against that interest. This purchase right lets the company resolve the charging order situation proactively rather than waiting for the creditor to obtain a foreclosure judgment.
- **The tax consequences of the charging order.** The charging order creates a situation where the charged member is allocated taxable income from the LLC, but the creditor may be receiving the corresponding cash distributions. This phantom income problem can create leverage for the LLC: the creditor, who is not technically the member, may or may not be obligated to pay tax on the income allocated to the charged membership interest. This complexity often motivates creditors to negotiate a resolution rather than holding the charging order indefinitely.

The Complete Partner Exit Framework

Building on the good leaver and bad leaver framework introduced in Chapter 5, this section presents the complete exit mechanics for every departure scenario a development company partnership may face. The framework addresses not only the economic consequences of each departure (the focus of Chapter 5) but also the governance transition, the timeline, and the specific operating agreement provisions that govern each scenario.

Voluntary Resignation

Voluntary resignation is the most common departure scenario and the one the operating agreement is most often inadequate to address with specificity. The relevant questions:

- **Advance notice.** The operating agreement should specify the minimum advance notice a resigning partner must provide, commonly 60 to 90 days for a founding partner, reflecting the company's need to plan for the operational transition. A partner who is not willing to provide the required notice may forfeit transition assistance rights or other departure benefits.
- **Transition obligations.** What operational obligations does the resigning partner have during the notice period? Is the partner expected to continue their management duties in full, assist in identifying a replacement, complete specific pending projects, and cooperate with the handover of investor relationships and deal responsibilities? These transition obligations should be specified in the operating agreement rather than negotiated in the middle of a departure that may be acrimonious.
- **Post-resignation economic rights.** A partner who resigns voluntarily retains their vested equity interest and the economic rights associated with it, subject to the good leaver and bad leaver determination. Their governance rights, the right to vote, to attend management committee meetings, to approve certain decisions, should be clearly addressed: does the resigning partner retain governance rights commensurate with their equity interest, or do those rights terminate or diminish upon resignation?
- **The buyout election.** Does the company have the right (or obligation) to buy out the resigning partner's equity interest? If the company elects to buy out, the buyout price and timeline are governed by the exit mechanics provisions. If the company does not, the resigning partner remains a member, with whatever governance rights the operating agreement specifies for non-managing members, until the company is sold or the interest is otherwise transferred or purchased.

Retirement

Retirement is conceptually similar to voluntary resignation but carries a presumption of longer service and a corresponding expectation of more favorable exit terms. For a founding partner who has served the company for a defined minimum period, often five to ten years, and who is departing for actual retirement rather than to pursue competitive activities, the operating agreement may provide more favorable exit terms than are available to a partner who resigns after a shorter tenure:

- Full vesting acceleration upon retirement after the minimum service period, recognizing that a partner who has served for ten years has fully earned their equity regardless of whether the vesting schedule has technically completed.
- An extended transition period and ongoing consulting arrangement (often six to twelve months) during which the retiring partner assists with investor relationship transitions, deal handovers, and the introduction of successor management.
- Ongoing economic participation in deals the retiring partner originated or for which they played a primary role, for a defined period after retirement, reflecting the value of long-term relationship and expertise contribution that should not be immediately severed.

Retirement provisions are most relevant for partnerships that anticipate long-term operations and where the founding partners may age into retirement during the company's life. They are less common in early-stage development companies where the founding partners are typically early-to-mid-career professionals with no immediate retirement horizon.

Termination for Cause

Termination for cause is the most legally sensitive departure scenario because its invocation simultaneously triggers the bad leaver consequences (forfeiture of unvested equity; buyout of vested equity at below-market price) and requires a finding of specific conduct that meets the

operating agreement's definition of cause. The provisions governing termination for cause must address:

- **The definition of cause.** As emphasized throughout this handbook, cause must be defined with specificity. The operating agreement must enumerate the specific categories of conduct that constitute cause: fraud, willful misconduct, conviction of a felony involving moral turpitude, material and uncured breach of the operating agreement, material misappropriation of company assets. A vague definition ('conduct detrimental to the company's interests') can be used to convert a governance dispute into a cause termination, producing the weaponized cause determination discussed in Chapter 5.
- **The required process.** Who makes the cause determination? The management committee, excluding the partner whose removal is proposed, is the appropriate decision-maker. What approval threshold is required? For consequences as severe as a bad leaver buyout, a supermajority of the disinterested committee is appropriate. Is a cure period required for remediable breaches? Thirty days is a common cure period for breaches of the operating agreement that do not involve fraud or felony.
- **The role of independent review.** For particularly contested cause determinations, where the disinterested committee is a bare majority and the alleged conduct is disputed, the operating agreement may provide for an independent arbitrator to make the threshold cause determination before bad leaver consequences are imposed. This protection prevents the majority from using a flimsy cause determination to execute a discounted buyout of a minority partner.
- **The transition from management role to member status.** A partner terminated for cause loses their management authority immediately and completely. Their equity interest, subject to the bad leaver consequences for the unvested portion, passes to the buyout mechanics. Their information rights may be restricted to prevent access to sensitive operational information during the period between the cause determination and the completion of the buyout.

Termination Without Cause

The company may remove a managing partner or partner from their management role without cause under the operating agreement's removal provisions. The key distinction from cause termination: a partner removed without cause has done nothing that justifies the bad leaver economic consequences. Their departure is the company's choice, not their misconduct, and the economic consequences must reflect this:

- **Good leaver treatment applies.** The partner retains their vested equity at fair market value. Unvested equity may be partially or fully accelerated depending on the operating agreement's provisions; full acceleration on involuntary termination without cause is the most partner-protective and the most appropriate treatment for a partner removed through no fault of their own.
- **The buyout obligation.** If the company elects to buy out the partner following a without-cause termination, the buyout must be at fair market value. The payment timeline should be reasonable; installments over 12 to 24 months with interest at a specified rate is typical for a company that may not have the liquidity to fund a lump-sum buyout.
- **The transition obligation.** A partner terminated without cause should be entitled to a transition period during which they can wind down their company relationships and work with a successor on investor and deal handovers. Refusing a reasonable transition period after a without-cause termination is both unfair and practically harmful to the company's investor relationships.

Death

The death of a founding partner is addressed in detail in Chapter 15's discussion of key-person life insurance and the buy-sell agreement. The operating agreement's death provisions must work in coordination with the life insurance program:

- The deceased partner's equity interest passes to their estate by operation of law. The estate has economic rights (to receive distributions on the vested interest) but should not automatically receive full governance rights. The company should not be required to accept the estate's executor or the ultimate heir as a full voting member.
- The vested equity is subject to full acceleration upon death: regardless of whether the four-year vesting schedule is complete, death is always treated as a good leaver departure and all unvested equity should vest immediately. The estate receives the full economic interest.
- The buy-sell agreement's insurance proceeds fund the buyout: the company or the surviving partners (depending on the buy-sell structure) use the life insurance proceeds to purchase the deceased partner's vested and accelerated interest from the estate at fair market value, within a defined period following death (commonly 90 to 180 days, providing time for the insurance claim to be processed and the estate to be opened).
- Governance continuity: during the period between the partner's death and the completion of the estate buyout, the company must be able to operate without the deceased partner's participation. The operating agreement should specify that management authority vests in the surviving partners during this period and that the estate's executor has no governance authority other than the right to receive information and to negotiate and close the buyout.

Permanent Disability

Long-term disability is the departure scenario most operating agreements address with the least specificity, perhaps because it is uncomfortable to plan for and lacks the emotional clarity of death. But a founding partner who is permanently disabled, who cannot perform their management duties for a defined extended period and is unlikely to recover to full capacity, creates the same governance and operational challenges as a departure through resignation, with the added complexity that the disabled partner remains alive, retains their legal rights, and may not be in a position to negotiate clearly about their departure. The operating agreement's disability provisions should address:

- **The definition of disability.** A partner should be considered permanently disabled when they have been unable to perform their material duties for a defined consecutive period (commonly 120 to 180 days) or for a defined period in any 12-month window (commonly 180 days), as confirmed by an independent medical evaluation. The definition should be objective and measurable, not dependent on the committee's subjective assessment.
- **The governance transition.** Management authority passes to the remaining partners during the disability period. The disabled partner's voting rights may be suspended or reduced during the period of disability, or may pass to a designated representative (a family member, attorney, or co-trustee) who can exercise those rights on the disabled partner's behalf.
- **The exit election.** After the disability has continued for the defined period, either the company or the disabled partner should have the right to elect a buyout of the disabled partner's equity interest at fair market value. The disabled partner should be treated as a good leaver with partial or full acceleration of unvested equity.

The Comprehensive Exit Scenarios Reference Table

The table below consolidates the exit mechanics for all major departure scenarios, providing a single reference that should be adapted and included as Appendix E to the operating agreement.

The founding team should review each line carefully, modify the terms to reflect their specific agreement, and ensure the resulting table is consistent with all other departure-related provisions in the operating agreement.

Departure trigger	Leaver type	Unvested equity	Vested equity price	Buyout timeline	Governance after departure
Voluntary resignation (post-cliff, full tenure)	Good	Forfeited; no acceleration	FMV; paid over 12 to 24 months at prime rate	Company election within 60 days of resignation; closing within 90 days thereafter	Economic rights retained; management authority terminates immediately; governance rights per OA
Voluntary resignation (pre-cliff)	Bad	100% forfeited	Lower of cost or nominal value	Company election within 30 days; expedited closing	All management and governance rights terminate on resignation date
Retirement (after defined minimum tenure)	Good (enhanced)	Full acceleration	FMV with premium for long tenure if OA provides	Transition period up to 12 months; buyout within 180 days	Transition consulting role if agreed; management authority transitions immediately
Termination without cause	Good	Full or partial acceleration per OA	FMV; paid over 12 to 24 months with interest	Company obligation to buy, or partner can require purchase at FMV	Management authority terminates; economic and reduced governance rights during buyout period
Termination for cause (after required process)	Bad	100% forfeited	Lower of cost or nominal value; possibly zero	Expedited; 30 to 60 days	All rights terminate on cause determination; information access restricted pending buyout
Death	Good (always)	Full acceleration; estate receives 100%	FMV; funded by life insurance proceeds	90 to 180 days post-death; insurance claim timeline	Estate has economic rights only; executor has no management authority; surviving partners manage
Permanent disability (defined period)	Good	Partial or full acceleration per OA	FMV; paid over 12 to 24 months	Either party may elect buyout after disability period confirmed; 90 to 120 days to close	Management authority passes to remaining partners; voting rights suspended or pass to representative
Bankruptcy	Bad (effectively)	Forfeited per OA; trustee takes subject to vesting	OA restrictions enforceable against trustee; FMV or ROFR price	ROFR triggered; company may seek bankruptcy court relief from stay	Trustee has economic rights only; no governance rights transfer to trustee
Divorce (community property)	Not a departure	Vesting unaffected by divorce decree	Spouse's share at FMV subject to ROFR	Company has election period to purchase spouse's share; 60 to 90 days from transfer	Non-member spouse receives economic interest only; no governance rights; must execute joinder
Material non-compete breach	Bad	Forfeited per OA	Below FMV; penalty provisions may apply	Expedited; company may seek emergency relief simultaneously	All rights may terminate pending injunction; tolling of covenant period applies

The Transition Plan: What Happens Operationally When a Partner Leaves

The legal and economic framework of the exit mechanics governs what happens to the departing partner's equity and economic rights. Equally important, and less often addressed in operating agreements, is what happens operationally when a founding partner leaves. The departure of a founding partner disrupts investor relationships, deal momentum, team morale, and the company's external reputation in ways the buyout mechanics do not address.

The operating agreement should require each founding partner to maintain a current transition plan the company can activate immediately upon a departure. The transition plan is a living document, updated annually as part of the business plan process, that addresses:

- **Investor relationship handover.** For each investor relationship the departing partner has been primarily responsible for, the transition plan identifies the partner or employee who will assume primary responsibility, the communication plan for notifying the investor of the transition, and the timeline for introducing the successor relationship manager. Investor transitions should happen before the departure is publicly known wherever possible: a letter or call from the departing partner introducing the successor is far more confidence-inspiring than an abrupt introduction from a stranger after the departure is announced.
- **Deal and project handover.** For each active deal or project the departing partner has been primarily responsible for, the transition plan identifies the successor project lead, documents

the deal's current status, outstanding decisions, and upcoming deadlines, and specifies the completion of any pending obligations before the departure date.

- **System and data access transition.** The departing partner's access to company systems, the investor CRM, the financial modeling tools, the project management platform, the company email, should be transitioned systematically: the departing partner's data is exported and archived, and access is terminated on the departure date. The transition plan specifies who assumes ownership of each critical system function and dataset.
- **Key relationships with third parties.** Lenders, general contractors, brokers, municipal contacts, and other third parties who have worked primarily with the departing partner should be introduced to their successor contact at the company before the departure is announced. The transition plan identifies each such relationship and the planned introduction timeline.

The transition plan requirement should be mutual and enforced: each partner should understand that their departure, under any circumstances, includes a transition obligation. A partner who refuses to cooperate with the transition plan, who departs abruptly without honoring transition obligations, has breached their obligations to the company and to the co-partners who will bear the transition's burden. That breach should be specifically referenced in the operating agreement's remedies section as a basis for adjustment to the departing partner's economic entitlements.

CHAPTER 16: KEY TAKEAWAYS

1. Transfer restrictions are the operating agreement's first line of defense against the company being forced to accept unwanted business associates through voluntary transfers, involuntary legal processes, or transactions that were never intended to bring outsiders into the partnership. The complete framework includes the lock-up period, the right of first refusal, drag-along rights, and tag-along rights, each protecting a different aspect of the company's right to control its membership.
2. The lock-up period is an absolute prohibition on any transfer of membership interests during the company's most vulnerable formation period. Permitted transfers during lock-up, to a revocable living trust or a wholly controlled entity, must be conditioned on the founding partner retaining beneficial ownership, the transferee executing a joinder to the operating agreement, and the partner remaining personally responsible for all vesting conditions and capital call obligations.
3. The right of first refusal gives the company and the remaining partners the opportunity to purchase a transferring partner's interest on the same terms as a proposed outside transfer, preventing the introduction of an unknown third party as a new business associate. The ROFR mechanics must address the priority of exercise (company first, then remaining partners pro-rata), the exercise period, payment matching for non-cash consideration, and the closing timeline.
4. Drag-along rights enable a defined majority to deliver 100 percent of the company to an acquirer without being blocked by minority holdouts. The drag-along threshold should require a meaningful supermajority; the mechanics must ensure pro-rata treatment for dragged partners; and specific protections (minimum price, reasonable representations only, capped indemnification) prevent the drag-along from being weaponized against minority partners.
5. Involuntary transfers through bankruptcy, divorce, and creditor charging orders require specific operating agreement provisions. Ipso facto clauses that automatically terminate a bankrupt partner's interest are not enforceable; instead, the company should have a right of first refusal at fair market value, exercisable with bankruptcy court approval.

Divorce in community property states requires spousal consent to the transfer restrictions at formation. Charging orders give creditors economic rights to distributions only, with no governance rights transferred.

6. The complete exit mechanics framework addresses every departure scenario from voluntary resignation through death, disability, bankruptcy, divorce, cause termination, and without-cause termination. The comprehensive reference table in this chapter provides the summary that should be adapted and included as an operating agreement exhibit. The critical variables for each scenario are: good leaver or bad leaver classification, unvested equity treatment, vested equity buyout price, payment timeline, and governance consequences.
7. The transition plan requirement, each partner maintaining a current document addressing investor relationship handovers, project continuity, system access transitions, and third-party relationship introductions, converts the abstract right to a partner's cooperation into a documented, enforceable obligation. A partner who departs without honoring transition obligations has breached a specific provision of the operating agreement, creating a basis for remedies beyond the normal exit mechanics.

WHAT COMES NEXT

Chapter 17 opens Part VI and takes up the governance mechanisms that let a company survive deep disagreement among its partners without destroying the business. Dispute resolution, deadlock mechanisms, and the governance tools that keep a fundamental impasse from becoming a forced liquidation are among the most technically important provisions in any partnership operating agreement, and among the most rarely used until they are desperately needed.

See also: *Chapter 5 (Good Leaver and Bad Leaver framework and vesting schedules) • Chapter 15 (Key-person life insurance and the buy-sell agreement) • Appendix E (Partner Exit Scenarios Table: the standalone exhibit referenced throughout this chapter) • Appendix J (Glossary: lock-up, ROFR, drag-along, tag-along, charging order, ipso facto clause, community property)*

CH. 17

PART VI: DISPUTES, SUCCESSION & LONG-TERM PLANNING

Dispute Resolution

and Deadlock Mechanisms

How to design a dispute resolution framework that resolves partner conflicts efficiently without litigation, and deadlock mechanisms that prevent a fundamental impasse from becoming a forced dissolution of a company that could otherwise survive.

Every partnership eventually experiences disagreement. The disagreements that resolve through normal governance, a management committee meeting, a deliberate discussion, a compromise both sides find acceptable, are not the ones this chapter addresses. This chapter is about the disputes that do not resolve through normal governance, that escalate despite the partners' best intentions, and that threaten the company's operational stability if they are not managed through a process designed for exactly this eventuality.

The dispute resolution framework in the operating agreement is one of the most important provisions a real estate development company's founders can negotiate, and one of the most consistently underestimated. Founding partners who are enthusiastic about their venture and confident in each other's judgment tend to treat this section as boilerplate. The partners who understand its importance are the ones who have either lived through a partnership dispute without one or counseled clients through the devastation of a contested LLC dissolution.

The Escalation Framework: A Tiered Approach to Conflict Resolution

The dispute resolution framework in a well-drafted operating agreement is not a binary choice between doing nothing and going to arbitration; it is a tiered escalation process that provides structured mechanisms for resolution at each level of conflict intensity, from a simple misunderstanding between co-founders to a full-blown governance deadlock that neither party is willing to break by capitulation.

The value of a tiered approach is both practical and psychological. Practically, most disputes that would otherwise proceed to arbitration or litigation can be resolved at a lower level of the escalation framework if the parties have a structured process to follow and a relationship with a neutral third party who can facilitate. Psychologically, the knowledge that a dispute can be escalated through defined steps, rather than jumping immediately from disagreement to litigation, reduces the incentive for strategic behavior: a party who cannot immediately threaten litigation has less ability to use the dispute as leverage.

TIER 1

Direct Negotiation Between the Principals

The first step in any dispute is direct discussion between the founding partners most directly involved in the disagreement. The operating agreement should require a defined good-faith negotiation period, commonly 30 days from written notice of the dispute, during which the principals attempt to resolve the matter themselves before any formal process is invoked. The notice

requirement matters: it creates a documented starting point for the timeline and prevents either party from claiming that informal conversations satisfied the direct negotiation requirement.

▼

TIER 2

Management Committee Escalation

If direct negotiation between the involved partners does not produce a resolution within the defined period, the dispute is escalated to the full management committee. The full committee brings additional perspectives and may identify compromise positions the directly involved parties could not see from within the dispute. The committee escalation should have its own defined period, typically 30 days, and should include a formal meeting dedicated to the dispute, with the objective of producing a documented resolution.

▼

TIER 3

Mediation

If committee escalation does not produce a resolution, the dispute proceeds to mediation: a structured process in which a trained, neutral mediator facilitates the parties' efforts to reach a mutually acceptable resolution. Mediation is non-binding, neither party is obligated to accept any resolution the mediator proposes, but it produces resolution in the vast majority of commercial disputes that reach it. The operating agreement should specify the mediation provider (JAMS, AAA, or a qualified independent mediator), the selection process if the parties cannot agree on a specific mediator, the location, and the cost allocation.

▼

TIER 4

Binding Arbitration

If mediation fails, the dispute proceeds to binding arbitration. The arbitrator's decision is final and enforceable as a court judgment. Arbitration is faster and more private than litigation, but it is also expensive and its outcomes are essentially unreviewable. The arbitration provision must address the arbitration provider (JAMS and AAA are the two primary options for commercial disputes), the number of arbitrators (one for smaller disputes, three for larger or more complex ones), the seat of arbitration, the governing law, and the allocation of arbitration costs.

The tiered structure is only as effective as the provisions that prevent parties from skipping steps. The operating agreement should specify that no party may invoke arbitration without first completing the direct negotiation and mediation steps, and that any attempted arbitration that skips these steps is premature and subject to dismissal. The only exception to the sequential requirement should be the emergency equitable relief carve-out discussed later in this chapter.

Mediation: The Most Undervalued Dispute Resolution Tool

Mediation is not a weaker version of arbitration but a fundamentally different process with a different objective: where arbitration produces a winner and a loser, mediation produces a negotiated resolution both parties have chosen to accept. This distinction matters enormously in the partnership context, where the parties will often continue to work together after the dispute is

resolved and where a resolution one party feels was forced on them will generate ongoing resentment that ultimately produces another dispute.

How Mediation Works

A commercial mediation typically proceeds as follows. The parties engage a mutually agreed neutral mediator, ideally a retired judge or senior attorney with experience in real estate partnership disputes. The mediator meets with both parties together for an opening session in which each side presents its view of the dispute and its objectives. The mediator then conducts separate, confidential sessions (caucuses) with each party, exploring the parties' interests, concerns, and negotiating positions in a confidential setting.

The key to mediation's effectiveness is the confidential caucus: each party can tell the mediator things they would not say in a joint session, the limits of their acceptable resolution, the personal dynamics driving the dispute, their concerns about the arbitration outcome if mediation fails. The mediator uses this information to facilitate movement between the parties' positions, identifying zone-of-agreement opportunities the parties themselves cannot see because of the adversarial dynamic of direct negotiation.

Commercial mediations resolve roughly 70 to 85 percent of the disputes that reach them, including many that both parties believed were irreconcilable before the process began. The investment of one or two days of time and $10,000 to $30,000 in mediator fees is trivial compared to the cost and duration of a contested arbitration, making mediation the highest-return dispute resolution tool available to a development partnership.

Selecting the Right Mediator

The mediator's experience and style significantly affect the outcome of the process. For a development company partnership dispute, the ideal mediator has:

- **Experience with real estate partnership disputes specifically.** Understanding the economic dynamics, the fiduciary duty framework, and the valuation questions that arise in real estate LLC disputes.
- **A facilitative or evaluative approach appropriate to the dispute.** A facilitative mediator focuses on helping the parties identify their interests and find their own resolution; an evaluative mediator more actively expresses views about the likely arbitration outcome if mediation fails. For disputes involving real legal uncertainty, an evaluative approach may accelerate resolution by helping the parties assess their litigation risks more realistically.
- **No prior relationship with either party** that could undermine the appearance of neutrality.
- **Experience managing high-conflict, interpersonally deteriorated partner disputes,** which differs from mediating an insurance coverage dispute between sophisticated corporations.

The operating agreement should establish a mediator selection process that does not require the parties to agree on a mediator in the middle of a dispute they have already failed to resolve by agreement. Common approaches: the parties each nominate one mediator candidate, and the two nominees together select a third; or the parties defer to the designated mediation provider's appointment process.

Making Mediation Mandatory

The operating agreement should require mediation as a condition precedent to arbitration. A party who files for arbitration without first completing the mediation requirement should be subject to dismissal of the premature arbitration demand and potentially to cost-shifting for the other party's legal fees in opposing the premature filing.

Mandatory mediation does not take away either party's ultimate right to arbitration. It simply requires that a serious effort at mediation precede the binding process. The only category of dispute that should not be required to pass through mediation before proceeding to court or arbitration is emergency equitable relief, where the immediate harm from waiting for a mediation schedule would be irreparable.

Binding Arbitration: Designing the Right Framework

Arbitration is the binding dispute resolution mechanism that replaces court litigation for contract disputes between the parties. It has advantages over litigation, speed, privacy, and finality, and disadvantages, expense, limited appellate review, and potentially less judicial expertise in complex legal questions. The arbitration provision's design determines whether those advantages are actually realized in a real dispute.

Arbitration Provider Selection

The two dominant providers of commercial arbitration in the United States are JAMS (Judicial Arbitration and Mediation Services) and the American Arbitration Association (AAA). Both have experienced commercial arbitrators, established procedural rules, and nationwide facilities. The choice between them is largely a matter of practical preference rather than a significant quality distinction. Key considerations:

- **JAMS** is generally viewed as slightly more expensive (higher arbitrator fees) and more oriented toward high-stakes complex commercial disputes. Its arbitrators tend to be more senior (retired federal and state court judges are common) and are often experienced in real estate and partnership disputes.
- **AAA** is generally less expensive and has a larger pool of arbitrators across a wider range of specializations. Its Commercial Arbitration Rules are well-established and widely respected. AAA also has specific real estate arbitration resources that can be advantageous for development company disputes.
- **For smaller disputes,** those under $500,000 or so, AAA's expedited procedures provide a streamlined and less expensive arbitration process than either party would receive in standard commercial arbitration.

The operating agreement should specify the arbitration provider and the specific rules under which the arbitration will be conducted, updated to the most current version at the time of the arbitration. If the parties do not specify rules, the arbitration will be conducted under whatever procedural framework the arbitrator imposes, which creates uncertainty.

Number of Arbitrators

The number of arbitrators affects both the cost and the quality of the proceeding. For a development company operating agreement, a practical approach:

- **Disputes under $1 million: a single arbitrator.** Single-arbitrator proceedings are significantly less expensive and often faster than three-arbitrator panels. The risk of a single arbitrator making an error is real but must be weighed against the cost of a three-arbitrator panel for a dispute of this size.
- **Disputes between $1 million and $5 million:** the operating agreement may give the parties the option of a single arbitrator or a three-arbitrator panel, with the selection made when the arbitration is initiated.
- **Disputes above $5 million: a three-arbitrator panel** provides the quality assurance appropriate for high-stakes disputes. The parties each appoint one arbitrator, and those two

arbitrators jointly select the third (the presiding arbitrator). The presiding arbitrator should be chosen from a list provided by the arbitration provider if the two party-appointed arbitrators cannot agree.

Discovery Limitations

One of arbitration's primary advantages over litigation is the ability to limit discovery, the pre-hearing process of exchanging documents and taking depositions. Unlimited discovery in commercial arbitration defeats much of the speed and cost advantage of the process; the arbitration provision should include specific discovery limitations:

- **Document requests.** Each party may request a defined number of document categories (10 to 20 categories is typical for a standard commercial dispute), with the respondent required to produce responsive, non-privileged documents within 30 days of the request.
- **Depositions.** Depositions should be limited to key fact witnesses (one to three per side in most commercial disputes) and any expert witnesses the parties intend to call. Unlimited depositions transform arbitration into expensive quasi-litigation without producing proportionate benefit.
- **Expert witnesses.** If the dispute involves valuation questions, the fair market value of a membership interest, the economic harm from a non-compete breach, each party should be entitled to retain one expert witness, with the expert reports exchanged and the experts made available for deposition before the hearing.

The arbitrator has authority to modify discovery limitations as the proceeding develops if the specific facts of the dispute require more or less discovery than the operating agreement's defaults specify. This flexibility is appropriate: the defaults should create reasonable parameters, not a rigid framework the arbitrator cannot adapt to the dispute's actual needs.

Cost Allocation

The operating agreement should specify how the costs of arbitration, arbitrator fees, administration fees, and attorney's fees, are allocated between the parties. Common approaches:

- **Loser pays.** The party who does not prevail in the arbitration pays all arbitration costs, including the prevailing party's reasonable attorney's fees. This is the most powerful deterrent to frivolous claims and is the most appropriate standard for sophisticated commercial disputes between founding partners represented by counsel.
- **Modified loser pays with threshold.** The loser pays the winner's attorney's fees and costs only if the award deviates significantly from the final written settlement offer made by the prevailing party before the hearing (commonly, if the award is more than 10 or 20 percent more favorable to the prevailing party than their final offer). This rewards reasonable pre-hearing settlement positions and penalizes unreasonable opening positions that refuse to narrow toward resolution.
- **Each party bears its own attorney's fees, with arbitration costs split equally.** The default in most United States jurisdictions in the absence of a fee-shifting agreement. Least desirable for a development company operating agreement because it removes the deterrent against meritless claims.

The loser-pays standard is the strongest deterrent against frivolous arbitration demands, but it can also create a chilling effect on meritorious claims by partners with fewer financial resources than their co-founders. The operating agreement should consider whether the fee-shifting provision applies to all disputes or only to those above a certain dollar threshold, allowing smaller disputes to proceed without the financial risk of a full fee-shift outcome.

The Equitable Relief Carve-Out: What Cannot Wait for Arbitration

The mandatory arbitration provision must include a specific and explicit carve-out for emergency equitable relief. Without it, a party who needs an immediate court order, a temporary restraining order prohibiting a partner from soliciting the company's investors, an emergency injunction preventing the unauthorized transfer of a membership interest, would be required to complete the mediation and arbitration process before seeking relief. By the time that process concluded, the irreparable harm the emergency relief was meant to prevent would already have occurred.

The equitable relief carve-out specifies that any party may seek emergency equitable relief from a court of competent jurisdiction, without prior mediation, without prior arbitration, and without waiving any right under the operating agreement's dispute resolution provisions, when:

- The party seeking relief alleges that a breach of the operating agreement, or of the fiduciary duties and restrictive covenants addressed in Chapters 13 and 14, is causing or threatens to cause irreparable harm, harm that cannot be adequately remedied by money damages.
- The delay associated with completing the escalation process would allow the irreparable harm to occur or to worsen before any remedy is available.
- The party seeking relief has complied with, or has demonstrated good cause for not complying with, the notice provisions of the operating agreement's dispute resolution section.

The equitable relief carve-out does not remove the underlying dispute from the arbitration framework. After the emergency court relief has been granted or denied, the underlying dispute continues through the escalation process: mediation and then arbitration. The court's emergency relief is temporary; the arbitration determines the final outcome.

Emergency Arbitration as an Alternative

Both JAMS and AAA have emergency arbitration procedures that provide for the appointment of an emergency arbitrator within 24 to 48 hours of a request for emergency relief. The emergency arbitrator can issue emergency orders that have the same binding effect as a court order, providing an alternative to court-based emergency relief in situations where the arbitral process is the preferred forum.

Emergency arbitration is faster than court emergency relief in some circumstances and maintains the privacy of the arbitral proceeding. It may be preferable to court emergency relief when the dispute involves confidential information the parties do not want entered into a public court record; when the emergency arbitrator has relevant expertise a general court judge may lack; or when the parties have a strong policy preference for the arbitral forum. The operating agreement should specify whether emergency arbitration is available as an alternative to court emergency relief and, if so, whether it is the preferred first step before court proceedings.

Deadlock: When the Governance Framework Cannot Produce a Decision

Deadlock occurs when the management committee cannot produce a binding decision on a matter that requires committee action, because the vote is tied, because a required supermajority cannot be achieved, or because the committee is so fundamentally divided that it cannot even agree on what question needs to be decided. In a two-partner company with equal ownership, every significant decision requiring a supermajority or unanimous consent is a potential deadlock scenario.

Deadlock is dangerous for an operating company. A company that cannot authorize new projects, approve a budget amendment, hire key personnel, or make strategic decisions is paralyzed. The consequences accumulate: deals that require timely decisions are lost; investor relationships

deteriorate; key employees leave because the company's instability is visible. A deadlock that lasts for months can destroy a company the underlying business could have sustained indefinitely.

The operating agreement's deadlock provisions are the governance mechanisms that prevent a temporary impasse from becoming a permanent catastrophe. They must be designed with care: too weak, and they do not actually break the deadlock; too powerful, and they create the risk that one party will invoke them strategically to force an outcome rather than resolve an impasse.

Deadlock Mechanisms: From Cooling-Off Periods to the Texas Shootout

Several mechanisms have been developed over time to break governance deadlocks in professional partnership agreements. They range from structured waiting periods to dramatic forced buyout provisions. The right mechanism depends on the partnership's specific governance structure, the nature of the decisions most likely to deadlock, and the partners' risk tolerance for the more drastic resolution approaches.

The Defined Cooling-Off Period

The most gentle deadlock mechanism is the cooling-off period: a defined period (commonly 30 to 90 days) during which any matter in deadlock is tabled and the parties suspend their dispute-related activities while they reflect and attempt to reach agreement without the pressure of the immediate decision. The cooling-off period is premised on the observation that many deadlocks arise not from a fundamental, irreconcilable difference of view but from a temporary breakdown of communication or an emotional reaction to a specific event that does not reflect the parties' long-term interests.

The cooling-off period is most effective for disputes that arise suddenly and escalate quickly: a heated committee meeting, a personal confrontation, a misunderstanding attributed to bad faith before anyone has stepped back to assess whether it might be attributed to miscommunication. It is less effective for deep, structural disagreements that have been building over months and that both parties understand clearly.

The Independent Advisor or Tiebreaker

A more substantive deadlock mechanism is the appointment of an independent advisor or tiebreaker: a neutral third party given the authority to cast the deciding vote or make the deciding recommendation on specific categories of deadlocked decisions.

This mechanism works best when the deadlocked decision involves a question of business judgment rather than a fundamental disagreement about the partnership's direction. If the partners are deadlocked on whether to proceed with a specific development project because they disagree about its risk and return profile, an independent real estate expert can review the underwriting, assess the market, and provide a binding recommendation that breaks the impasse on that specific project.

The operating agreement should specify who has the authority to appoint the independent advisor if the parties cannot agree; the categories of decisions to which the tiebreaker mechanism applies, and notably the categories to which it does not, decisions so fundamental that no tiebreaker is appropriate because each partner's veto reflects a legitimate interest no third party should override; and the timeline within which the advisor must render a decision.

The independent tiebreaker is most useful for operational deadlocks, specific business decisions that must be made to keep the company moving. It is less useful for structural deadlocks, fundamental disagreements about the company's strategy, ownership structure, or the partners' relationship that cannot be resolved by a specific business decision.

The Offer-Counteroffer / Buy-Sell Mechanism

The offer-counteroffer mechanism, sometimes called the shoot-out or Russian roulette provision, is a forced buyout mechanism triggered when the partners reach a fundamental deadlock that cannot be resolved through negotiation or a third-party tiebreaker. Its logic is elegant: either partner can trigger it, which means neither party is willing to trigger it unless they believe the disagreement is irreconcilable.

The basic structure: Partner A delivers written notice to Partner B setting a price at which Partner A is willing either to buy Partner B's entire interest or to sell Partner A's entire interest at that same price. Partner B then has a defined period (commonly 30 to 60 days) to elect either to buy Partner A's interest at the stated price or to sell their own interest to Partner A at the stated price. Partner B chooses which position to take, but the price per unit of ownership is the same in both directions.

The mechanism produces a fair outcome because the party setting the price, Partner A, does not know which side of the transaction they will end up on. Setting the price too high risks being forced to pay an excessive price for Partner B's interest; setting it too low risks losing their own interest at a bargain price. The rational response is to set a price as close to fair market value as possible, which is exactly the outcome the mechanism is designed to achieve.

The Texas Shootout

The Texas Shootout is a variation of the buy-sell mechanism designed to produce the fairest possible price in a forced buyout. Rather than having one party set a price the other party must respond to, the Texas Shootout proceeds as follows:

- Both parties independently and simultaneously submit sealed bids specifying the price at which they are willing to purchase the other party's interest.
- The bids are opened simultaneously by a neutral party (the escrow agent, the operating agreement's arbitrator, or a designated independent party).
- The party who submitted the higher bid acquires the other party's interest at that higher bid price.

The Texas Shootout eliminates the strategic first-mover advantage of the standard buy-sell mechanism. In the standard mechanism, Partner A sets the price and Partner B has the information advantage of knowing the price before deciding which side to take. In the Texas Shootout, both parties submit simultaneously with no information about the other party's bid, which produces a more competitive outcome. The Texas Shootout is the most commercially sophisticated of the forced buyout mechanisms and is most appropriate for partnerships between sophisticated parties who have access to independent valuation advice and can make informed bids without knowing the other party's position.

The Fair Market Value Appraisal Buyout

A less dramatic but often more practical deadlock mechanism is the fair market value appraisal buyout: when a defined deadlock trigger is met, the company's equity is valued by an independent appraiser and one or more partners are bought out at that appraised value, with the decision about who is bought out (and whether the buyer is the company or the remaining partners) made separately from the valuation.

The appraisal process provides a price determined by objective evidence rather than by the strategic positions of the parties in a forced negotiation. Its weakness is time: a full business valuation takes weeks to months, during which the company must continue to operate under deadlock conditions. The fair market value appraisal buyout is most appropriate when the parties agree the partnership should be dissolved but disagree only about the price at which the buyout should occur, not about which party should exit.

When Deadlock Is Actually Irreconcilable: The Dissolution Option

Some deadlocks represent not a temporary governance failure but a fundamental, irreconcilable breakdown of the partnership. The partners no longer share a common vision for the company's direction, no longer trust each other's judgment, and no longer believe that continuing the partnership serves their individual interests better than ending it. In these situations, the forced buyout mechanisms described earlier in this chapter may produce a financially sound outcome, but they require one party to continue operating the business the other is exiting, which may not be what either party wants.

The operating agreement should address the voluntary dissolution option as a deadlock resolution mechanism of last resort: when a defined deadlock has persisted for a defined period (commonly 90 to 180 days), when the forced buyout mechanisms have been offered and declined, or when both parties express a preference for dissolution over a forced buyout, the partners should have the ability to wind down the company in an orderly manner that protects investors, completes or properly winds down active projects, and distributes assets equitably.

Voluntary dissolution as a deadlock resolution is addressed more fully in Chapter 18. The key point here is that dissolution should appear in the operating agreement's deadlock section as a real option the partners can elect, not as a threat or a worst-case outcome no one actually wants, but as a legitimate business decision that may sometimes be the right choice when a partnership has run its course.

Choosing the Right Deadlock Mechanism for Your Partnership

No single deadlock mechanism is right for every development company partnership. The appropriate mechanism depends on the specific ownership structure, the nature of the decisions most likely to deadlock, the financial positions and resources of the respective partners, and the founding team's philosophy about how conflicts should ultimately be resolved. The following analysis guides the selection:

Deadlock mechanism	Best used when	Primary risk	Appropriate partnership structure
Cooling-off period	Deadlock arises from emotional escalation rather than fundamental disagreement; the company can tolerate a 30 to 90 day pause without material harm	Does not resolve structural disagreements; may delay an inevitable confrontation without producing resolution	All structures; should be the first-level deadlock mechanism in every operating agreement
Independent tiebreaker	Deadlock involves a specific business decision (a deal, a budget, a hire) where an expert's judgment can resolve the substantive question	The tiebreaker may make a decision neither party fully endorses, creating compliance difficulties; not appropriate for fundamental strategic disagreements	Two-partner companies with equal or near-equal ownership where specific business decisions must be made to keep the company operating
Buy-sell / shoot-out	Partners are prepared to separate; one partner is willing to be the buyer; both have access to financing or liquidity to fund a buyout	The financially stronger partner has a significant advantage; the party who triggers it has no information advantage but cannot control which side of the deal they get	Most appropriate when both partners have comparable financial resources; less appropriate when one significantly outresources the other
Texas Shootout	Both partners are sophisticated; both have access to independent valuation advice; neither has a significant financial advantage that would distort the bidding	Operationally complex; requires simultaneous sealed bids and an independent opening party; less common because of mechanical complexity	Sophisticated partnerships where fairness in the buyout price is the primary concern and both parties can make informed bids
FMV appraisal buyout	Partners agree the partnership should be dissolved but dispute only the price; operations can continue without material harm during the appraisal	Slowest mechanism; the appraisal takes weeks to months; the company must operate under deadlock conditions during this period	Partnerships where operations are not critically dependent on active partner management decisions during the appraisal period

Governing Law, Venue, and Confidentiality

Three practical provisions the operating agreement's dispute resolution section must address explicitly, and that are frequently omitted or handled with insufficient specificity:

Governing Law

The operating agreement should specify the governing law for all disputes arising from it, typically the law of the state of formation (most often Delaware), which provides the most well-developed body of LLC law, or the law of the state where the company's principal place of business is located. The choice of governing law affects:

- The interpretation of fiduciary duty provisions: Delaware's highly developed body of LLC case law provides the most predictable framework for interpreting the operating agreement's fiduciary duty modifications.
- The enforceability of the arbitration provision: most states strongly favor enforcement of commercial arbitration agreements between sophisticated parties, but the specifics vary.
- The availability of specific statutory remedies: some states' LLC statutes provide specific remedies for member oppression, deadlock, and dissolution that the parties' agreement can modify or incorporate.

The governing law selection should be consistent with the entity's state of formation: a Delaware LLC should be governed by Delaware law in its operating agreement. A New York LLC that specifies Delaware law as the governing law creates a potential conflict, since some New York courts apply New York law to disputes involving New York operating companies regardless of a Delaware choice-of-law provision.

Venue

The operating agreement should specify the venue for any arbitration or court proceeding, the specific city or metropolitan area where the proceedings will occur. The choice of venue matters practically: it determines where the parties must travel for hearings, which local courts have jurisdiction for any emergency relief applications, and which court has enforcement authority over any arbitral award.

For a Delaware LLC with founding partners located in Dallas, the appropriate venue for the arbitration might be Dallas (for practical convenience) while the seat of the arbitration for purposes of the Federal Arbitration Act and the arbitration provider's rules is specified separately. The venue for emergency court relief should be a court of competent jurisdiction in the state where the company's principal place of business is located, since that court has the most practical ability to enforce emergency orders against the parties and the company.

Confidentiality of the Dispute Resolution Process

One of the most significant practical advantages of arbitration over litigation is the privacy of the proceedings: unlike court proceedings, which are public unless specifically sealed, arbitration proceedings and their outcomes are confidential by default. The operating agreement should reinforce this confidentiality by specifying that:

- All mediation communications, including any mediator's proposals and the parties' responses, are confidential and not admissible in any subsequent proceeding.
- All arbitration proceedings, submissions, evidence, and awards are confidential and may not be disclosed by either party or the arbitrator without the written consent of both parties, except as necessary to enforce an award.
- Neither party may publicize or disclose the existence, nature, or outcome of any dispute resolution proceeding to any investor, potential investor, counterparty, or media outlet without the written consent of the other party.

The confidentiality provision is particularly important for a company that manages outside investor capital. A public dispute between the founding partners, or even the knowledge that a dispute exists, can create investor concern that reaches investors before the company has had an opportunity to provide appropriate context. Maintaining the confidentiality of the dispute resolution process protects the company's investor relationships during a period when those relationships are most at risk.

CHAPTER 17: KEY TAKEAWAYS

1. The dispute resolution framework is a tiered escalation process, not a binary choice between doing nothing and going to arbitration. The four tiers, direct negotiation (30 days), management committee escalation (30 days), mandatory mediation, and binding arbitration, provide structured mechanisms at each level of conflict intensity. No party may invoke arbitration without completing the preceding tiers, except when emergency equitable relief is needed.
2. Mediation is the most undervalued dispute resolution tool available to a development partnership. It resolves roughly 70 to 85 percent of commercial disputes that reach it, including many that both parties believed were irreconcilable. One to two days of mediation time and $10,000 to $30,000 in mediator fees is trivial compared to a contested arbitration. The operating agreement should require mediation as a condition precedent to arbitration, with a mediator selection process that does not require agreement in the middle of a dispute.
3. The binding arbitration provision must specify the provider (JAMS or AAA), the number of arbitrators (one for disputes under $1 million; three for disputes above $5 million), the seat and venue, the governing law, the discovery limitations, and the cost allocation. The loser-pays cost allocation is the strongest deterrent against frivolous claims but can create a chilling effect on meritorious claims by less-resourced partners.
4. The equitable relief carve-out is essential: a party must be able to seek emergency injunctive relief from a court without first completing mediation and arbitration when a breach of the operating agreement is causing or threatens to cause irreparable harm. Without the carve-out, the mandatory dispute resolution process protects the violating party by requiring the harmed party to wait through months of process while the harm continues.
5. Deadlock occurs when the governance framework cannot produce a binding decision. The five mechanisms for breaking deadlock range in aggressiveness: cooling-off period (for emotional escalations), independent tiebreaker (for specific business decisions), buy-sell or shoot-out (when partners are prepared to separate and have comparable financial resources), Texas Shootout (most commercially sophisticated, with both parties submitting simultaneous sealed bids), and FMV appraisal buyout (when parties agree to separate but dispute only the price).
6. The buy-sell or shoot-out mechanism produces a fair outcome because the party setting the price does not know which side of the transaction they will end up on. Setting the price too high risks paying an excessive price for the other party's interest; setting it too low risks losing their own interest at a bargain. The rational response is to set a price as close to fair market value as possible. The Texas Shootout eliminates the strategic first-mover advantage by requiring simultaneous sealed bids.
7. Governing law (typically Delaware), venue (a specified city for arbitration; a court of competent jurisdiction in the company's principal place of business state for emergency relief), and confidentiality of all mediation and arbitration proceedings must be

addressed explicitly. The confidentiality provision is particularly important for companies managing outside investor capital: public knowledge of a founding partner dispute can damage investor relationships before the company can provide appropriate context.

WHAT COMES NEXT

Chapter 18 addresses succession planning and dissolution: how to plan for the orderly transition of the company's leadership as it matures, and how to wind down the company in a manner that protects investors, employees, and the founding partners' own economic interests when the partnership has run its course, or when a deadlock of the kind addressed in this chapter ultimately leads to an irreconcilable conclusion.

See also: *Chapter 14 (Restrictive Covenants: the equitable relief carve-out applied to non-compete and trade secret violations) • Chapter 16 (Transfer Restrictions: the exit mechanics that may be triggered when a deadlock mechanism produces a forced buyout) • Appendix J (Glossary: mediation, arbitration, deadlock, buy-sell, Texas Shootout, JAMS, AAA, equitable relief, cooling-off period)*

CH. 18

PART VI: DISPUTES, SUCCESSION & LONG-TERM PLANNING

Succession Planning

and Dissolution

How to plan for the orderly evolution and eventual conclusion of a real estate development company: building internal leadership depth, managing the transition from founding-partner dependence to institutional resilience, and winding down with integrity when the partnership has run its course.

Succession planning is not a topic founding partners of an early-stage development company instinctively prioritize. They are building something, not planning for its end. The concerns that fill their working days are operational, closing the next deal, raising the next round of investor capital, managing the current project's construction schedule, not the multi-year horizon questions of who will lead this company when the founders are no longer at the helm, or how its assets and obligations will be resolved if the partnership ultimately concludes.

But the founding period is precisely the right time to design the succession and dissolution framework, because the parties' interests are not yet entangled in the specific outcomes those provisions will eventually govern. A company whose dissolution framework was designed before the first dispute is one whose founding partners agreed to rules when they could be objective about them. A company whose dissolution framework is negotiated in the middle of a partnership breakdown is one whose provisions reflect the specific leverage positions of the parties at their most adversarial.

Why Succession Planning Belongs in Formation Documents

The case for including succession planning provisions in the original operating agreement rests on two practical realities the founding team should understand clearly.

The first reality: a real estate development company's value is concentrated in its human capital in a way most other businesses are not. The company's investor relationships, its deal flow pipeline, its institutional knowledge about specific markets and asset types, and its reputation for delivering on development commitments all exist primarily in the minds and relationships of specific individuals. When those individuals are exclusively the founding partners, the company's value proposition and its operational continuity depend entirely on the founding team's continued participation. That concentration of key-person risk is a vulnerability, for investors who have committed capital to a company whose management team has no identified successors, and for the company itself, which cannot scale beyond what the founding partners can personally oversee.

The second reality: the gap between when a company needs a succession plan and when it naturally develops one tends to be very long. Companies build organizational depth reactively, in response to a near-miss (a key partner's illness, a close call with a departure), an external requirement (an institutional investor who demands evidence of a succession plan as a condition of commitment), or an actual crisis. Planning that occurs under duress is inferior to planning that occurs when the company has the bandwidth and the objectivity to think through the options carefully.

Including succession planning provisions in the original operating agreement forces the founding team to address three questions that establish the framework for all future succession decisions:

- What does succession look like for this specific company: is the goal to develop internal leaders who can assume the founding partners' roles, to sell the company to a larger platform, or to wind down after the founding partners retire?
- What obligations do the founding partners have to each other and to their investors to maintain operational continuity as the company grows?
- Who has the authority to make succession decisions, and what approval thresholds govern those decisions?

The Destination Vision: Planning Toward an Outcome

Effective succession planning requires a shared view of where the company is going, what the founding partners' ultimate destination for the business is, and over what time horizon they expect to reach it. Chapter 1 of this handbook addressed the destination vision as part of the foundational alignment conversations. This chapter returns to that vision in the context of planning for the transitions that will occur before the destination is reached. The three most common destination visions for a real estate development company are:

The Institutional Platform

The founding partners intend to build a company that outlasts their own operational involvement, an institutional platform with professional management depth, consistent investment processes, and a track record and investor base that give it enduring value independent of any single principal. For this destination, succession planning is not an end-state conversation; it is an ongoing operational obligation. The company must continuously develop and elevate internal leaders, systematize its processes to reduce key-person dependence, and build relationships with investors who understand and accept the management team's evolution.

Succession planning for an institutional platform includes identifying the next generation of internal leadership (whose development is addressed in Chapter 12's human capital framework); developing formal mentorship and leadership development programs; defining the competencies and experience required for a person to be considered for partnership admission; and maintaining a documented succession plan for each key functional role, reviewed and updated annually as part of the business planning process.

The Sale

Some founding partnerships are built with an explicit intention to sell, either the company itself (a platform sale to a larger asset manager, a private equity firm, or a public REIT) or its portfolio (a disposition of all active projects, followed by an orderly wind-down). For a sale-oriented destination, succession planning is primarily about building the company in ways that make it attractive to acquirers and about managing the company's operational dependencies to maximize enterprise value at the time of sale.

A development company whose value is entirely concentrated in two founding partners who have no named successors, and whose investor relationships are not documented or transferable, is a difficult acquisition target, because no acquirer can underwrite the management team's post-acquisition continuity with confidence. Building institutional resilience, systematized deal processes, documented investor relationship management, named successors for key roles, and formal operating procedures, creates the organizational depth that makes the company acquirable at maximum value.

For a sale-oriented company, the operating agreement should address the mechanism by which the partners agree to sell the company (the drag-along rights discussed in Chapter 16, plus the

supermajority approval threshold required to authorize a company sale); the allocation of sale proceeds among the founding partners and any key employees with equity participation; and the founders' post-acquisition obligations (employment agreements, non-compete terms, and transition support an acquirer will require).

The Wind-Down

For some partnerships, particularly those formed around a specific investment opportunity, a defined fund with a fixed term, or a collaborative arrangement the founding partners do not intend to continue indefinitely, the appropriate destination is an orderly wind-down: completing the current portfolio, returning capital to investors, and closing the operating company. The wind-down may be planned from inception (as with a fund that has a defined term) or elected by the founding partners after a defined period of operation.

Succession planning for a wind-down-oriented company is primarily about designing the operating agreement's dissolution provisions so that the wind-down, when it occurs, is orderly, fair, and protective of investor interests. The dissolution provisions must address the specific operational realities of a development company: active projects that cannot be immediately liquidated, investor commitments that extend beyond the dissolution decision, employees whose positions will need to be transitioned, and ongoing fee income the company is contractually entitled to receive through the completion of active projects.

Building Internal Leadership Depth

Regardless of the company's ultimate destination vision, building internal leadership depth is the most important operational succession strategy a development company can pursue. A company that has developed capable leaders at multiple levels, people who can originate deals, manage relationships, oversee construction, and communicate with investors, not just execute on tasks assigned by the founders, is resilient against the departure or incapacity of any single founding partner in a way that a founding-team-dependent company is not.

Identifying and Developing Successor Leaders

Internal leadership development begins with a deliberate assessment of the company's human capital: who among the current team has the potential to assume expanded leadership responsibilities, what specific development they need to be prepared for those responsibilities, and what organizational structure will give them the opportunity to demonstrate their capabilities. The assessment should address each functional area the founding partners currently cover:

- **Deal origination and market relationships.** Is there a person in the organization who has developed independent relationships with brokers, landowners, and municipal contacts, and who is capable of originating deals on their own initiative rather than following the founding partners' direction?
- **Investor relations and capital raising.** Is there a person who has developed real relationships with the company's investors, not just service relationships but advisory relationships where investors trust the person's judgment and would commit capital to a deal based on their recommendation?
- **Development execution.** Is there a person who has managed a complete development project from acquisition through certificate of occupancy, with the authority to make construction and cost decisions without the founding partners' constant involvement?

- **Financial management and reporting.** Is there a person who understands the company's financial position, the deal economics, and the investor reporting obligations with enough depth to manage those functions independently?

The assessment will often reveal that none of these leaders currently exists at the required level of capability, which is itself an important finding. It indicates either that the company needs to hire more aggressively for these roles or that the founding partners need to delegate more authority to develop existing staff. Succession planning that does not lead to specific development actions is not succession planning; it is an abstract aspiration that changes nothing.

The Partner Track: Formalizing the Path to Partnership Admission

For a company committed to the institutional platform destination, the formal partner track, a defined pathway through which a senior employee can earn their way into full partnership, is the organizational infrastructure that converts internal leadership development from an aspiration into a defined process with measurable milestones. A partner track specifies:

- The roles and titles that constitute the partner track (Senior Associate, Director, Managing Director, Partner, for example).
- The functional competencies, experience levels, and demonstrated achievements required for admission to each level.
- The equity participation available at each level: profits interests sized and structured as described in Chapter 6 and Chapter 12, with vesting schedules that create real retention incentives.
- The timeline from entry to partnership consideration: typically four to seven years for a person who joins at the senior associate or director level with strong foundational experience.
- The approval process for partner admission: the unanimous or supermajority approval of the existing partners, the required committee review, and the documentation requirements.
- The economic terms of partnership admission: the equity percentage, the carried interest participation, the guaranteed payment level, and the co-investment obligations that attach to partner status.

The partner track benefits both the company and the prospective partners. The company retains high-performers who might otherwise leave for partnerships at competing firms. The prospective partners have clarity about what they need to accomplish and what economic rewards await them if they do, which is a more powerful retention and performance incentive than any bonus structure the company could design.

Reducing Key-Person Dependence

Key-person dependence, the degree to which the company's operations, investor relationships, and deal flow depend on specific individuals rather than on documented processes and shared institutional knowledge, is the primary organizational vulnerability of a young development company and the primary challenge of succession planning. Reducing it requires deliberate operational design, not simply hoping that other people will develop the same capabilities the founding partners have over time.

Systematizing Deal Processes

A company whose deal evaluation, underwriting, and execution processes are entirely in the founding partners' heads cannot be handed to successors because there is nothing to hand over. The process is the partners. Systematizing those processes, documenting the underwriting methodology, the site evaluation criteria, the entitlement risk assessment framework, the contractor

selection process, and the investor communication protocol, creates an organizational asset that outlasts any individual's participation.

Systemization does not mean bureaucracy. A one-page deal evaluation checklist that captures the ten factors the managing partner considers before deciding to pursue a site further is more valuable from a succession perspective than a 50-page procedural manual no one reads. The goal is to make the founding partners' institutional knowledge visible and transferable, to turn the implicit into the explicit, not to replace judgment with procedure.

Investor Relationship Documentation

The investor relationship is the most concentrated key-person risk in a development company that manages outside capital. When an investor's relationship with the company is entirely mediated through a single founding partner, a partner who calls them personally on every deal, who has dinner with them annually, who is their primary point of contact for questions about any project, the investor's relationship with the company is functionally a relationship with that partner. When that partner leaves, the relationship does not automatically transfer to the company.

Investor relationship documentation, and the deliberate expansion of investor touch points beyond a single founding partner, is the most important succession preparation a development company managing outside capital can undertake. Specific practices:

- Document every investor relationship in the company's CRM with enough detail that another person could step into the relationship and understand its history, its dynamics, and its status without beginning from zero.
- Include multiple company representatives in investor interactions over time: the partner who manages investor relations introduces the CFO, the construction manager, or a senior associate to each investor in the context of project updates and events, building multiple relationship threads between the investor and the company.
- Establish investor communication practices that are institutionally branded rather than personally branded: the quarterly investor letter comes from the company, not from a specific partner; the annual investor meeting presents multiple team members, not just the founding partner.
- Plan specific relationship introduction events, an annual investor dinner where each member of the senior team has meaningful time with key investors, as a systematic practice rather than an ad hoc occurrence.

The Company Sale: Planning for an Exit

For a development company pursuing an institutional platform strategy, a sale of the company is often the ultimate mechanism for liquidity, the moment at which the accumulated enterprise value of years of platform-building is converted to cash. For founding partners who have been compensated primarily through fee income and promoted interests on specific deals, the company sale represents the realization of the residual equity value they have built in the platform itself.

What Acquirers Buy

Understanding what a potential acquirer of a development company is actually buying is essential to building a company that can be sold at maximum value. An acquirer of a development management company typically values:

- **The AUM and the recurring fee income it generates.** The management fees, asset management fees, and other fee income the company earns from its current portfolio are the

most directly capitalized component of enterprise value. A company with $200 million in AUM generating $3 million per year in recurring management fees is more predictably valuable than one with a larger portfolio but highly variable fee income.

- **The investor relationships and the ability to deploy additional capital.** An acquirer who is growing their own platform values access to the target company's investor base, the capital relationships that will fund future deals. A company with deep, documented relationships with active investors who commit capital repeatedly is more valuable than one with transactional investor relationships that do not reliably recur.
- **The team and their ability to continue operating independently.** An acquirer concerned that the company's value will walk out the door the day after closing will reduce their offer or require extensive lock-up arrangements. A company with a deep management team, multiple people who can originate deals, manage projects, and communicate with investors without the founding partners' constant involvement, is more acquirable than a two-person founding team with no succession depth.
- **The track record and reputation in specific markets.** The company's history of delivered projects, returns achieved relative to projections, and the professional reputation it has built in its target markets. A consistent track record of on-budget, on-schedule delivery with documented investor returns is one of the most durable sources of enterprise value.

Founder Post-Acquisition Obligations

When a development company is sold, the founding partners typically face a set of post-acquisition obligations negotiated as part of the sale. These should be anticipated in the operating agreement's succession planning provisions so the partners have a shared understanding of what a sale will require of each of them:

- **Employment or consulting arrangements.** Most acquirers require the founding partners to remain with the combined entity for a defined transition period, typically one to three years. The terms of these arrangements, base compensation, bonus structure, role, authority, and termination rights, are negotiated as part of the acquisition and should be reasonable and acceptable to the founding partners.
- **Non-compete and non-solicitation periods.** An acquirer paying for the development company's platform value needs protection against the founding partners immediately starting a competing company. Post-acquisition non-competes of two to five years are common and generally enforceable in the context of a sale of business, even in California, where general employment non-competes are banned.
- **Earn-out provisions.** If a portion of the acquisition price is contingent on the company's post-acquisition performance, an earn-out based on AUM growth, fee revenue, or deal volume over a defined period, the founding partners need to understand and accept the performance metrics on which their additional compensation will be based.

These obligations are not merely details to be worked out at the time of sale; they are fundamental terms that affect whether the acquisition is economically attractive to the founding partners. The operating agreement should at minimum contemplate that these obligations may attach to a company sale and that the partners' acceptance of them is a condition of approving the transaction at the supermajority threshold specified in the Decision Authority Matrix.

Voluntary Dissolution: The Decision and Its Triggers

Voluntary dissolution is the decision by the company's members to wind down the company's operations, liquidate or transfer its assets, satisfy its obligations, and distribute any remaining

assets to the members. It is a legitimate and sometimes optimal business decision, not a failure. A company that has completed its intended portfolio, returned capital to its investors, and achieved the founding partners' original goals has succeeded regardless of whether it continues indefinitely.

What Triggers a Dissolution Decision

The operating agreement should specify the circumstances under which dissolution can be elected, the approval threshold required, and the process that follows the decision. Common dissolution triggers:

- **Unanimous partner consent.** The cleanest trigger: all founding partners agree the company has fulfilled its purpose, or that continuing operations no longer serves their collective interests, and they elect to wind down by unanimous decision. This trigger is always available regardless of the company's financial condition or operational status.
- **Failure to achieve defined milestones.** If the company was formed with specific operational objectives, closing a first deal within 18 months, raising a first fund within 24 months, reaching a defined AUM threshold within 36 months, the operating agreement may specify that failure to achieve those milestones triggers a dissolution election process. This prevents a company from drifting indefinitely at minimal activity when it has failed to gain the traction its founding assumption required.
- **Irreconcilable deadlock.** As discussed in Chapter 17, a deadlock that persists through all available resolution mechanisms, and that the partners are unwilling to resolve through a forced buyout, is a legitimate trigger for voluntary dissolution. The operating agreement should specify the timeline (a deadlock of more than 90 or 180 days, after all other mechanisms have been exhausted) and the required approval threshold (which may be a majority or supermajority rather than unanimous, since unanimity is impossible in a true deadlock).
- **Expiration of a defined term.** For a company formed around a specific fund or investment vehicle with a defined term, the dissolution of the company may follow naturally from the expiration of the fund term and the completion of the portfolio wind-down.

The Required Approval Threshold

The default approval threshold for voluntary dissolution by member vote varies by state. Many states that follow the Revised Uniform LLC Act default to unanimous member consent, while the Delaware LLC Act defaults to the vote or consent of members owning more than two-thirds of the profits interests, in each case unless the operating agreement specifies otherwise. A high default threshold may be appropriate for many development company partnerships, because dissolution is so fundamental a decision that a member's veto or near-veto right is protective of their investment and their ongoing economic interests. But a high threshold creates a problem in the deadlock scenario, where the consent needed to dissolve is precisely what is unavailable.

The operating agreement should address dissolution triggered by deadlock separately from dissolution elected voluntarily: the voluntary election may require unanimous consent, while the deadlock-triggered election may require a supermajority (or even a majority) of the members, provided the deadlock has persisted through a defined period and all available resolution mechanisms have been exhausted.

The Orderly Wind-Down: Protecting Investors and Preserving Value

Once a dissolution decision has been made, the company must wind down its operations in an orderly manner that protects the interests of its investors, satisfies its contractual obligations, and

distributes any remaining assets to the members in accordance with the operating agreement's distribution framework. The dissolution process for a real estate development company is more complex than the wind-down of a simpler business because the company's assets include active development projects, committed investment programs, ongoing fee income streams, and contractual relationships with investors, lenders, and contractors that extend well beyond the dissolution date.

The Winding-Up Process

The winding-up of a real estate development company's operations typically involves the following sequential steps, each of which must be addressed in the operating agreement's dissolution provisions:

- **Notification of dissolution.** The company must notify its investors, lenders, key vendors, employees, and counterparties that the company is winding down. The operating agreement should specify the timing and form of these notifications and should require that they be made promptly following the dissolution decision so counterparties can make appropriate plans.
- **Completion or transfer of active projects.** The company's most significant obligation in a wind-down is the disposition of its active development projects. A project in the middle of construction cannot simply be abandoned; the company must either complete the project (if the dissolution timeline permits) or arrange for a qualified successor manager to assume the management role under the development management agreement. The operating agreement should address whether the company is obligated to complete active projects and under what conditions project management can be transferred to a successor.
- **Satisfaction of contractual obligations.** The company must satisfy all binding contractual obligations before distributing assets to members. These include outstanding invoices, employee severance obligations, lease termination costs, and any other commitments that survive the dissolution decision.
- **Collection of receivables.** The company is entitled to collect all fees and other amounts owed to it by project entities, investors, and other parties through the date of dissolution. The collection of these receivables is an ongoing obligation of the winding-up period, and the operating agreement should specify who has authority to pursue collections during this period.
- **Payment of liabilities.** All known liabilities of the company must be paid or reserved for before any distribution is made to the members. The operating agreement should require that a reasonable reserve be established for contingent and unknown liabilities (disputed claims, potential regulatory actions, indemnification obligations) before the final distribution.
- **Distribution of remaining assets.** After all obligations have been satisfied and appropriate reserves established, the remaining assets of the company are distributed to the members in accordance with the operating agreement's distribution priorities.

The Dissolution Priority Waterfall

The distribution of assets in dissolution follows a specific priority waterfall that differs from the operating distributions during normal operations. State LLC statutes specify the default dissolution priority, but the operating agreement can and should customize it for the specific circumstances of the development company. A standard dissolution priority waterfall:

- **First.** Payment of all company debts and liabilities, including amounts owed to creditors who are not members. Third-party debts have absolute priority over any distribution to members.
- **Second.** Payment of amounts owed to members who are also creditors of the company, outstanding loans from members, unpaid guaranteed payments, and other amounts the

company owes to specific members. These member-creditor claims are typically treated as company liabilities rather than equity interests and are paid before any equity distributions.

- **Third.** Return of member capital accounts in proportion to positive capital account balances. Each member receives a distribution equal to their positive capital account balance before any remaining assets are distributed proportionally to equity ownership.
- **Fourth.** Distribution of any assets remaining after the above priorities have been satisfied, in proportion to each member's ownership percentage.

The operating agreement's dissolution provision should confirm that this waterfall applies and should address any specific modifications the founding partners have agreed to, for example, a capital account restoration obligation for members with negative capital accounts, or a specific treatment for the company's interest in active development projects that cannot be liquidated at the time of dissolution.

Active Projects at Dissolution: The Hardest Wind-Down Problem

The most operationally complex aspect of winding down a development company is the disposition of active projects, development projects that are in the middle of construction, entitlement, or lease-up when the dissolution decision is made. These projects cannot simply be abandoned because the company has contractual obligations to investors, lenders, and project counterparties that survive the dissolution decision. The operating agreement's dissolution provisions must address three specific scenarios involving active projects:

- **Projects in early stages (pre-construction, site control only).** These may be released from the company's development pipeline by terminating the purchase contract or option, with any costs borne as dissolution expenses. The investors in these projects, if any, must be notified and their committed capital returned if the project is being abandoned.
- **Projects in active construction.** The company cannot walk away from a project in active construction without breaching its obligations to the construction lender, the investors, and the general contractor. The operating agreement should specify that active construction projects must be completed or transferred to a qualified successor manager before dissolution is complete, and that the managing partner has authority to take all necessary actions to complete or transfer these projects notwithstanding the dissolution decision.
- **Projects in lease-up or stabilization.** Projects that have completed construction but have not yet been disposed of may be sold as part of the wind-down, transferred to a successor manager, or held until the investment timeline specified in the offering documents, whichever serves the investors' interests best. The operating agreement should give the managing partner (or the wind-down manager, if designated separately) authority to negotiate and execute disposition transactions as part of the wind-down.

Investor Communications During Dissolution

A development company that manages outside investor capital has obligations to its investors that continue through the dissolution process. Investors who committed capital to specific deals did so on the basis of representations about the management team that will oversee their investment. If that management team is dissolving, investors are entitled to know, and the company has a duty to inform them promptly and clearly.

What to Tell Investors and When

The timing and content of investor communications during dissolution depend on the nature of the dissolution and its cause:

- **Planned, consensual dissolution at the end of a fund term.** Investors were informed from inception that the fund has a defined term. Dissolution communications in this context confirm an expected event rather than disclose an unexpected change. They should focus on the timeline, the disposition plan for any remaining assets, and the expected distribution schedule.
- **Dissolution following partner departure or deadlock.** Investors did not anticipate this outcome and may view it as a material adverse change in the management team. The communications must be prompt, within a commercially reasonable period following the dissolution decision, and honest about the reason for dissolution while respecting the confidentiality of the internal dispute. The company must describe the plan for completing active projects, the identity of any successor manager, and the expected impact on investment timelines and returns.
- **Emergency dissolution following financial distress.** If the company is winding down because it is financially unable to continue operations, the investor communications must be especially direct and must disclose the company's financial condition with the specificity investors need to understand their situation and make appropriate decisions.

In all cases, investor communications during dissolution must not contain material misstatements or omissions that would mislead investors about the true nature and cause of the dissolution, the condition of their investments, or the expected outcome. The securities anti-fraud rules apply with equal force during dissolution as during normal operations.

The Successor Manager

A dissolution that leaves active investor capital without a management team raises the question of who will manage the remaining investments through completion and disposition. The operating agreement should address the succession of management obligations in dissolution by identifying the process for appointing a successor manager, either a pre-identified successor from within the existing team, a named third party, or a process for selecting a qualified successor.

Institutional investors whose capital is committed to a specific deal or fund are entitled to have their investment managed by a qualified, professional team through the life of the investment, regardless of what happens to the GP entity. The operating agreement's dissolution provisions should specify that the company's dissolution does not terminate the management obligations under any development management agreement or investment advisory agreement currently in effect, and that the company will use commercially reasonable efforts to arrange for a qualified successor to assume those obligations on terms at least as favorable to investors as the current arrangements.

Judicial Dissolution: When Voluntary Wind-Down Is Not Available

When the partners cannot reach the agreement required to elect voluntary dissolution, because they are in a deadlock the operating agreement's mechanisms cannot resolve, because one partner is actively preventing a dissolution the other partners believe is necessary, or because the managing partner has abused their position to such a degree that the other members have lost confidence in the company's governance, any member may petition a court for judicial dissolution of the LLC.

Most states' LLC statutes authorize judicial dissolution upon a showing that it is not reasonably practicable to carry on the business in conformity with the operating agreement, or that the management of the company is deadlocked or so dysfunctional that the company cannot make or implement basic decisions. Judicial dissolution is a last resort, a forced wind-down imposed by a court over the objection of one or more partners, but it is a real remedy that sophisticated operating

agreements should contemplate and attempt to make unnecessary through robust voluntary dissolution and deadlock provisions.

Conditions for Judicial Dissolution

The conditions that support a petition for judicial dissolution vary by state but generally include:

- **Irreversible deadlock.** The members are so fundamentally divided that the company cannot make decisions, and no available mechanism can break the impasse. A petitioner who has exhausted the operating agreement's dispute resolution and deadlock provisions without resolution is in a stronger position to establish this ground.
- **Oppression of minority members.** The controlling members are managing the company in a manner fundamentally unfair to the minority, squeezing out the minority's economic rights, using the company for personal benefit at the minority's expense, or preventing distributions to which the minority is entitled. Minority oppression claims are most commonly associated with closely held corporations but are increasingly available in LLC contexts as well.
- **Fraudulent or illegal conduct.** The managing member has engaged in fraud, illegality, or willful misconduct that has damaged or threatens to damage the company. A member who brings a judicial dissolution petition on these grounds typically also brings parallel claims against the managing member personally.

The Operating Agreement as a Defense Against Judicial Dissolution

A well-drafted operating agreement with robust deadlock provisions, a clear dissolution process, and an effective dispute resolution framework is the best protection against judicial dissolution. Courts are reluctant to force the dissolution of a company whose operating agreement provides reasonable mechanisms for resolving the specific dispute that has arisen, particularly if the petitioning member has not exhausted those mechanisms before filing for judicial dissolution.

The operating agreement should specifically state that judicial dissolution is an option of last resort available under applicable state law, and that the members intend the operating agreement's dispute resolution and deadlock provisions to provide an adequate alternative to judicial dissolution for the types of conflicts most likely to arise in the company's operations. This provision does not prevent a member from seeking judicial dissolution, the statutory right cannot be waived in advance in most states, but it creates a documented record of the parties' intent to use the operating agreement's mechanisms first.

CHAPTER 18: KEY TAKEAWAYS

1. Succession planning belongs in the formation documents because the founding period is the only time when the parties' interests are not yet entangled in the specific outcomes the succession provisions will eventually govern. Succession planning under duress, in response to a near-miss, an institutional investor's demand, or an actual crisis, produces inferior results compared to planning that occurs when the company has the bandwidth and objectivity to think through the options carefully.
2. The destination vision shapes the succession plan. An institutional platform requires continuous leadership development, systematized processes, and documented investor relationship management. A sale-oriented company requires institutional resilience and management depth that makes the company acquirable at maximum value. A wind-down-oriented company or fund requires dissolution provisions that protect investors and honor contractual commitments through completion of the current portfolio.

3. Building internal leadership depth is the most important operational succession strategy, regardless of destination vision. Identifying successor leaders by functional area (deal origination, investor relations, development execution, financial management), creating a formal partner track with defined milestones and documented criteria, and deliberately delegating authority to develop existing staff converts an aspiration into an organizational capability.
4. Reducing key-person dependence requires systematizing deal processes (documenting underwriting methodology, site evaluation criteria, and execution protocols in accessible, transferable form) and deliberately expanding investor relationship touch points beyond a single founding partner. An investor whose relationship with the company is mediated entirely through one founding partner has a relationship with that partner, not with the company.
5. Voluntary dissolution requires a clear trigger (unanimous consent, milestone failure, irreconcilable deadlock, fund term expiration) and a defined approval threshold. The default varies by state (unanimous under the Revised Uniform LLC Act; more than two-thirds of the profits interests under the Delaware LLC Act), so the operating agreement should set the threshold deliberately, and a winding-up process that accounts for the operational realities of a development company: active projects that cannot be immediately liquidated, investor commitments that survive the dissolution decision, and contractual obligations that extend beyond the dissolution date.
6. The orderly wind-down follows a priority waterfall: payment of third-party debts, payment of member-creditor claims, return of positive capital account balances, then pro-rata distribution of remaining assets. Active projects at dissolution require specific treatment: pre-construction projects may be released; construction-phase projects must be completed or transferred to a qualified successor; stabilized projects may be sold or held per the investment terms. The managing partner must have authority to complete or transfer active projects notwithstanding the dissolution decision.
7. Investor communications during dissolution must be prompt, honest, and free of material misstatements about the nature and cause of the dissolution, the condition of their investments, and the expected outcome. The company must identify a successor manager for active investor commitments; dissolution of the GP entity does not terminate the management obligations under active development management agreements. Judicial dissolution, a last resort available when the operating agreement's mechanisms have been exhausted, is best prevented by a well-drafted operating agreement with robust deadlock provisions and a clear voluntary dissolution process.

WHAT COMES NEXT

Part VII of the handbook turns to the regulatory and legal compliance framework within which every development company must operate. Chapter 19 addresses securities law compliance in depth: the legal framework for raising capital from investors, the exemptions that make private real estate offerings possible, and the disclosure obligations that protect investors while preserving the company's ability to access private capital. Chapter 20 addresses investment adviser obligations and regulatory registration, a frequently overlooked compliance requirement for development companies that manage assets for compensation.

See also: *Chapter 1 (Destination Vision: the foundational alignment on where the company is going) • Chapter 15 (Key-Person Life Insurance: the buy-sell agreement as a succession funding mechanism) • Chapter 17 (Deadlock Mechanisms: the circumstances that may lead to dissolution)*

- *Appendix J (Glossary: succession plan, partner track, wind-down, voluntary dissolution, judicial dissolution, dissolution waterfall)*

CH. 19

PART VII: SECURITIES LAW, INVESTMENT ADVISER COMPLIANCE & TAX

Securities Law Compliance

Raising Capital Legally

The legal framework for raising equity capital from private investors: which exemptions apply, what conditions must be satisfied, what must be disclosed, and where the lines are drawn that a real estate sponsor must never cross.

Every real estate development company that raises money from investors is in the securities business. This is not a statement about the type of investors involved, the structure of the offering, or the sophistication of the parties. It is a statement about the legal character of what is being exchanged: a membership interest in a real estate LLC offered to outside investors in exchange for capital, with the expectation of profits derived primarily from the efforts of others, is a security under federal and state law regardless of how the transaction is characterized.

Understanding the securities law framework is not optional for a development company that raises investor capital. The consequences of operating outside that framework, civil liability to investors, SEC enforcement actions, potential criminal prosecution, and the loss of the right to raise capital in future offerings, are severe enough that ignorance of the law is no mitigation and no defense. This chapter provides the educational foundation every founding partner must have, with the explicit caveat that applying securities law to a specific offering requires engagement of qualified securities counsel.

The Foundation: What Is a Security

The Securities Act of 1933 defines a security to include any investment contract, a term the Supreme Court interpreted in its landmark 1946 decision in SEC v. W.J. Howey Co. to encompass any investment of money in a common enterprise with the expectation of profits derived primarily from the efforts of others. This Howey test captures virtually every real estate equity investment structure used by private development companies. A membership interest in a development company's deal-level LLC offered to investors who are contributing equity capital and who are not managing the project satisfies the Howey test unambiguously:

- **Investment of money.** The investor contributes cash or other consideration.
- **In a common enterprise.** The investor's returns depend on the project's overall performance, not on any individual arrangement.
- **With the expectation of profits.** The investor expects a financial return above the preservation of principal.
- **Derived primarily from the efforts of others.** The development company's GP entity manages the project; the investor is a passive participant.

The consequence of this classification is straightforward but far-reaching: every offering of membership interests in a real estate development project to outside investors is an offering of securities, subject to the registration requirements of the Securities Act of 1933 unless a specific exemption applies. Because registration with the SEC is expensive, time-consuming, and generally inappropriate for private real estate offerings, virtually all development company capital raises rely on specific exemptions from registration. Understanding which exemptions are available, which

conditions must be satisfied, and how to stay within their boundaries is the core of securities law compliance for a real estate development company.

Regulation D: The Primary Exemption Framework

Regulation D, promulgated by the SEC under the Securities Act of 1933, provides the most widely used exemptions from registration for private securities offerings. For real estate development companies, two Regulation D exemptions are most commonly used: Rule 506(b) and Rule 506(c). Understanding the differences between them, and the conditions each requires, is fundamental to designing a compliant capital raise.

Rule 506(b): The Relationship-Based Exemption

Rule 506(b) is the traditional private placement exemption, the one most development companies use for capital raises based on pre-existing investor relationships. Under Rule 506(b):

- The offering may be made to an unlimited number of accredited investors and up to 35 non-accredited but sophisticated investors.
- No general solicitation or general advertising is permitted: the company cannot broadly advertise the offering to the public, post it on social media, or present it at conferences attended by people with whom the company has no pre-existing relationship.
- Non-accredited investors who participate must receive specified disclosure documents, including audited financial statements, a significant additional burden relative to accredited-investor-only offerings.
- No verification of accredited investor status is required: the company may rely on investor representations in subscription documents, though best practices include some reasonable inquiry.

The most critical condition of Rule 506(b) is the prohibition on general solicitation. In practice, the company must have a pre-existing, substantive relationship with each investor before presenting the offering opportunity. A pre-existing relationship is one the company established for purposes other than the specific offering: a prior investment in a previous deal, attendance at a company-hosted event, a referral from a trusted professional advisor, or a relationship developed over time through ordinary business contact.

What does not constitute a sufficient pre-existing relationship: a cold call made specifically to recruit an investor into the current offering; an introduction made by a broker-dealer specifically for the purpose of the offering; a meeting arranged at a real estate conference with an investor the company had not previously known; or contact through a social media post promoting the offering to unknown recipients. The substance of the relationship matters: a three-year business relationship with multiple communications and a real mutual understanding is clearly sufficient; a six-week email exchange initiated in connection with the current offering is almost certainly not.

The General Solicitation Problem

The general solicitation prohibition under Rule 506(b) is among the most frequently misunderstood and most frequently violated requirements in private real estate offerings. Sponsors accustomed to promoting their deals through social media posts, email newsletters to broad investor lists, conference presentations, and crowdfunding platforms are engaging in general solicitation that disqualifies the Rule 506(b) exemption. The consequences of an inadvertent violation are serious:

- The exemption is lost, making the offering an unregistered offering in violation of Section 5 of the Securities Act. The SEC can seek civil enforcement, including disgorgement of proceeds raised, civil penalties, and injunctive relief.

- Investors who participated in a violating offering have a right of rescission: they can demand the return of their investment, plus interest, regardless of the offering's performance. An investor who made a 15 percent profit has no rescission right; one who lost money has a powerful legal claim.
- The bad actor disqualification provisions of Regulation D may apply if the violation reflects willful misconduct, preventing the company from using Regulation D exemptions in future offerings.

The rule of thumb for Rule 506(b) compliance: if you are not certain you had a pre-existing, substantive relationship with every investor receiving information about the offering before the offering was initiated, do not use Rule 506(b) for that offering. Use Rule 506(c) instead.

Rule 506(c): General Solicitation With Verification

Rule 506(c) was created by the JOBS Act of 2012 and became effective in 2013. It permits general solicitation and general advertising of securities offerings, including social media posts, conference presentations, email newsletters to unknown recipients, and other forms of broad public outreach, subject to one critical condition: every investor who actually participates in the offering must be verified as an accredited investor through a reasonable verification process.

The distinction between Rule 506(b) and Rule 506(c) is not about whether investors must be accredited. As a practical matter, virtually all private real estate offerings limit participation to accredited investors under either rule. The distinction is about general solicitation (permitted under 506(c), prohibited under 506(b)) and accredited investor verification (required under 506(c), not required under 506(b)). What constitutes reasonable verification of accredited investor status under Rule 506(c):

- **Income-based status for natural persons.** Review of W-2s, tax returns, or other documents showing income exceeding $200,000 per year (or $300,000 combined with a spouse) in each of the two most recent years, plus a written representation that the same income level is expected in the current year.
- **Net-worth-based status for natural persons.** Review of bank statements, brokerage statements, tax assessments, and other evidence of assets; review of a credit report or other evidence of liabilities; and a written representation that the net worth threshold ($1,000,000 excluding the primary residence) is currently met.
- **Entity status.** Review of organizational documents confirming the entity type (registered investment adviser, bank, insurance company, and the like) or review of evidence that all equity owners are accredited investors.
- **Professional confirmation.** A written letter from the investor's attorney, CPA, or registered investment adviser confirming the investor is accredited based on their professional knowledge of the investor's financial situation.

The verification requirement has significant practical implications for investor relations. An investor who committed to previous deals based on a subscription document representation of accredited status may be surprised to be asked for tax returns or brokerage statements to verify accredited status under Rule 506(c). The company's choice between the two exemptions should be made before the investor outreach process begins, and investors should be informed of the verification requirements before they commit.

Accredited Investor: Who Qualifies

The accredited investor standard determines who may participate in private securities offerings without the full disclosure and protection framework that applies to public offerings. The SEC's

definition of accredited investor, set forth in Rule 501 of Regulation D, was most recently expanded in 2020 to add categories based on financial sophistication and professional certifications beyond the traditional financial threshold tests.

Accredited Investor Status for Natural Persons

An individual qualifies as an accredited investor under one or more of the following standards:

- **Income threshold.** The individual had individual income exceeding $200,000 in each of the two most recent calendar years, and has a reasonable expectation of reaching the same income level in the current year. Joint income with a spouse exceeding $300,000 satisfies the threshold when both spouses invest together.
- **Net worth threshold.** The individual has a net worth, or joint net worth with a spouse, exceeding $1,000,000 at the time of the investment, excluding the value of the primary residence. Any debt secured by the primary residence is counted as a liability in the net worth calculation.
- **Professional license holder.** As of 2020, an individual holding a valid Series 7, Series 65, or Series 82 securities license in good standing is an accredited investor, regardless of income or net worth. This category recognizes that professional licensing demonstrates investment sophistication independent of personal wealth.
- **Knowledgeable employee of a private fund.** An individual who is a knowledgeable employee of the private fund entity making the offering, including executive officers, directors, and employees who participate in the fund's investment activities, qualifies as accredited for that fund's offering.

Accredited Investor Status for Entities

Entities may qualify as accredited investors based on their type and structure:

- **Entities with at least $5,000,000 in total assets.** Any corporation, partnership, LLC, or trust not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000.
- **Regulated financial institutions and registered advisers.** Banks, savings associations, broker-dealers, insurance companies, registered investment companies, and registered investment advisers, regardless of asset size.
- **Family offices and family clients.** Family offices with at least $5,000,000 in assets under management and their family clients as defined under the Investment Advisers Act.
- **Entities composed entirely of accredited investors.** Any entity, regardless of asset size, in which all equity owners are accredited investors.

The accredited investor determination should be made at the time of each investment, not at the time of the fund's formation. An investor who was accredited at formation may not meet the threshold at the time of a subsequent capital call or a future investment. The company's subscription documents should require each investor to represent and warrant their accredited investor status as of the date of each investment, not merely as of the initial subscription.

Rule 506(b) and 506(c): Choosing the Right Exemption

The choice between Rule 506(b) and Rule 506(c) is one of the first and most consequential compliance decisions a development company makes when planning a capital raise. The decision is not merely technical; it affects the company's marketing approach, its investor relations process,

and the administrative burden of the offering. The following comparison provides a framework for making the choice:

Factor	Rule 506(b)	Rule 506(c)
General solicitation	Prohibited. All offers must be made pursuant to a pre-existing, substantive relationship established before the offering began.	Permitted. The company may use social media, email campaigns, conference presentations, and other broad outreach.
Investor eligibility	Unlimited accredited investors; up to 35 non-accredited but sophisticated investors (with additional disclosure requirements for non-accredited participants).	Accredited investors only. No non-accredited investors permitted, regardless of sophistication.
Accredited investor verification	Not required. The company may rely on investor representations in subscription documents, with reasonable inquiry.	Required. The company must take reasonable steps to verify each investor's accredited status through documentation review or professional certification.
Marketing approach	Deal-by-deal outreach to existing investor relationships. No public advertising.	Public marketing permitted: website listings, social media, conference presentations, crowdfunding platforms.
Best suited for	Companies with established investor relationships raising from known investors through a network-based approach.	Companies seeking to expand their investor network beyond existing relationships, including online platforms and broad outreach.
Administrative burden	Moderate: must document pre-existing relationships and ensure no general solicitation occurred.	Higher: must implement and document accredited investor verification for each investor.
Bad actor disqualification	Applies. The company and covered persons must not be disqualified persons.	Applies. The same disqualification provisions apply.

For most emerging development companies whose capital raises are based on personal relationships, professional networks, and referrals from existing investors, Rule 506(b) is the appropriate exemption. For companies actively expanding their investor networks through digital marketing, conference participation, or investor platforms, Rule 506(c) permits broader outreach at the cost of more rigorous verification.

A company cannot mix Rule 506(b) and Rule 506(c) in the same offering: once general solicitation has occurred in connection with a specific offering, that offering must comply with Rule 506(c) for all investors who participate in it. A company that begins a Rule 506(b) offering and then sends a marketing email to a broad list has contaminated the offering with general solicitation and must either retrofit it as a Rule 506(c) offering (verifying all investors) or treat it as a potential violation.

The Private Placement Memorandum

The Private Placement Memorandum (PPM) is the disclosure document through which a development company describes its offering, its business, its management team, its investment strategy, its risk factors, and its economic terms to prospective investors. Although no SEC rule specifically requires a PPM for Regulation D offerings (Regulation D is an exemption from registration, not a substitute registration process), the securities anti-fraud rules effectively require a document that gives investors the information they need to make an informed investment decision.

The anti-fraud rules, Section 10(b) of the Securities Exchange Act and Rule 10b-5, as well as Section 17(a) of the Securities Act, prohibit any material misstatement or omission of material fact in connection with the purchase or sale of any security. An offering made without a comprehensive written disclosure document is one in which the company has given investors no information against which to measure what they were told in verbal presentations, which creates enormous exposure to claims that material information was omitted or misrepresented.

The PPM is not simply a legal protection document. It is the company's most comprehensive communication about its investment opportunity and its organization. Investors who read it carefully, and institutional investors always do, learn more about the company from the PPM than from any other source. A PPM that is thoughtfully written, accurately reflects the company's strategy and

economics, and provides the depth of information a sophisticated investor needs to make a reasoned decision is an investor relations asset, not just a legal requirement.

Required PPM Components

A comprehensive PPM for a real estate development offering should address the following components, each corresponding to categories of information a reasonable investor would consider material to their investment decision:

- **Cover page and offering summary.** The name of the offering entity, the type of security being offered, the total offering amount, the minimum investment amount, the offering exemption being relied upon, and a clear statement that the securities have not been registered with the SEC and that resale is restricted.
- **Executive summary.** A concise overview of the investment opportunity, the investment strategy, the management team, and the key economic terms, written for a sophisticated reader who may review only this section before deciding whether to read further.
- **The offering terms.** The specific terms of the membership interests being offered, including the purchase price, the minimum investment, the closing mechanics, the distributions policy, the preferred return structure, the promote waterfall, and the management fee schedule.
- **Description of the business and investment strategy.** The company's investment thesis, target market, asset class focus, deal sourcing approach, underwriting methodology, and competitive positioning.
- **Management team.** Biographical information for each principal, including educational background, professional experience, prior investment track record, and any material litigation or regulatory history.
- **Track record.** A description of prior investments made by the management team, including returns achieved, deals completed, and the performance of comparable projects, with appropriate disclaimers that past performance does not guarantee future results.
- **Use of proceeds.** How the capital raised will be deployed, including the specific project or portfolio to be funded and the expected timeline for deployment.
- **Fee schedule.** A complete description of all fees the management company or its affiliates will earn in connection with the offering, including rates, bases, payment timing, and related-party relationships, as discussed in depth in Chapter 10.
- **Risk factors.** A comprehensive description of the material risks of the investment, including risks specific to real estate development (construction delays, cost overruns, entitlement failures, market timing risk), risks specific to the company's strategy and structure, and risks common to all illiquid private investments.
- **Conflicts of interest.** A complete description of all material conflicts between the management company's interests and the investors' interests, including related-party transactions, outside business activities, and fee structures that create incentive misalignments.
- **Investment structure.** A description of the legal entities involved in the investment, the relationship between the management company, the GP entity, and the deal-level SPE, and the governance rights investors receive or do not receive.
- **Tax considerations.** A description of the federal income tax consequences of investing, including pass-through taxation, the treatment of depreciation and losses, the treatment of disposition gains, and the specific tax consequences of the promoted interest structure.
- **Investor qualifications.** A statement of the accredited investor requirement and any other investor qualification conditions, and the representations the investor is making about their own status and sophistication.

- **Subscription procedures.** How to subscribe for interests, what documents are required, the closing mechanics, and the conditions to closing.

The Full and Fair Disclosure Standard

The standard against which the PPM's adequacy is measured, under both the anti-fraud rules and in any subsequent investor dispute, is whether the document provides full and fair disclosure of all material information a reasonable investor would consider important in making an investment decision. This standard has several practical implications:

- **Materiality is a low bar.** A fact is material if there is a substantial likelihood that a reasonable investor would consider it important in making their decision. This does not require the fact to be outcome-determinative; it requires only that it be the kind of fact a reasonable investor would want to know. Fees, conflicts of interest, prior litigation involving the management team, and limitations on the track record all clear the materiality threshold without difficulty.
- **Omissions are as dangerous as misstatements.** The anti-fraud rules prohibit not just false statements but omissions that make the statements actually made misleading. A PPM that accurately describes the management team's successful projects but omits the projects that failed to deliver the projected returns has not made a false statement about the successful projects, but it has created a materially misleading impression about the team's track record.
- **Disclosure must be specific enough to be actionable.** A risk factor that says construction projects involve risk is not adequate disclosure of the specific construction risks applicable to the company's development strategy. Adequate disclosure identifies the specific risk, explains its potential impact, and describes what the company is doing, if anything, to mitigate it.

The Bad Actor Disqualification

Regulation D's Rule 506 exemptions are not available to companies or their principals who are bad actors under Rule 506(d), persons who have been subject to specific types of criminal convictions, regulatory sanctions, court orders, or disciplinary proceedings relating to the securities markets. The disqualification is automatic: if a covered person is a bad actor, the exemption is unavailable, regardless of whether the company was aware of the disqualifying event.

Who Is a Covered Person

The bad actor disqualification applies to any covered person in connection with the offering, including:

- The issuing entity itself.
- Each general partner, managing member, and executive officer of the issuing entity.
- Each director, officer, and managing member of the GP entity.
- Any beneficial owner of 20 percent or more of the voting securities of the issuing entity.
- Any investment manager or promoter in connection with the offering.
- Any person compensated for soliciting investors in connection with the offering.

For a development company with multiple founding partners and a GP entity that sits between the management company and the deal-level entity, the covered person analysis must be conducted at each entity level. Every individual who is a managing member, director, officer, or 20 percent or greater beneficial owner at any level of the offering structure is a covered person whose history must be reviewed.

Disqualifying Events

A covered person is a bad actor if they have experienced any of the following:

- A criminal conviction for any felony or misdemeanor in connection with the purchase or sale of any security, involving the making of a false filing with the SEC, or arising out of the conduct of a broker, dealer, municipal securities dealer, investment adviser, or investment company, within the past ten years (or five years for the issuer itself).
- Any court injunction or restraining order issued within the past five years in connection with the purchase or sale of securities, involving a false SEC filing, or relating to the conduct of a securities professional.
- A final order from a state securities, banking, credit union, or insurance regulator that bars the covered person from association with a regulated entity or from engaging in a securities-related business.
- Any SEC disciplinary order, cease-and-desist order, or order suspending or revoking registration.
- Suspension or expulsion from membership in a self-regulatory organization (FINRA, a national securities exchange).
- United States Postal Service fraud orders.

The Reasonable Care Exception and Disclosure

If a disqualifying event occurred before the founding partners knew or could have known about it, for example, a founding partner who was previously an officer at a company that received an SEC cease-and-desist order without the founding partner's knowledge or involvement, the issuer may still qualify for the Regulation D exemption if it can demonstrate that it did not know and, in the exercise of reasonable care, could not have known of the disqualifying event.

In addition, a disqualifying event that occurred before September 23, 2013 (the effective date of the current bad actor rules) does not automatically disqualify the issuer from using the Rule 506 exemption, but the issuer must disclose the event to investors. Disclosure of pre-cutoff disqualifying events in the PPM's risk factors section is mandatory.

The practical implication: before conducting any Rule 506 offering, the company should conduct a comprehensive background check on every covered person, including every founding partner, every entity in the offering structure, and every person who will be compensated for soliciting investors. The background check should be documented and retained as part of the offering's compliance record. A company that discovers a potential disqualifying event during this review should consult with securities counsel before proceeding.

Form D: The Required Filing

Within 15 days of the first sale of securities in a Regulation D offering, the company must file a Form D with the SEC through the EDGAR filing system. Form D is a short notice that identifies the issuer, describes the offering (the exemption being relied upon, the amount offered, the amount sold, and the number of investors), and provides contact information for the company's principals.

The Form D filing is not a registration statement; it is not a public disclosure of the PPM or the offering terms. It is a notice of the exempt offering that allows the SEC to monitor the use of the Regulation D exemptions across the private capital markets. Failing to file Form D does not by itself invalidate the exemption in most circumstances, but it is a technical violation of Rule 503 of Regulation D and can be used by investors and regulators as evidence of compliance deficiencies in connection with other claims.

State Blue Sky Requirements

In addition to the federal Form D filing, Regulation D offerings must comply with the securities laws of each state in which investors are located. These state securities laws, historically called blue sky laws, impose separate filing requirements, investor qualification standards, and disclosure obligations that vary significantly by state. Federal law provides partial preemption of state blue sky laws for offerings under Rule 506: states cannot impose substantive disclosure or merit review requirements on Rule 506 offerings as a condition of the offering. States may and typically do, however, require:

- A state notice filing, which typically involves submitting a copy of the federal Form D to the state securities regulator within a specified period (commonly 15 days of the first sale to a state investor).
- Payment of a state filing fee, which varies by state from a nominal amount to several thousand dollars.
- Compliance with the state's consent-to-service-of-process requirements.

The state filing requirements must be completed for each state in which an investor is resident, not just the state where the company is formed or headquartered. A company that closes its offering without filing in the investor's home state has violated that state's securities laws, even if the federal Regulation D requirements were perfectly satisfied. The company's securities counsel maintains a list of state filing requirements and should coordinate the state filings as part of the overall offering compliance.

Common Violations and How to Avoid Them

Real estate development companies that raise private investor capital commit a predictable set of securities law violations, most of which result from ignorance, optimism, and the haste that often characterizes an early-stage company's first capital raises. The following analysis addresses the most common violations and the specific practices that prevent each.

Conducting an Offering Without a PPM

A development company that raises investor capital based solely on verbal presentations, investor deck slides, and pro forma financial projections, without a comprehensive written disclosure document, has created the maximum possible anti-fraud exposure. When that offering underperforms, and eventually some offering will underperform, the investors' attorneys will argue they were never given complete, accurate information about the investment's risks, the management team's conflicts of interest, and the realistic range of possible outcomes. Without a written PPM to point to, the company has no documentary record of what it disclosed and no basis for defending the adequacy of its disclosure.

The solution is straightforward: no investor capital should be accepted without a comprehensive, counsel-reviewed PPM having been delivered to the investor in advance of their subscription. The cost of a PPM, typically $15,000 to $35,000 in legal fees for a well-drafted standalone deal PPM, and $50,000 to $150,000 or more for a fund-level PPM, is not optional. It is the legal infrastructure that makes the capital raise permissible.

Inadvertent General Solicitation

As discussed earlier in this chapter, general solicitation under Rule 506(b) is among the most common compliance failures in private real estate offerings. The specific behaviors that constitute inadvertent general solicitation:

- Posting information about an available investment opportunity on LinkedIn, Instagram, or other social media platforms accessible to people outside the company's existing investor relationships.
- Presenting an available investment opportunity at a real estate conference, investor summit, or networking event attended by people the company does not have a pre-existing relationship with.
- Sending an email newsletter that describes an available investment to a broad distribution list that includes recipients who are not existing investor relationships.
- Publishing a website or landing page that identifies a specific investment opportunity and invites investor inquiries from unknown visitors.

The prevention: before any outreach in connection with a specific offering, determine whether the company has a pre-existing, substantive relationship with each potential recipient. If the planned outreach would reach anyone outside those relationships, use Rule 506(c) rather than Rule 506(b).

Inadequate Offering Documents

A PPM that is generic, outdated, or materially incomplete is almost as problematic as no PPM at all. Common inadequacies:

- Risk factors that are generic rather than specific to the offering: a company whose specific risks include a concentrated geographic market, a specific entitlement risk on the subject property, or an untested development strategy should describe those specific risks in detail, not simply list generic real estate investment risks.
- Track record disclosure that omits underperforming or failed deals: selectively presenting only the management team's successful prior projects while omitting projects that lost money or underperformed is a material omission that violates the anti-fraud rules.
- Fee disclosure that uses vague terms: a fee schedule that says the sponsor may earn customary fees without specifying the rates, bases, and dollar amounts is inadequate disclosure under the full and fair disclosure standard.
- A PPM that has not been updated to reflect material changes in the offering, the management team, the project, or the company's legal or regulatory status since it was originally prepared.

The Track Record Representation Problem

The track record is one of the most fraught disclosure areas in a real estate development company's PPM. The temptation is to present only the best deals, the high-return, on-schedule projects that make the management team look exceptional. The legal obligation is to provide a balanced, accurate picture of the team's prior investment performance that includes both the successes and the failures. Several specific problems:

- Presenting deals completed at a prior employer as the individual founding partner's personal track record, when the partner was one of many principals involved and cannot be solely credited with the results.
- Using realized returns on completed projects alongside projected returns on unrealized projects in a way that implies the projected returns are as reliable as the realized ones.
- Omitting deals where the projected return was not achieved, even if the project was not technically a loss.
- Presenting return metrics without disclosing the fee loads, preferred returns, and promote structures that affected the investor returns included in the track record.

The SEC has brought enforcement actions against real estate sponsors specifically on the basis of misleading track record presentations. The safe approach: present the complete track record,

including underperforming deals, with a clear methodology note explaining how returns are calculated, what fees are included or excluded, and what assumptions underlie any projected returns on unrealized investments.

The Consequences of Securities Violations: Why Compliance Is Not Optional

The SEC's Division of Enforcement runs an active real estate fraud program. Sponsors who raise investor capital without proper securities law compliance, or who make material misrepresentations in connection with their offerings, face civil enforcement actions seeking disgorgement of all proceeds raised plus civil penalties; investment ban orders preventing the individual from serving as an officer, director, or investment professional; investor rescission rights allowing each investor to demand the return of their investment plus interest regardless of whether the investment performed well or poorly; and, in egregious cases, criminal referrals to the Department of Justice.

None of these consequences requires a finding of intent. Civil anti-fraud liability under Section 17(a) of the Securities Act can be established on a negligence theory: the sponsor did not need to intend to deceive investors; it is enough that they failed to provide complete, accurate disclosure a reasonable investor would have considered material. The cost of building a compliant offering process, including qualified securities counsel, a comprehensive PPM, and a rigorous investor qualification process, is a fraction of the cost of defending a single securities enforcement action or investor lawsuit.

The Ongoing Compliance Obligations After Closing

Securities law compliance does not end when the offering closes and investor capital is committed. Development companies that manage securities offerings have ongoing obligations to their investors that persist through the life of the investment and that are grounded in the same anti-fraud principles that govern the offering itself.

Investor Reporting Obligations

The development company's ongoing reporting obligations to its investors are typically defined in the operating agreement and the subscription documents, but they are also informed by the anti-fraud rules' prohibition on material misstatements and omissions in connection with the management of investor securities. An investor who does not receive accurate, timely information about the performance of their investment cannot make informed decisions about whether to seek redemption (where available), whether to exercise their governance rights, or whether the management team is performing as represented. Minimum investor reporting obligations:

- **Quarterly financial reports.** A statement of the project or portfolio's financial performance during the quarter, including revenue, expenses, net operating income, and comparison to the original underwriting.
- **Construction and development updates.** For projects in active development, a quarterly update on construction progress, budget status (actual versus projected), timeline status, and any material issues affecting the project's execution.
- **Annual financial statements.** Annual financial statements prepared in accordance with GAAP, reviewed or audited by an independent CPA. Institutional investors typically require audited financials; individual investors may accept reviewed or compiled financials for smaller offerings.

- **Material event notification.** Prompt notice (commonly within 15 to 30 days) to all investors of any material event affecting the investment, including construction delays above a defined threshold, cost overruns above a defined threshold, changes in the management team, regulatory actions, and material changes in the investment's projected return.
- **K-1 delivery.** The annual Schedule K-1 for each investor, delivered by March 15 or, if an extension is filed, as soon as reasonably practical. Late K-1 delivery creates practical difficulties for investors who cannot file their personal tax returns until they receive the K-1 and is a recurring source of investor relations tension that good accounting infrastructure can avoid.

Material Changes and Amended Disclosures

If a material change occurs after the PPM is delivered and subscriptions are accepted, a change in the management team, a significant change in the project's scope or risk profile, a material change in the fee structure, or any other development that would have been material to an investor's decision to invest, the company has an obligation to disclose that change to investors who have not yet funded their subscriptions. Investors who have already funded generally have no legal right to rescind based on post-closing material changes, but the duty of disclosure to unfunded investors is clear.

For offerings with multiple closings over an extended period, the PPM should be updated or supplemented before each subsequent closing to reflect any material changes that have occurred since the prior closing. A stale PPM that does not reflect the current state of the project or the management team is inadequate disclosure for subsequent investors, even if it was accurate at the time of the first closing.

CHAPTER 19: KEY TAKEAWAYS

1. Every offering of membership interests in a real estate development project to outside investors is an offering of securities under the Howey test. There is no exemption based on the structure of the offering, the sophistication of the investors, or the characterization of the transaction. Securities law compliance is mandatory for any development company that raises investor capital.
2. Rule 506(b) permits private offerings to unlimited accredited investors and up to 35 sophisticated non-accredited investors, but prohibits general solicitation. Every investor must have a pre-existing, substantive relationship with the company established before the offering began, not a relationship formed for the purpose of the specific offering. Inadvertent general solicitation (a social media post, a conference presentation to unknown attendees, an email to a broad list) destroys the 506(b) exemption.
3. Rule 506(c) permits general solicitation and broad marketing but requires verification of every investor's accredited status through documented review of financial records or written certification from a licensed professional. The company cannot mix 506(b) and 506(c) in the same offering: once general solicitation has occurred, all investors must be verified as accredited.
4. The Private Placement Memorandum is the foundational disclosure document for any Regulation D offering. Although not technically required by rule, the anti-fraud obligations effectively require a comprehensive written disclosure document that provides investors with complete, accurate information about the offering, the management team, the fee structure, all material conflicts of interest, the complete

track record (including underperforming deals), and all material risks. Vague, generic, or selective disclosure violates the full and fair disclosure standard.

5. The bad actor disqualification eliminates the Rule 506 exemptions for offerings involving covered persons (managing members, officers, 20 percent or greater beneficial owners, and compensated solicitors) who have experienced specific criminal convictions, regulatory sanctions, or court orders. Before any offering, the company must conduct a comprehensive background check on every covered person and document the results. A company that proceeds with an offering involving an undiscovered bad actor has no defense based on ignorance.
6. Form D must be filed with the SEC within 15 days of the first sale of securities. State blue sky notice filings must be made for each state in which investors are resident, with state-specific fees and timing requirements. Federal law preempts state merit review of Rule 506 offerings but does not eliminate state notice filing and fee requirements.
7. Ongoing compliance after closing includes quarterly financial reports and development updates, annual financial statements (reviewed or audited), prompt notice of material events within 15 to 30 days, and timely K-1 delivery. The anti-fraud rules apply through the life of the investment, not just at the time of the offering. Material changes after closing require disclosure to investors who have not yet funded and PPM supplementation before subsequent closings.

WHAT COMES NEXT

Chapter 20 addresses investment adviser obligations and regulatory registration, a compliance dimension closely related to the securities offering framework addressed in this chapter but directed at a distinct question: when does a development company's ongoing management of investor assets for compensation require registration as an investment adviser under federal or state law, and what compliance obligations attach to that registration?

See also: *Chapter 10 (The Fee Architecture: fee disclosure obligations in the PPM) • Chapter 13 (Fiduciary Duties: conflict of interest disclosure in the PPM) • Appendix F (Securities Law Compliance Checklist) • Appendix J (Glossary: security, Howey test, Rule 506(b), Rule 506(c), accredited investor, general solicitation, PPM, Form D, blue sky, bad actor disqualification)*

CH. 20

PART VII: SECURITIES LAW, INVESTMENT ADVISER COMPLIANCE & TAX

Investment Adviser Obligations

and Regulatory Registration

How the Investment Company Act and the Investment Advisers Act intersect with a real estate development company's operations, with particular focus on the Section 3(c)(5)(C) exclusion that most real estate sponsors rely on to avoid Investment Company Act registration, and what the Exempt Reporting Adviser and Registered Investment Adviser frameworks require.

Two federal statutes govern the regulatory environment in which a real estate development and sponsor company manages investor capital: the Investment Company Act of 1940 and the Investment Advisers Act of 1940. Most real estate sponsors focus almost exclusively on the Advisers Act, the question of whether they need to register as an investment adviser, while treating the Investment Company Act as an abstract concern applicable to mutual funds and hedge funds rather than real estate companies. This is a serious analytical error.

The Investment Company Act question must be answered first and correctly, because the answer determines which Investment Company Act exclusion the development company's deal vehicles rely on, and that choice, in turn, affects which investment adviser exemption is available and what ongoing compliance obligations attach. For the vast majority of real estate sponsors, the correct answer to the Investment Company Act question runs through Section 3(c)(5)(C), not Section 3(c)(1) or 3(c)(7). Understanding why, and how to structure deal vehicles to properly rely on 3(c)(5)(C), is the most important technical content in this chapter.

The Investment Company Act Problem: Why It Matters First

The Investment Company Act of 1940 broadly defines an investment company as any issuer that is primarily engaged in the business of investing, reinvesting, or trading in securities. Because the membership interests that investors hold in a real estate development LLC are securities, as established by the Howey test analysis in Chapter 19, a development company that raises investor capital and manages those investments must carefully analyze whether it is required to register as an investment company.

A company required to register as an investment company under the Act faces consequences that are fundamentally incompatible with private development company operations: mandatory leverage limitations, strict restrictions on affiliated transactions, requirements for independent board oversight, mandatory diversification requirements, and continuous public reporting. No serious real estate development company can operate within those constraints. Every deal vehicle and fund structure must be organized to qualify for one of the Investment Company Act's statutory exclusions.

This analysis must precede the investment adviser analysis. The specific exclusion that a development company's deal vehicles rely on to avoid Investment Company Act registration directly shapes which investment adviser exemptions are available under the Advisers Act. A company whose vehicles rely on the Section 3(c)(5)(C) exclusion operates in a fundamentally different regulatory environment than one relying on 3(c)(1) or 3(c)(7).

The Three Principal Investment Company Act Exclusions for Real Estate Sponsors

Three exclusions from the Investment Company Act are most commonly relied upon by real estate development and sponsor companies. Understanding the differences among them, and why Section 3(c)(5)(C) is the right answer for the vast majority of real estate sponsors, requires understanding the statutory language and the SEC's interpretive guidance that defines each exclusion's scope.

Section 3(c)(1): The 100-Investor Exclusion

Section 3(c)(1) excludes from the Investment Company Act any issuer whose outstanding securities are beneficially owned by not more than 100 persons, and which is not making or proposing to make a public offering. This exclusion is straightforward to understand and commonly discussed in the context of private fund formation.

Section 3(c)(1) has a critical limitation for real estate sponsors: the 100-investor ceiling is a hard cap that applies to each individual investment entity. A development company that structures each deal vehicle as a 3(c)(1) fund must track beneficial owner counts with precision, cannot exceed 100 investors in any single vehicle regardless of deal size, and cannot readily expand its investor base across multiple deals without eventually bumping against the ceiling in ways that create structural problems. More importantly, as discussed below, 3(c)(1) is the wrong exclusion for a company whose primary assets are mortgage loans and interests in real property, because the SEC has established a clear analytical framework that makes 3(c)(5)(C) the appropriate exclusion for those asset types.

Section 3(c)(7): The Qualified Purchaser Exclusion

Section 3(c)(7) excludes from the Investment Company Act any issuer whose outstanding securities are owned exclusively by qualified purchasers, persons who own at least $5 million in investments (for natural persons), or who own and invest at least $25 million on a discretionary basis (for institutional investors acting for their own accounts). Unlike 3(c)(1), there is no cap on the number of qualified purchasers who may invest in a 3(c)(7) vehicle, making it appropriate for larger institutional funds.

The qualified purchaser standard is significantly more demanding than the accredited investor standard. For most emerging development companies whose investor base consists primarily of high-net-worth individuals rather than institutional investors, the 3(c)(7) standard will exclude a meaningful portion of their investor relationships. A real estate professional with $1 million in net worth and a good income qualifies as an accredited investor but does not meet the $5 million investment threshold required for qualified purchaser status.

Like 3(c)(1), Section 3(c)(7) is not the appropriate analytical framework for a development company whose primary assets are interests in real property and mortgage loans. The SEC has made clear that companies primarily engaged in those asset types should be analyzing their exclusion under Section 3(c)(5)(C), not under the investor-count-based exclusions of 3(c)(1) or 3(c)(7). Using 3(c)(1) or 3(c)(7) when 3(c)(5)(C) is the more appropriate exclusion creates unnecessary investor eligibility restrictions and fails to use the exclusion Congress specifically designed for entities primarily engaged in real estate investment.

Section 3(c)(5)(C): The Correct Exclusion for Most Real Estate Sponsors

Section 3(c)(5)(C) of the Investment Company Act excludes from the definition of investment company any issuer that is primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate, commonly referred to as the other real estate assets

exclusion. This exclusion was specifically designed for entities primarily engaged in real estate investment, mortgage companies, real estate investment trusts, and private real estate sponsors, and it is the exclusion the vast majority of real estate development and sponsor companies should structure their deal vehicles to rely upon.

The statutory text of Section 3(c)(5)(C) excludes from the Investment Company Act any person primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. In practice, the SEC has interpreted this language to exclude a company that holds a portfolio of assets that are primarily qualifying assets, assets that represent interests in real estate or are backed by real estate, rather than non-qualifying assets such as securities or financial instruments with no direct real estate backing.

Section 3(c)(5)(C) in Depth: The Other Real Estate Assets Framework

The Section 3(c)(5)(C) exclusion is the most practically important Investment Company Act provision for a real estate development company, and it deserves more careful attention than most formation handbooks provide. The exclusion rests on a specific analytical framework the SEC has developed over decades of no-action letters, interpretive guidance, and enforcement actions, a framework that requires the company to understand not just the exclusion's general availability but the specific asset categories that qualify to support it.

The Qualifying Asset Test

The SEC's interpretive framework for 3(c)(5)(C) requires that at least 55 percent of the company's total assets consist of qualifying assets, assets the SEC has identified as constituting mortgages and other liens on and interests in real estate within the meaning of the exclusion. An additional requirement effectively imposes a portfolio test: at least 80 percent of total assets must consist of qualifying assets and real estate-related assets. The two-tier asset test works as follows:

- **Tier 1 (55 percent minimum in qualifying assets).** The core of the exclusion. Assets that qualify at the 55 percent tier are direct interests in real estate the SEC treats as equivalent to the mortgages and other liens on and interests in real estate the statute identifies.
- **Tier 2 (additional assets up to 80 percent combined).** Assets that are sufficiently related to real estate to be treated as real estate-related for purposes of the exclusion, but that do not qualify for the 55 percent tier. These assets can fill the space between 55 percent and 80 percent of the portfolio.
- **Non-qualifying assets (no more than 20 percent of total assets).** Assets that are not qualifying assets or real estate-related assets. The company may hold these assets (cash, treasury securities, operating assets of the management company), but they cannot exceed 20 percent of the total portfolio without jeopardizing the exclusion.

What Counts as a Qualifying Asset Under 3(c)(5)(C)

The determination of whether a specific asset is a qualifying asset for the 55 percent tier is the most technically demanding aspect of the 3(c)(5)(C) analysis. The SEC's guidance, developed through a series of no-action letters spanning several decades, has identified the following as qualifying assets:

- **Fee interests in real property.** The direct ownership of land and improvements. A development company that holds fee simple title to a development site, a completed building, or any other improved or unimproved real property holds a qualifying asset.

- **Leasehold interests in real property.** A long-term leasehold interest in real property, such as a ground lease, is generally treated as a qualifying asset where the leasehold represents a real economic interest in the underlying real estate.
- **Mortgage loans and other direct real estate loans.** A loan made directly to a borrower that is secured by a first or subordinated lien on real property. This includes construction loans, bridge loans, mezzanine loans secured directly on real property (as opposed to mezzanine loans secured on equity interests in property-owning entities), and permanent mortgage loans.
- **Certain interests in entities that directly own real estate.** The SEC has generally treated an interest in an entity as a qualifying asset when the entity itself holds qualifying real estate assets and the interest represents a controlling or nearly controlling ownership stake, rather than a passive minority interest. A development company that holds a 100 percent membership interest in a single-asset LLC that owns the underlying real property holds what the SEC has treated as a qualifying asset.

Certain assets that might intuitively seem like real estate assets do not qualify for the 55 percent tier:

- **Minority interests in real estate entities.** A passive, non-controlling minority membership interest in an entity that owns real property is generally treated as a security, a non-qualifying asset, rather than as a direct interest in real estate. This is one of the most surprising and practically significant aspects of the 3(c)(5)(C) framework for development companies that structure their deals as multi-investor LLCs.
- **Mortgage-backed securities and CMBS.** Instruments backed by pools of mortgage loans, mortgage-backed securities, CMBS, and CMOs, are securities, not direct mortgage loans. They are generally treated as non-qualifying assets or, at best, as real estate-related assets for the Tier 2 analysis.
- **Equity interests in publicly traded REITs and real estate companies.** Shares of publicly traded real estate companies are securities, not direct interests in real estate, and are generally non-qualifying.

The Controlling Interest Problem: Why Deal Structure Matters

The SEC's treatment of interests in entities differently depending on whether they are controlling or non-controlling creates a significant structural consideration for real estate development companies that syndicate equity from outside investors. This distinction is at the heart of why 3(c)(5)(C) requires more careful structuring analysis than simply assuming the exclusion is available.

In a typical real estate development syndication, the deal-level entity is a multi-member LLC with the following ownership structure: the GP and sponsor entity holds a small managing member interest (say, 5 to 10 percent) plus the promoted interest; and the LP investors hold the remaining 90 to 95 percent as non-managing members. From the sponsor's perspective, the sponsor entity's interest in the deal-level LLC, including its managing member control, may be treated as a qualifying asset if the control element is sufficient and the deal-level LLC's primary assets are qualifying real estate.

The LP investors' interests present the more complex question. If the LP investors hold passive, non-controlling minority interests in the deal-level LLC, and if those LLC interests are classified as securities (as they are for securities law purposes under the Howey test), then the LP investors' own analysis of whether they need to register as investment companies may need to examine whether their interests in the development LLC are qualifying assets or non-qualifying securities.

For the development company and its GP entity, the critical structural question is whether the entity that needs 3(c)(5)(C) protection holds its real estate assets in a form the SEC will treat as qualifying assets. The answer is yes when the GP entity holds a controlling interest in deal-level entities that

directly own qualifying real estate. The answer becomes uncertain when the GP entity holds only passive minority interests in entities that themselves hold real estate.

The Primarily Engaged In Requirement

Even when the company's asset portfolio satisfies the 55 percent and 80 percent test, Section 3(c)(5)(C) requires that the company be primarily engaged in purchasing or acquiring the qualifying assets. The primarily engaged in standard is a business activity test, not just an asset test. A company that happens to hold qualifying real estate assets but whose primary business activity is something other than acquiring and managing real estate may not satisfy the exclusion.

For a real estate development company whose entire business model is centered on acquiring, developing, and managing real property, the primarily engaged in requirement presents no particular difficulty: the company's primary business is precisely what the exclusion describes. The analysis becomes more complex for a company that has diversified into non-real-estate activities, technology, advisory services, or financial services, that may be growing as a proportion of total business activity.

The primarily engaged in requirement also means the exclusion must be maintained continuously, not just at the time the entity is formed. A development company that shifts its strategy mid-cycle, moving toward passive investment in third-party real estate securities rather than active development of owned properties, may find that it is no longer primarily engaged in acquiring qualifying real estate assets, and that the 3(c)(5)(C) exclusion has become unavailable without any formal decision to abandon it.

No Investor Count or Qualification Restriction

One of the most significant practical advantages of the Section 3(c)(5)(C) exclusion over Sections 3(c)(1) and 3(c)(7) is that it carries no restriction on the number of investors or on investor qualification standards. A company that properly structures its business to qualify for the 3(c)(5)(C) exclusion can accept investment from any number of investors, and those investors are not required to be accredited investors or qualified purchasers for Investment Company Act purposes.

This does not mean investor qualification requirements disappear altogether: the accredited investor standard from Regulation D still applies to the securities offering under the Advisers Act exemption analysis. But it does mean the 3(c)(5)(C) exclusion does not impose an additional, separate investor qualification standard above and beyond what the securities offering exemption already requires. The company does not need to limit its investor count to 100, does not need to require investors to hold $5 million in investments, and does not face the operational complexity of tracking investor counts against a statutory cap.

This is one of the most important practical advantages of the 3(c)(5)(C) approach for an emerging development company that anticipates growing its investor base over time. The 3(c)(1) approach becomes operationally constraining as the company grows; the 3(c)(5)(C) approach scales without investor count limitations.

Why 3(c)(5)(C) Is the Right Starting Point for Most Real Estate Sponsors

A common pattern in real estate sponsor formation: the attorney drafting the offering documents defaults to the 3(c)(1) exclusion for the deal-level entities because it is familiar, commonly used, and easy to explain. The 100-investor limit seems generous for a company doing its first or second deal. The qualified purchaser standard of 3(c)(7) seems like a problem for the future.

> Several deals later, the company discovers that the 3(c)(1) investor count is creating structural problems: a deal with 50 investors from the last round, followed by a deal with 60 new investors, followed by a third deal where the same investors want to participate again, starts to create counting complexity and eligibility questions that were never anticipated. Meanwhile, the company has been operating in the analytical framework of a fund-style investment company when its actual business, acquiring, developing, and managing real property, has always fit more naturally under 3(c)(5)(C).
>
> Restructuring deal vehicles from 3(c)(1) to 3(c)(5)(C) after the fact is not impossible, but it is legally complex and creates investor relations complications. The correct time to establish the 3(c)(5)(C) structure is at formation, when counsel can properly analyze the business model and design the deal vehicle structure to maintain the exclusion through the life of each investment.

The Investment Advisers Act: When the Development Company Also Needs to Register as an Adviser

With the Investment Company Act exclusion question properly analyzed, the development company must also determine whether it is required to register under the Investment Advisers Act of 1940 as an investment adviser. The two analyses are distinct but related: the Investment Company Act analysis addresses the status of the deal-level entities; the Advisers Act analysis addresses the status of the management company or GP entity that manages those deal-level entities for compensation.

The Investment Advisers Act defines an investment adviser as any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in, purchasing, or selling securities. A development company's GP entity that manages deal-level entities on behalf of outside investors, earns asset management fees and promoted interest, and exercises discretion over investment and disposition decisions likely meets this definition, even if those deal-level entities qualify for the 3(c)(5)(C) Investment Company Act exclusion.

The fact that the deal-level entity avoids Investment Company Act registration through 3(c)(5)(C) does not mean the GP entity avoids investment adviser registration. These are separate questions under separate statutes.

The Advisers Act Registration Framework

If the GP entity meets the investment adviser definition, it must either register or qualify for an available exemption. The registration framework has three primary categories:

Registered Investment Adviser (RIA)

A Registered Investment Adviser has completed full SEC registration by filing Form ADV and is subject to comprehensive SEC regulatory oversight. SEC registration is generally required for investment advisers with $110 million or more in regulatory assets under management (RAUM). The full RIA compliance program includes a written compliance manual, a designated Chief Compliance Officer, a code of ethics, annual compliance reviews, the Custody Rule (Rule 206(4)-2), the Marketing Rule (Rule 206(4)-1), and extensive Form ADV disclosure obligations. The

compliance burden and ongoing cost of full RIA registration are substantial. Most development companies prefer to operate under an available exemption for as long as possible.

The Real Estate Adviser Exemption and the 3(c)(5)(C) Connection

Here is where the Investment Company Act and Advisers Act analyses intersect in a way that directly rewards the sponsor who structures deal vehicles under 3(c)(5)(C). Under the Advisers Act, there are several exemptions from registration. The Private Fund Adviser Exemption, which provides exempt reporting adviser status, is available only to advisers whose clients are private funds, defined as funds that would be investment companies absent the 3(c)(1) or 3(c)(7) exclusions.

A sponsor whose deal vehicles rely on Section 3(c)(5)(C) rather than 3(c)(1) or 3(c)(7) is managing entities that are not private funds under this definition, because 3(c)(5)(C) entities do not need 3(c)(1) or 3(c)(7) to avoid investment company status: they avoid it through a completely different statutory provision. This means the Private Fund Adviser Exemption is technically unavailable to a sponsor whose deal vehicles are structured exclusively as 3(c)(5)(C) entities. In practice, this creates a nuanced compliance picture:

- A sponsor who manages only 3(c)(5)(C) entities must look to a different basis for Advisers Act exemption. Historically, the SEC and state securities regulators have recognized that a company primarily engaged in the real estate business, acquiring, managing, and disposing of real property, may not be in the business of advising about securities in the sense that triggers Advisers Act registration, because the primary business is the real estate itself rather than the management of investor securities.
- Many real estate sponsors whose RAUM is relatively modest rely on state-level registration exemptions or on the argument that their primary business is real estate investment and management, not investment advisory services. These positions are fact-specific and should be evaluated with qualified legal counsel.
- Some larger sponsors maintain a mixed portfolio of entities: some deal vehicles structured as 3(c)(5)(C) entities (for the direct property holding entities) and others structured as 3(c)(1) or 3(c)(7) entities (for fund-level vehicles that hold interests in 3(c)(5)(C) entities). This layered structure requires careful Advisers Act analysis at each entity level.

The Exempt Reporting Adviser for Mixed Structures

For a development company that operates a layered structure, a fund entity (organized as a 3(c)(1) or 3(c)(7) vehicle) that invests in deal-level entities (organized as 3(c)(5)(C) vehicles), the Exempt Reporting Adviser status is available for the management of the fund-level entity. The fund-level entity qualifies as a private fund because it relies on 3(c)(1) or 3(c)(7) to avoid investment company status. The GP entity that manages the fund is advising a private fund and may qualify for the Private Fund Adviser Exemption if total RAUM attributable to private funds is below $150 million.

An ERA must file a partial Form ADV within 60 days of first relying on the exemption and update it annually within 90 days after fiscal year end. ERA filing requirements and ongoing obligations are addressed later in this chapter.

State Investment Adviser Registration

An investment adviser with less than $100 million in RAUM is generally required to register at the state level rather than with the SEC. State registration is administered through the IARD system, requires the filing of Form ADV (Parts 1 and 2), and involves state-specific fees (typically $200 to $500 per state), surety bond requirements in some states, and compliance with state-specific investment adviser regulations.

For a development company that has concluded it is an investment adviser, whether because it manages 3(c)(1) or 3(c)(7) entities, or because its state securities regulator takes the view that its real estate management activities constitute advisory services, state registration may be the appropriate starting point. The compliance burden of state registration is generally less than SEC registration, and the practical threshold at which the SEC begins actively monitoring a sponsor's compliance is significantly higher than the formal registration threshold.

The 3(c)(5)(C) Compliance Calendar: Maintaining the Exclusion

A real estate development company that structures its deal vehicles to rely on Section 3(c)(5)(C) must actively maintain the exclusion through a continuous asset composition test. Unlike the 3(c)(1) exclusion, which requires only counting investors, the 3(c)(5)(C) exclusion requires monitoring the entity's asset portfolio on an ongoing basis to ensure that qualifying assets remain at or above 55 percent of total assets and that the combined qualifying and real estate-related assets remain at or above 80 percent.

Monitoring the Asset Composition Test

Each deal-level entity claiming the 3(c)(5)(C) exclusion should conduct a periodic review of its asset composition, at minimum quarterly, and more frequently during periods when the portfolio is changing significantly (acquisition, disposition, or refinancing events). The review should categorize each asset held by the entity as:

- **Qualifying asset (for the 55 percent Tier 1 requirement).** Fee interests in real property, leasehold interests, direct mortgage loans, and controlling interests in single-asset entities that directly own qualifying real estate.
- **Real estate-related asset (for the 80 percent combined requirement).** Minority interests in entities that own real property, certain CMBS and mortgage-backed securities, and preferred equity investments in real estate entities.
- **Non-qualifying asset (limited to 20 percent of total assets).** Cash, treasury securities, interests in non-real-estate businesses, and publicly traded securities unrelated to real estate.

If the asset composition test is not satisfied at any point during the entity's life, the entity may be required to register as an investment company, which is a catastrophic outcome that can generally be avoided only by restructuring the portfolio, and which may impose immediate regulatory obligations on both the entity and the GP entity.

Construction Phase Complications

One of the most practically significant complications in maintaining the 3(c)(5)(C) exclusion for a development company occurs during the construction phase of a development project. A project in active construction presents an interesting asset characterization question: the entity holds a development asset that is partially land (clearly a qualifying real estate interest), partially a structure under construction (a work in progress that represents the anticipated real property improvement), and potentially partially funded by a construction loan commitment (a liability, not an asset, but one that affects the composition of the asset side of the balance sheet).

The SEC's guidance suggests that construction-in-progress assets are generally treated as qualifying real estate interests for 3(c)(5)(C) purposes, consistent with the principle that the company is engaged in the business of acquiring and developing real property rather than investing in securities. Sponsors should consult with legal counsel to confirm the specific treatment of construction assets in their deal structures, as the analysis can vary based on how title is held and how the construction is financed.

Cash and Temporary Investments

Cash raised from investors at the closing of a private placement is not a qualifying real estate asset: it is cash, a non-qualifying asset. If investors contribute $10 million at the closing of a deal and the acquisition does not occur until 60 days later, the entity's asset portfolio during that interim period may consist primarily of cash, which does not satisfy the 55 percent qualifying asset test.

The SEC has provided guidance indicating that reasonable interim cash holdings pending investment in qualifying assets will not jeopardize the 3(c)(5)(C) exclusion, provided the company has a real intention to deploy the cash into qualifying real estate assets within a reasonable time and is actively pursuing those acquisitions. What constitutes a reasonable time is not defined by statute and requires judgment based on the specific facts. A company holding investor cash for an extended period without making progress toward the promised acquisitions is at greater risk of having the interim cash position characterized as a non-qualifying asset that threatens the exclusion.

ERA Compliance: What the Exemption Requires When Available

For a development company that manages fund-level entities structured under 3(c)(1) or 3(c)(7), and that therefore has clients that are private funds for Advisers Act purposes, the Exempt Reporting Adviser status under the Private Fund Adviser Exemption may be available if total RAUM in private funds is below $150 million. An ERA must satisfy specific ongoing obligations even though it is not required to complete full SEC registration.

The ERA Form ADV Filing

An ERA must file a Form ADV Part 1A with the SEC through the IARD system within 60 days of first relying on the exemption. The annual updating amendment must be filed within 90 days after the close of the adviser's fiscal year. The Form ADV Part 1A is a public document that provides information about the adviser's organizational structure, the private funds it manages, beneficial ownership of the adviser, and disciplinary history of the adviser and its supervised persons.

Common ERA Form ADV compliance errors: incorrect RAUM calculation (using equity value rather than gross asset value; failing to include all managed funds); inaccurate beneficial ownership information; failure to file interim amendments promptly when material information changes; and inconsistency between the Form ADV and the PPM disclosures made to investors. Each of these creates specific compliance exposure.

Section 206 Anti-Fraud Obligations Apply to All Advisers

The Investment Advisers Act's anti-fraud provision, Section 206, applies to all investment advisers, whether registered or exempt. It prohibits employing any device, scheme, or artifice to defraud any client or prospective client; engaging in transactions or practices that operate as a fraud or deceit; and engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. These obligations apply to the ERA's investor communications, investment decisions, fee practices, and conflict management with the same force as they apply to a full RIA.

The Supreme Court established in SEC v. Capital Gains Research Bureau (1963) that investment advisers owe a fiduciary duty to their clients, a duty of loyalty and a duty of care, that requires making investment decisions in the clients' best interest, disclosing all material conflicts of interest, and maintaining honest and transparent communication. An ERA is subject to this fiduciary duty standard across all of its investor-facing activities.

Full RIA Registration: When Required and What It Demands

When a development company's RAUM crosses the relevant thresholds, generally $100 million for state registration and $110 million for SEC registration, with adjustments for the specific adviser's structure and client composition, full investment adviser registration becomes required. The RIA compliance program is substantially more demanding than the ERA's filing obligations.

The Compliance Rule and Written Program

Advisers Act Rule 206(4)-7 (the Compliance Rule) requires every registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, to review those policies annually, and to designate a Chief Compliance Officer. For a development company, the written compliance manual must address investment decision-making processes and controls; fee practices and conflict management; advertising and marketing; custody of client assets; privacy and information security; and books and records maintenance.

The Code of Ethics

Advisers Act Rule 204A-1 requires every registered investment adviser to adopt a code of ethics governing supervised persons' standards of conduct, personal securities transaction reporting, gifts and entertainment policies, outside business activity requirements, and political contributions restrictions (under Rule 206(4)-5, the Pay-to-Play Rule). For a real estate development company whose supervised persons may hold personal interests in real estate entities that could overlap with the adviser's client portfolios, the code of ethics must specifically address how these personal investment activities are monitored and managed.

The Marketing Rule

SEC Rule 206(4)-1 (the Marketing Rule, substantially updated effective 2021) governs all advertising and marketing communications by registered investment advisers, including investment track record presentations, testimonials, endorsements, and hypothetical performance data. For a development company whose marketing materials feature past deal returns, investor testimonials, and performance claims, the Marketing Rule imposes specific requirements: net performance must be presented with equal or greater prominence than gross performance; testimonials must disclose any compensation paid; and track record presentations must follow the rule's specific requirements for completeness and accuracy. All marketing materials should go through a formal pre-clearance process before use.

The Practical Compliance Decision: A Framework for Real Estate Sponsors

The regulatory analysis for a real estate development company touches a series of distinct questions, each of which must be addressed in sequence before the company raises its first dollar of investor capital. The following framework organizes the analysis:

Question	Implication and required action
Step 1: Can the deal-level entity qualify for the Section 3(c)(5)(C) exclusion?	Analyze the entity's primary asset composition. If at least 55 percent of assets will be qualifying real estate assets (fee interests, direct mortgage loans, controlling interests in single-asset property-owning entities) and at least 80 percent will be qualifying plus real estate-related assets, structure the entity to rely on 3(c)(5)(C). This is the preferred approach for most real estate sponsors.
Step 2: If 3(c)(5)(C) does not apply, which investor-count exclusion is appropriate?	If the entity's asset portfolio does not satisfy the 3(c)(5)(C) asset tests (for example, the entity will hold primarily minority interests in real estate entities rather than controlling interests), analyze whether 3(c)(1) (100 investors, accredited) or 3(c)(7) (unlimited investors, qualified purchasers) is more appropriate for the specific offering.

Question	Implication and required action
Step 3: Does the GP entity qualify as an investment adviser?	Analyze whether the GP entity meets the three-element test: compensation, the business of advising, and advice as to securities. If the GP entity manages 3(c)(5)(C) entities exclusively, the investment adviser analysis is more complex and requires state-specific legal advice. If the GP entity manages 3(c)(1) or 3(c)(7) private funds, it is almost certainly an investment adviser.
Step 4: If an investment adviser, which registration or exemption applies?	Calculate total RAUM. If RAUM is below $150 million and all clients are private funds (3(c)(1) or 3(c)(7) entities), consider the Private Fund Adviser Exemption (ERA status). If RAUM is below $100 million, state registration may be required. If RAUM is $110 million or more, SEC registration is required.
Step 5: What ongoing compliance obligations apply?	ERA: file and maintain Form ADV Part 1A; comply with Section 206 anti-fraud obligations; maintain fiduciary duties to all clients. RIA: implement the full compliance program under Rule 206(4)-7; file and deliver Form ADV Parts 1, 2A, and 2B; designate a CCO; comply with the Marketing Rule, Custody Rule, Code of Ethics Rule, and all other applicable Advisers Act rules.
Step 6: Is the 3(c)(5)(C) exclusion being actively maintained?	Conduct quarterly asset composition reviews to confirm the 55 percent and 80 percent tests are satisfied. Monitor during the construction phase, at acquisition closings, and during periods when significant cash is held pending investment. Consult counsel if the composition test approaches or falls below the required thresholds.

This framework does not substitute for qualified legal counsel. The application of the Investment Company Act and the Advisers Act to a specific development company's operations requires a fact-intensive analysis that must account for the specific assets held, the specific structure of the offering, the identity and composition of the investor base, and the specific jurisdiction in which the company operates. The founding partners should engage securities counsel with experience in both the Investment Company Act and the Investment Advisers Act, not just a general securities practitioner, to conduct this analysis before the company's first offering.

CHAPTER 20: KEY TAKEAWAYS

1. The Investment Company Act of 1940 analysis must come first, before the Advisers Act analysis. Every real estate development company that manages investor capital through deal-level entities must structure those entities to qualify for an Investment Company Act exclusion. Failure to qualify requires registration as an investment company, an outcome functionally incompatible with private development company operations.
2. Section 3(c)(5)(C) is the most appropriate Investment Company Act exclusion for most real estate sponsors. It excludes entities primarily engaged in acquiring mortgages and other liens on and interests in real estate. Unlike 3(c)(1) and 3(c)(7), Section 3(c)(5)(C) imposes no investor count ceiling and no qualified purchaser requirement. It scales without investor eligibility constraints and was specifically designed for entities whose primary business is real estate investment.
3. The Section 3(c)(5)(C) exclusion requires an active asset composition test: at least 55 percent of total assets must be qualifying assets (fee interests, direct mortgage loans, controlling interests in single-asset property-owning entities), and at least 80 percent of total assets must be qualifying assets plus real estate-related assets. Non-qualifying assets cannot exceed 20 percent of the total portfolio. The test must be monitored continuously, not just at formation.
4. The most common pitfall of the 3(c)(5)(C) approach is the controlling versus non-controlling interest distinction. A controlling interest in a single-asset entity that directly owns qualifying real estate is itself a qualifying asset. A passive, non-controlling minority interest in a real estate entity is generally a security, a non-qualifying asset. Deal structures must be designed with this distinction in mind from the outset.
5. The Investment Company Act exclusion used by the deal-level entities directly affects which Investment Advisers Act exemptions are available to the GP entity. The Private

Fund Adviser Exemption (which supports Exempt Reporting Adviser status) is available only to advisers whose clients are private funds, defined as funds that would be investment companies but for the 3(c)(1) or 3(c)(7) exclusions. A GP entity that manages exclusively 3(c)(5)(C) entities does not manage private funds under this definition and cannot rely on the Private Fund Adviser Exemption without additional analysis.

6. Section 206 of the Advisers Act, the anti-fraud provision, applies to all investment advisers, registered or exempt, including ERAs and companies that may qualify for an exemption from registration. The fiduciary duty established in SEC v. Capital Gains Research Bureau (1963) requires every investment adviser to act in clients' best interest, disclose all material conflicts, and maintain honest and transparent communication throughout the life of the investment.
7. Full RIA compliance, when required, includes the written compliance program under Rule 206(4)-7 (with a CCO, code of ethics, and annual review), the Form ADV Parts 1, 2A, and 2B with annual delivery obligations, the Marketing Rule requirements for track record and performance presentations, and the Custody Rule if the adviser has custody of client assets. Development companies approaching the RAUM thresholds should begin building RIA compliance infrastructure at least 12 to 18 months before registration is required.

WHAT COMES NEXT

Chapter 21 completes Part VII by turning to the financial and operational infrastructure that distinguishes a professionally managed development company from an ad hoc venture: financial controls, tax planning, and the reporting standards that protect investor capital and demonstrate institutional discipline. Chapter 22, the handbook's final chapter, is the comprehensive formation roadmap, a sequenced action plan that consolidates the entire handbook into the specific steps a founding team must take to move from the initial conversation to a properly formed, fully documented, compliantly operating real estate development company.

See also: *Chapter 19 (Securities Law Compliance: Regulation D offering exemptions and the accredited investor framework) • Chapter 10 (The Fee Architecture: asset management fee implications for adviser status) • Appendix F (Securities Law Compliance Checklist: includes investment company and investment adviser registration requirements) • Appendix J (Glossary: Investment Company Act, Investment Advisers Act, 3(c)(5)(C), 3(c)(1), 3(c)(7), qualifying asset, RAUM, ERA, RIA, private fund, qualified purchaser, Section 206)*

CH. 21

PART VII: SECURITIES LAW, INVESTMENT ADVISER COMPLIANCE & TAX

Financial Controls, Tax Planning *and Reporting Standards*

The financial infrastructure that distinguishes a professionally managed development company from an ad hoc venture: accounting architecture, internal controls, tax planning strategies, K-1 and investor reporting, and the audit and review standards that protect investor capital and build institutional credibility.

Financial controls and tax planning are not the most glamorous aspects of building a real estate development company. They are, however, among the most consequential. The company that operates with rigorous financial discipline from its first day is the company that institutional investors can trust with larger commitments, that lenders extend more favorable terms to, and that survives the occasional bad deal without an existential financial crisis. The company that treats financial controls as bureaucracy to be worked around is the company whose investors eventually discover discrepancies, whose lenders lose confidence, and whose founding partners find themselves in disputes a clean set of books would have prevented.

This chapter addresses the financial architecture of a professionally managed development company: how to structure the accounting at the management company and deal-level entity levels, what internal controls are required from the first dollar of investor capital, how pass-through taxation works in a development company context and what tax planning strategies are available, how K-1 and investor reporting obligations must be met, and what level of financial statement preparation is required at different stages of the company's growth.

The Multi-Entity Accounting Architecture

A real estate development company that operates multiple deal-level entities alongside its management company has a more complex accounting architecture than most founders anticipate at the time of formation. The management company, each deal-level SPE, and the GP entity all have separate legal existences and all require separate books and records, not because of arbitrary bureaucratic convention, but because the investors in each deal vehicle, the lenders to each project, and the regulators overseeing the company's securities offerings each have specific rights to information about specific entities that may not be co-mingled with information about other entities.

Getting the accounting architecture right from the beginning is significantly easier than retrofitting it after two or three deals have been completed with inadequate separation. The specific structure required:

The Management Company's Books

The management company's financial statements capture the operating economics of the development platform itself: the fee income earned from managing projects, the guaranteed payments made to founding partners, the operating expenses of running the business, and the management company's own balance sheet (its cash, any balance sheet investments, its obligations to partners and employees, and any partner loans). The management company's books are the founding partners' primary window into the health of the business they are building.

The management company should maintain its books on an accrual basis under generally accepted accounting principles (GAAP), recording revenues when earned rather than when received and expenses when incurred rather than when paid. Accrual accounting provides a more accurate picture of the company's financial position than cash accounting, particularly for a company with fee income that may be earned in one period and received in another. The management company's annual financial statements, a balance sheet, income statement, and statement of cash flows, should be prepared by the company's CPA firm and reviewed or audited depending on the company's stage and the requirements of its investors and lenders.

The Deal-Level Entity Books

Each deal-level special purpose entity (SPE), the LLC or LP that holds the specific development project and into which investor equity is contributed, requires its own complete set of books and records, entirely separate from the management company's books. The deal-level books record the equity contributed by each investor, the debt advanced by the construction lender, all project costs as they are incurred, all fee payments made to the management company (which appear as expenses in the deal-level entity and as revenues in the management company), and all distributions made to investors.

The deal-level entity's books are the primary basis for investor reporting, for lender reporting, and for the K-1s each investor receives annually. They must be maintained with precision because errors in deal-level accounting flow directly into investor tax reporting. An investor who receives a K-1 that incorrectly reports their allocable income or loss has a tax problem that requires amendment of their personal return, a costly and frustrating outcome that damages the investor relationship and reflects poorly on the development company's operational quality.

Deal-level entity books should be maintained on the tax basis of accounting rather than GAAP for entities taxed as partnerships (the standard for LLCs with multiple members). Tax basis accounting records assets and liabilities at their tax cost rather than their GAAP fair market value, which is the basis on which the K-1 allocations must be made. A company that maintains GAAP books for deal-level entities and then attempts to reconcile them to tax basis at year-end for K-1 preparation is creating an unnecessary analytical burden; maintaining the books on tax basis from the outset eliminates this annual reconciliation.

The GP Entity Books

The GP entity, the LLC that holds the promoted interest in each deal, also requires its own books and records. The GP entity's books capture its economic interests: the promoted interest percentages in each project, the carry distributions received when projects are disposed, the allocation of carry among the founding partners, and any clawback obligations that may attach to prior carry distributions.

The GP entity's books are directly relevant to the founding partners' individual tax returns, because the promoted interest allocations and distributions are passed through to the partners' individual returns on their K-1s. An error in the GP entity's books produces an error in the founding partners' individual tax returns, with the same consequences for tax filings and partner relations that deal-level errors produce for investor relations.

The Prohibition on Co-Mingling

The cardinal rule of multi-entity accounting for a development company is no co-mingling of funds between separate legal entities. The management company's operating cash account, the deal-level entity's construction account, and the GP entity's carry distributions must each be held in separate bank accounts, transferred between entities only through properly documented intercompany transactions, and recorded in each entity's own books with complete accuracy.

Co-mingling is both a legal problem and an accounting problem. From a legal perspective, co-mingled funds can create the basis for an alter-ego claim against the entities, an argument that the separate entity status should be disregarded because the entities are not operated as truly separate enterprises. From an accounting perspective, co-mingled funds make it impossible to accurately prepare the entity-level financial statements, K-1s, and investor reports the company's investors and regulators rely on. The cost of maintaining separate bank accounts and separate books for each entity is trivial; the cost of unwinding co-mingled accounting is substantial.

Internal Controls: What the Company Must Have Before the First Investor Dollar

Internal controls are the policies, procedures, and organizational structures that prevent financial errors, detect fraud, and ensure that the company's financial records accurately reflect its actual financial condition. For a development company that manages outside investor capital, internal controls are not an optional enhancement to an otherwise functional financial operation; they are a prerequisite for managing investor capital with the fiduciary care the law requires. The following internal controls must be in place before the company accepts its first dollar of investor capital.

Segregation of Duties

Segregation of duties is the most fundamental internal control principle: the person who authorizes a transaction should not be the same person who records it in the books, and neither of them should have sole access to the assets involved in the transaction. In a small development company with limited staff, complete segregation is not always possible, but the founding partners should understand which roles create the highest fraud risk when combined in a single person and should implement at least partial segregation for those specific combinations. The highest-risk role combinations for a development company:

- A single person with both the authority to approve payments and sole access to the bank accounts from which those payments are made. At minimum, require two-person authorization (or at least dual knowledge of the banking credentials) for payments above a defined dollar threshold.
- A single person who both processes investor subscriptions and has access to the investor trust accounts. Separate the subscription processing function from the bank account access function.
- A single person who both records transactions in the accounting system and prepares the financial reports from that system. Have a second person (a founding partner, the CPA, or an independent bookkeeper) review and approve financial reports before they are distributed.

The specific dollar thresholds at which two-person authorization is required, and the specific role combinations that are prohibited, should be documented in the company's internal control policy and reviewed annually by the management committee.

Bank Account Controls

Every bank account the company maintains, management company operating accounts, deal-level escrow accounts, investor trust accounts, and construction draw accounts, should be subject to the following minimum controls:

- Two-person authorization for payments above a defined threshold (commonly $10,000 to $25,000 for management company accounts; $50,000 to $100,000 for construction draw accounts where payment frequency is high).

- Monthly bank reconciliation by a person who did not have authority to make payments from the account in the reconciliation period.
- Online banking alerts for all transactions above a defined threshold, delivered to a managing partner who does not have direct payment authority on the account.
- Annual rotation of who reviews bank statements and performs reconciliations, to prevent any single person from managing the control environment for an extended period.

Construction Draw Controls

The construction draw process is the highest-volume, highest-dollar financial transaction process in an active development company, and it is the process most susceptible to fraud and error. Each construction draw request, the monthly or periodic request for the construction lender to advance funds against the approved loan commitment, involves the review and approval of potentially hundreds of vendor invoices, change orders, and subcontractor payment applications. Minimum construction draw controls:

- All draw requests must be prepared by the construction manager or project accountant and reviewed by a second person (a senior partner or the CFO) before submission to the lender.
- Vendor invoices must be matched to approved purchase orders or contracts before they are included in a draw request; no payment should be made to a vendor who is not on the approved vendor list and who has not executed a contract at approved terms.
- Change orders must be approved in writing before they are included in a draw request, with a documented approval authority threshold (for example, change orders under $10,000 approved by the project manager; change orders between $10,000 and $50,000 requiring managing partner approval; change orders above $50,000 requiring management committee approval).
- A lien release from each vendor and subcontractor should be required before the corresponding draw payment is disbursed.

Investor Capital Controls

Investor capital, the equity contributed by outside investors to deal-level entities, is the most sensitive financial asset a development company manages, and it requires specific controls that prevent misappropriation and ensure that investor funds are applied to the purposes for which they were raised:

- Investor capital must be held in a dedicated trust or escrow account separate from the management company's operating accounts. No management company operating expenses may be paid from investor capital accounts except for project costs specifically authorized by the deal-level entity's operating agreement and the offering documents.
- Capital call notices must be reviewed and approved by the management committee (or by the designated authority level per the Decision Authority Matrix) before they are issued to investors. The capital call amount and timing must be consistent with the approved project budget and the capital call provisions of the deal-level operating agreement.
- Investment of investor capital pending deployment (in the pre-construction period when investor equity has been committed but not yet deployed into project costs) must comply with the operating agreement's investment guidelines, typically limited to money market funds, treasury securities, or FDIC-insured bank accounts.
- The management company may not borrow from investor capital accounts, use investor funds as collateral for management company obligations, or co-mingle investor capital with management company operating funds for any purpose, regardless of the term or the management company's intention to repay.

Pass-Through Taxation: The Foundation of Development Company Tax Planning

Real estate development companies organized as LLCs taxed as partnerships are pass-through entities for federal income tax purposes: the entity itself pays no federal income tax. Instead, each item of income, gain, loss, deduction, and credit is allocated to the members on their annual K-1s and taxed at the member's individual rate. This pass-through character is one of the most significant structural advantages of the LLC form and is the foundation on which all development company tax planning rests.

The pass-through taxation framework is not self-executing. It requires careful attention to several specific aspects of partnership tax law that are unique to the development company context and that have meaningful economic consequences for the founding partners and their investors.

Special Allocations and the Substantial Economic Effect Test

One of the most powerful features of partnership taxation is the ability to allocate specific items of income, gain, loss, and deduction among the partners in proportions that differ from their overall ownership percentages. These special allocations allow the partners to direct particular tax benefits, accelerated depreciation deductions or specific income categories, to the partners who can make the best use of them.

For a special allocation to be respected by the IRS, it must satisfy the substantial economic effect test under Treasury Regulation Section 1.704-1(b). The substantial economic effect test requires, in essence, that the special allocation have real economic consequences for the partner receiving it, that the partner's economic position is actually affected by the allocation in the same way as their tax position. An allocation that provides a tax benefit without a corresponding economic benefit is a tax-motivated allocation the IRS will reallocate under the regulations.

The practical implication for a development company: the operating agreement's economic provisions, the capital account framework, the liquidation distribution provisions, and the loss allocation provisions, must be designed with the substantial economic effect test in mind from the beginning. An operating agreement that allocates depreciation deductions to investors in a way that does not correspond to the investors' actual economic exposure to loss has created a special allocation that may not survive IRS scrutiny.

The Capital Account Framework

The capital account is the running total of each partner's investment in the partnership from the partnership's perspective, adjusted for income allocations, loss allocations, contributions, and distributions. Maintaining accurate capital accounts for every partner in every entity is not optional for a development company that wants to:

- Allocate income and loss under the substantial economic effect test (which requires capital accounts to be maintained in a specific manner).
- Support profits interests granted to key employees or new partners (which require a threshold based on current capital account balances).
- Distribute assets on liquidation in accordance with the partners' economic rights (which should correspond to capital account balances for the liquidation provisions to have real economic effect).
- Make the book-up adjustments required when a new partner is admitted at a price reflecting unrealized appreciation in the existing assets.

Capital accounts must be maintained continuously throughout the life of each entity, updated at the time of each significant transaction. A company that tries to reconstruct capital accounts retroactively, because it failed to maintain them during the entity's life, faces both a practical reconstruction challenge and a legal risk that the retroactive reconstruction may not be accepted by the IRS or respected by the courts.

Real Estate Tax Planning: Key Strategies for Development Companies

Real estate development companies have access to a set of federal income tax planning strategies that are specific to the nature of real property investment. These strategies, cost segregation studies, the IRC Section 1031 like-kind exchange, opportunity zone investments and the qualified opportunity fund framework, and the passive loss rules, can materially affect the tax cost of development activities and the after-tax returns available to both the company and its investors. Understanding them at a foundational level is essential for a founding partner who wants to communicate the company's tax advantages to investors and to make informed decisions about project structuring.

Depreciation and Cost Segregation

Real property improvements are depreciated over 27.5 years for residential assets and 39 years for commercial assets under the Modified Accelerated Cost Recovery System (MACRS). Depreciation deductions reduce taxable income allocated to investors on their K-1s each year during the holding period, creating a tax-deferred return of capital that is one of the primary tax advantages of real estate investment.

Cost segregation is the process of disaggregating the cost of a completed building into its components, structural components, personal property, and land improvements, and assigning the shorter depreciation lives available for personal property (5- and 7-year MACRS) and land improvements (15-year MACRS) to the portions of the building that qualify. A ground-up multifamily project with a $10 million construction cost might have $2.5 million to $3.5 million of its costs reclassified as 5-year, 7-year, or 15-year property through a cost segregation study, dramatically accelerating the depreciation deductions available in the early years of the holding period.

The interaction between cost segregation and bonus depreciation magnifies the benefit. Bonus depreciation allows the full cost of qualifying property (assets with a MACRS recovery period of 20 years or less, which includes the 5-, 7-, and 15-year property identified in a cost segregation study) to be deducted in the year the property is placed in service, rather than over the component's regular MACRS life. Bonus depreciation was first introduced at 100 percent by the Tax Cuts and Jobs Act of 2017 for property placed in service after September 27, 2017, then began phasing down after 2022 (to 80 percent in 2023, 60 percent in 2024, and 40 percent in 2025). The One Big Beautiful Bill Act, signed into law on July 4, 2025, permanently restored 100 percent bonus depreciation for qualifying property acquired after January 19, 2025, eliminating the scheduled phase-down. For most property placed in service in 2026, the bonus depreciation rate is 100 percent. This front-loading of depreciation deductions creates significant near-term tax benefits for investors, at the cost of larger depreciation recapture at disposition.

Cost segregation studies should be commissioned from qualified engineering firms shortly after a project is placed in service. The study's cost is typically $15,000 to $40,000 for a multifamily project, and its tax benefit, the present value of accelerated depreciation deductions, typically exceeds the study's cost by a multiple of 10 or more.

The Section 1031 Like-Kind Exchange

Section 1031 of the Internal Revenue Code allows a taxpayer to defer the recognition of gain on the sale of real property held for productive use in a trade or business or for investment, provided the sale proceeds are reinvested in qualifying like-kind property within specified time limits. The deferred gain is not forgiven; it is carried forward into the new property and reduces the new property's tax basis. When the new property is eventually sold without a 1031 exchange, the deferred gain is recognized. For a development company selling a completed project, the Section 1031 exchange allows the company to defer capital gains recognition and to reinvest the full proceeds (rather than the after-tax proceeds) into the next project, compounding the investment base. The exchange mechanics require:

- The taxpayer must identify the replacement property within 45 days of the closing of the relinquished property sale.
- The taxpayer must close on the replacement property within 180 days of the closing of the relinquished property sale (or the due date of the taxpayer's tax return for the year of the sale, if earlier, unless an extension is filed).
- The exchange proceeds must be held by a qualified intermediary, an independent third party that holds the sale proceeds and uses them to acquire the replacement property, preventing the taxpayer from having constructive receipt of the funds during the exchange period.
- The replacement property must be of like-kind to the relinquished property (all real property held for investment or business use qualifies as like-kind to all other such real property, regardless of specific type).

A critical planning note: Section 1031 exchanges are available to taxpayers who hold property as investment or business property, not to dealers who hold property primarily for sale. A development company whose primary strategy is to build and immediately sell projects, a for-sale residential developer, for example, may be classified as a dealer whose gains are ordinary income rather than capital gain, making the Section 1031 exchange unavailable. This dealer status analysis is fact-specific and should be discussed with the company's tax advisors as part of the overall project structuring process.

Opportunity Zone Investments

The Tax Cuts and Jobs Act of 2017 created the Qualified Opportunity Zone (QOZ) program, which provides tax incentives for investment of capital gains proceeds into Qualified Opportunity Funds (QOFs) that invest in designated low-income census tracts (opportunity zones). For a development company whose projects are located in designated opportunity zones, the QOZ program can provide meaningful tax benefits to both the company and its investors. The primary QOZ tax benefits:

- Temporary deferral of gain: a taxpayer who realizes capital gain and invests the gain proceeds in a QOF within 180 days of the gain recognition event may defer recognition of the original gain. For investments under the original program (made through the end of 2026), the deferred gain is recognized on the earlier of the date the QOF investment is sold or December 31, 2026.
- Tax-free appreciation: a QOF investment held for at least ten years qualifies for a step-up in basis to fair market value on the date of sale, effectively eliminating federal income tax on the appreciation in the QOF investment during the holding period.

The One Big Beautiful Bill Act made the Opportunity Zone program permanent. For investments made after December 31, 2026, the program shifts to a rolling five-year deferral (the deferred gain is recognized on the fifth anniversary of the investment rather than on a fixed calendar date), and states will designate a new round of opportunity zones effective January 1, 2027. The original program continues to govern investments made through the end of 2026.

For a development company pursuing opportunity zone projects, the QOF structure requires specific organizational considerations: the company must organize a separate Qualified Opportunity Fund entity that holds the opportunity zone investment, the entity must hold at least 90 percent of its assets in qualifying opportunity zone business property, and the property must meet specific original use or substantial improvement requirements. The detailed QOF structuring requirements are beyond the scope of this handbook, but the program's potential tax benefits, now on a permanent footing, make it an important consideration for development companies whose target markets include designated opportunity zones.

The Passive Activity Loss Rules

The passive activity loss rules under IRC Section 469 restrict the ability of investors to use real estate investment losses to offset ordinary income from other sources. Under these rules, losses from passive activities, including most real estate investments where the investor does not materially participate in the activity, can only be used to offset passive income, not ordinary income or portfolio income.

For a development company's investors, who are passive members of the deal-level LLC and who do not materially participate in the company's development activities, the depreciation and other losses allocated on their K-1s are subject to the passive activity loss rules. These passive losses can generally only be used to offset passive income from other sources or are suspended until the investment is disposed. At disposition, the suspended passive losses are released and can offset the gain on sale. There are two important exceptions that may benefit certain investors in a development company:

- **Real estate professionals.** An investor who qualifies as a real estate professional under IRC Section 469(c)(7), meaning they spend more than 750 hours per year in real property trades or businesses in which they materially participate, and those activities constitute more than half of all their personal service time, is exempt from the passive activity loss characterization for their real estate activities. A real estate professional can deduct real estate losses against ordinary income without the passive activity limitation.
- **The $25,000 allowance.** Non-professional investors who actively participate in rental real estate activities and whose adjusted gross income does not exceed $100,000 may deduct up to $25,000 of passive rental real estate losses against ordinary income. This allowance phases out ratably for AGI between $100,000 and $150,000 and is completely phased out above $150,000.

The passive activity loss rules are a significant factor in investor relations for development companies: investors frequently ask about the deductibility of K-1 losses against their other income, and the accurate answer, that passive losses are generally not deductible against ordinary income for most investors, requires a nuanced explanation the company's investor communications must handle correctly. Misrepresenting the deductibility of K-1 losses in marketing materials is a potential securities anti-fraud issue as well as a tax misrepresentation.

Depreciation Recapture: The Tax Cost Hidden in Every Disposition

Depreciation deductions taken during the holding period of a real estate investment reduce the property's tax basis dollar for dollar. When the property is sold, the gain on sale is the difference between the sale price and the reduced tax basis, a gain larger than it would have been if no depreciation had been taken. The recapture rules require the seller to recognize a portion of this gain as ordinary income rather than as capital gain, at rates higher than the preferential capital gains rates that would otherwise apply to real property appreciation.

Section 1250 Recapture

Section 1250 of the IRC governs depreciation recapture on real property. Under current law, the amount of gain attributable to prior depreciation deductions on real property improvements is subject to a maximum federal tax rate of 25 percent (the unrecaptured Section 1250 gain rate), rather than the 20 percent maximum long-term capital gains rate that applies to gain above the recapture amount. The Section 1250 recapture represents the tax cost of having received accelerated depreciation deductions during the holding period.

The practical implication: a development company that takes aggressive cost segregation deductions during the hold period is effectively borrowing a tax deferral from the IRS that must be repaid at a 25 percent federal rate at disposition. The after-tax economics of the cost segregation strategy must account for this eventual recapture, including the time value of money benefit of the interim tax deferral, which must exceed the incremental tax cost at disposition (the spread between the 25 percent recapture rate and the 20 percent capital gain rate) to make the strategy economically beneficial on a present-value basis.

Planning Around Recapture

Several strategies can mitigate the economic impact of depreciation recapture:

- **Section 1031 exchange.** Deferring the recapture along with the gain by rolling the proceeds into a like-kind replacement property, as discussed earlier in this chapter.
- **Installment sale.** Spreading the gain over multiple tax years through a seller-financed sale, which can defer the recapture tax if the installment payments are received over multiple years (though the installment method is not available for sales to related parties and has other limitations).
- **Charitable remainder trust.** Transferring appreciated property to a charitable remainder trust, which can sell the property without immediate gain recognition and make distributions to the transferor over time.
- **Opportunity zone investment.** Reinvesting realized gain (including recapture gain) into a QOF to defer the gain and potentially eliminate future appreciation from federal tax.

K-1 Reporting: What Partners and Investors Receive and When

The Schedule K-1 is the tax document each partner in a partnership receives annually, reporting their allocable share of the partnership's income, losses, deductions, credits, and other tax items for the year. In a development company context, every founding partner receives a K-1 from the management company, every investor in a deal-level entity receives a K-1 from that entity, and the management company itself may receive a K-1 from deal-level entities in which it holds an interest.

K-1 preparation is one of the most operationally demanding aspects of running a development company with multiple entities and multiple investors. It requires complete, accurate, and final tax-basis financial information for every entity before the K-1s can be prepared, and that information is often not finalized until several months after the tax year ends, due to late invoices from construction vendors, delayed lender reporting, and the complexity of allocating costs and income among multiple entities.

The K-1 Deadline

Partnership K-1s are due to partners when the partnership return (Form 1065) is due: March 15 of the year following the tax year, or September 15 if a six-month extension is filed. For a development company with multiple investors who need their K-1s to file their own individual returns, the March

15 deadline is rarely achievable, and the September 15 extension deadline is the more realistic target.

Investors frequently complain about late K-1 delivery, and their frustration is legitimate. An investor who cannot file their personal tax return because they are waiting for a K-1 from a development company deal has a real tax-filing problem. The company's K-1 delivery timeline is a material investor relations consideration, and the company should invest in the accounting infrastructure, a qualified CPA firm with real estate partnership experience, proper deal-level bookkeeping throughout the year, and timely collection of all vendor and lender information after year-end, to make its best-effort K-1 delivery timeline as early in the extension period as possible.

What the K-1 Reports

The Schedule K-1 for a real estate partnership typically reports the following items to each partner:

- **Ordinary income or loss from business operations.** The partner's allocable share of the partnership's ordinary income or loss from its real estate activities, including fee income, operating income from stabilized properties, and operating expenses.
- **Net rental real estate income or loss.** Income or loss from rental real estate activities, reported separately from ordinary business income because of the passive activity loss rules.
- **Net short-term capital gain or loss.** The partner's share of any short-term capital gains or losses recognized by the partnership during the year.
- **Net long-term capital gain or loss.** The partner's share of long-term capital gains or losses, including gain from the sale of development projects held for more than one year.
- **Unrecaptured Section 1250 gain.** The partner's share of gain from disposition of real property improvements that is subject to the 25 percent recapture rate.
- **Section 199A information.** Information needed to calculate the partner's qualified business income deduction, if applicable.
- **Foreign transactions.** Any applicable foreign transaction reporting.
- **Other information.** Various other items required by the partnership's specific activities, including at-risk limitations, passive activity characterizations, and investment interest expense.

The complexity of what the K-1 reports reflects the complexity of partnership taxation itself. Investors who receive K-1s from a development company frequently need guidance from their personal tax advisors to understand what the K-1 means for their individual tax returns. The development company can support this process by providing a K-1 explanatory letter that describes, in plain language, the most significant items on the K-1 and their expected tax treatment, without providing specific tax advice, which must come from each investor's own advisor.

Financial Statement Standards: Compiled, Reviewed, and Audited

The level of financial statement preparation a development company must obtain, compiled, reviewed, or audited, depends on the stage of the company's development, the requirements of its investors and lenders, and the specific regulatory obligations that apply to its operations. Understanding the differences among these three levels is important for planning purposes and for setting appropriate expectations with investors and counterparties.

Compiled Financial Statements

A compilation is the most basic level of CPA involvement with a company's financial statements. In a compilation engagement, the CPA firm organizes the financial information provided by

management into the form of financial statements without expressing any assurance, positive or negative, about whether the statements are accurate or prepared in accordance with GAAP. Compiled financial statements are appropriate for internal use and for early-stage companies that do not yet have investors or lenders requiring higher assurance levels.

A compilation provides very little comfort to an investor or lender about the accuracy of the financial information, because the CPA has not verified or tested any of the underlying data. Development companies that manage outside investor capital should not provide compiled financial statements to those investors as their primary financial reporting vehicle; investors who are relying on the company's financial information to assess their investment deserve a higher level of assurance.

Reviewed Financial Statements

A review provides limited assurance that no material modifications are needed for the financial statements to be in conformity with GAAP. In a review engagement, the CPA firm performs analytical procedures and makes inquiries of management, but does not perform the verification, confirmation, and testing procedures of an audit. The CPA issues a report stating that nothing came to their attention that caused them to believe the financial statements are not in conformity with GAAP. Reviewed financial statements are appropriate for:

- Management companies with individual investor relationships where full audits are not yet required.
- Deal-level entities with individual (non-institutional) investors where the operating agreement specifies reviewed financial statements as the annual reporting standard.
- Companies whose lenders require annual financial statements but do not specifically require an audit.

Audited Financial Statements

An audit provides the highest level of assurance: the CPA firm expresses an opinion that the financial statements present fairly, in all material respects, the financial position and results of operations in conformity with GAAP. The audit involves examination of evidence supporting the amounts and disclosures in the financial statements, testing of internal controls, confirmation with third parties (banks, lenders, major vendors), physical inspection of assets, and analytical procedures. The audit opinion is the highest standard of financial statement assurance. Audited financial statements are required for:

- Development companies with institutional investor relationships: most institutional LPs, family offices, and endowments require annual audited financial statements for investment vehicles in which they participate, as a fundamental due diligence requirement.
- Registered investment advisers: the SEC's Custody Rule (Rule 206(4)-2) requires RIAs who have custody of client assets to provide annual audited financial statements of each fund to the fund's investors.
- Companies with certain lender requirements: construction lenders and permanent lenders may require audited financial statements of the borrowing entity as a condition of loan covenant compliance.
- Companies pursuing institutional capital raises: even where not technically required, providing audited financial statements in connection with an institutional capital raise signals organizational maturity and reduces the friction of the investor's due diligence process.

Annual audits for a development company's deal-level entities typically cost $15,000 to $40,000 per entity, depending on the entity's complexity, the number of investors, and the CPA firm performing the engagement. The management company's annual audit typically costs $25,000 to $75,000 or more depending on its size and complexity. These costs should be budgeted as a regular operating expense for any company that manages institutional investor capital.

The Annual Tax Calendar: What Must Happen When

A development company operating multiple entities faces a complex annual tax compliance calendar that must be managed proactively. Missing a filing deadline creates penalties, interest, and potential investor relations problems. The following calendar covers the primary federal tax compliance obligations for a management company and its associated deal-level entities:

Deadline	Obligation	Entity	Penalty for failure
January 31	W-2 and 1099 forms provided to employees and contractors	Management company	$60 to $660 per form, based on timing of correction
January 31	W-2 and 1099 forms filed with IRS and SSA	Management company	Same as above
February 28 (paper) / March 31 (electronic)	Form 1099 copies filed with IRS	Management company	Same as above
March 15 (or September 15 with extension)	Form 1065 partnership return and K-1s due	All LLCs taxed as partnerships	$255 per partner per month (up to 12 months) for late filing
March 15	Form 1065 extension request (Form 7004) if needed	All partnership entities	No penalty for a timely extension; six-month extension granted automatically
April 15 (or October 15 with extension)	Individual Form 1040 returns for founding partners	Each founding partner personally	5 percent per month of unpaid tax; interest on unpaid amounts
Various quarterly dates	Estimated tax payments on guaranteed payment and distributive share income	Each founding partner personally	Underpayment penalty on insufficient estimated payments
September 15 (or applicable extended deadline)	Extended Form 1065 and K-1s due	All partnership entities	$255 per partner per month for failure to file on the extended deadline
Within 30 days of grant	Section 83(b) election for any profits interest grants	Each recipient individually	Loss of favorable capital gains treatment on future appreciation; no ability to cure a missed election
Within 15 days of formation or qualification	State entity registration and annual reports	All entities in each state of operation	Varies by state; loss of good standing; inability to enforce contracts in some states

The penalties for missing partnership return deadlines are particularly punishing. The $255 per-partner, per-month penalty (at current rates) for a late-filed Form 1065 accumulates quickly for a deal-level entity with 30 investors: a one-month late filing generates a penalty of $7,650 for that entity alone. For a company with five active deal entities each averaging 30 investors, a one-month delay in filing generates total penalties exceeding $38,000, entirely avoidable with proper accounting infrastructure and proactive deadline management.

Building the Right CPA and Advisory Relationships

The quality of a development company's accounting and tax advisory team is one of the most consequential professional infrastructure decisions the founding partners make. A CPA firm that understands real estate partnership taxation, development company accounting, cost segregation, K-1 preparation, and the specific reporting obligations that come with managing outside investor capital is a real competitive advantage. A general CPA firm without real estate expertise is a liability that compounds over time.

What to Look for in a Real Estate CPA Firm

The criteria for selecting a CPA firm as the development company's primary accounting and tax advisor:

- **Specific real estate partnership tax experience.** The firm should prepare partnership returns for multiple real estate investment vehicles, have direct experience with cost segregation analysis, understand the passive activity loss rules in the real estate context, and

be current on the bonus depreciation and Section 199A rules as amended by the One Big Beautiful Bill Act.

- **Development company experience specifically.** Understanding the accounting challenges of a development company, construction-in-progress accounting, the multiple-entity architecture, and the interplay between management company and deal-level entity accounting, is more specialized than general real estate accounting and requires CPA firms with direct development company clients.
- **K-1 production capability and track record.** The firm should have a demonstrated track record of producing accurate K-1s within the extension deadline for partnership clients comparable in complexity to the development company's expected operations.
- **Investment adviser awareness.** If the company will operate as a registered investment adviser or exempt reporting adviser, the CPA firm should have experience with the specific financial reporting and compliance obligations that attach to those registrations.
- **SEC reporting experience.** If the company anticipates needing audited financial statements for institutional investors or regulatory compliance, the CPA firm should be a PCAOB-registered firm with audit experience in the real estate fund context.

The In-House Versus Outsourced Accounting Decision

In its early years, a development company should almost certainly outsource its accounting and tax functions rather than hiring dedicated in-house accounting staff. The reasons are both financial and operational:

- The transaction volume in an early-stage development company's first two to three years does not justify a full-time CPA or controller. A company with two or three active projects, monthly draw reconciliations, quarterly investor reporting, and an annual tax return process can typically be served effectively by a CPA firm on a retainer basis at a fraction of the cost of a full-time internal hire.
- Outsourced accounting provides inherent segregation of duties. When accounting functions are performed by an independent firm, the CPA firm provides a natural check on management's financial representations without requiring the company to implement elaborate internal control structures.
- The CPA firm relationship grows with the company. A good CPA firm with real estate experience can serve the company's tax planning needs as the portfolio grows, the entity structure becomes more complex, and new tax planning strategies (cost segregation, opportunity zone investments, 1031 exchanges) become relevant.

The transition to in-house accounting, hiring a full-time controller or CFO, is appropriate when the company's transaction volume, reporting complexity, and investor base have grown to the point where the CPA firm's responsiveness is limiting the company's operational efficiency. That transition typically occurs when the company has five or more active projects simultaneously, is managing $50 million or more in AUM, and is producing quarterly investor reports and monthly draw packages that require daily accounting support rather than periodic CPA engagement.

CHAPTER 21: KEY TAKEAWAYS

1. The multi-entity accounting architecture of a development company, separate books for the management company, each deal-level SPE, and the GP entity, must be established correctly from the first day of operations. Co-mingling funds between entities is both a legal problem (creating alter-ego liability exposure) and an accounting

problem (making accurate K-1 preparation and investor reporting impossible). Each entity requires its own bank accounts, its own books, and its own financial statements.

2. Internal controls must be in place before the first investor dollar is accepted. The minimum required controls are segregation of duties for transaction authorization, recording, and asset access; two-person authorization for payments above defined thresholds; monthly bank reconciliation by a person who did not have payment authority; construction draw controls requiring pre-approved purchase orders and lien releases; and investor capital controls that prohibit co-mingling with management company operating funds.
3. Pass-through taxation is the foundation of development company tax planning. The LLC taxed as a partnership pays no entity-level federal income tax; all income, gain, loss, and deduction flows through to the partners' individual K-1s. Special allocations that differ from ownership percentages must satisfy the substantial economic effect test under Treasury Regulation Section 1.704-1(b), which requires accurate capital account maintenance from the date of formation.
4. The primary tax planning strategies for development companies are cost segregation (disaggregating building costs into shorter-life components to accelerate depreciation deductions, now amplified by the permanent restoration of 100 percent bonus depreciation under the One Big Beautiful Bill Act for property acquired after January 19, 2025); the Section 1031 like-kind exchange (deferring gain on disposition by reinvesting proceeds in like-kind replacement property within the statutory time limits); and Qualified Opportunity Zone investments (deferring and potentially eliminating gain through investment in designated low-income census tracts, a program made permanent by the same legislation). Each strategy requires advance planning and may not be available to dealer-status developers.
5. Depreciation recapture under Section 1250 taxes gain attributable to prior depreciation deductions at a maximum federal rate of 25 percent rather than the 20 percent capital gains rate. The after-tax economics of cost segregation must account for this eventual recapture through a present-value analysis that compares the benefit of accelerated deductions against the incremental tax cost at disposition.
6. K-1s must be provided to partners by March 15 (or September 15 with extension) of the year following the tax year. The penalty for late partnership return filings is $255 per partner per month, which accumulates quickly for deal-level entities with multiple investors. Investing in qualified accounting infrastructure and proactive deadline management is far less expensive than paying late-filing penalties across multiple entities for multiple years.
7. The appropriate level of financial statement assurance depends on the company's stage and investor base: compilations are appropriate only for internal use; reviewed statements suffice for individual investor relationships where audits are not specifically required; audited statements are required for institutional investor relationships, RIA Custody Rule compliance, and institutional capital raises. Audited statements for a deal-level entity typically cost $15,000 to $40,000 per entity annually, a cost that should be budgeted as a regular operating expense from the first institutional investor commitment.

WHAT COMES NEXT

Chapter 22 is the final chapter of the handbook and its most practical: the complete formation roadmap. It consolidates the entire handbook's content into a sequential, actionable plan, the

specific steps a founding team must complete, in the correct order, to move from the initial partner conversation through formation, documentation, regulatory compliance, and first capital raise. Chapter 22 is designed to be used as an operational checklist alongside the substantive guidance that precedes it.

See also: *Chapter 7 (Partner Compensation and Distributions: the mandatory tax distribution provisions that connect to K-1 reporting) • Chapter 19 (Securities Law Compliance: investor reporting obligations under the anti-fraud rules) • Appendix H (Annual Compliance Calendar: the comprehensive regulatory and tax filing calendar) • Appendix J (Glossary: MACRS, cost segregation, Section 1031, opportunity zone, passive activity loss, Section 1250, capital account, substantial economic effect)*

CH. 22

PART VIII: BRINGING IT TOGETHER

The Formation Roadmap:

From First Conversation to Open for Business

A sequenced, actionable formation roadmap that consolidates the entire handbook into a phase-by-phase plan, covering every critical decision, document, and compliance step a founding team must complete to move from initial partner alignment through entity formation, legal documentation, regulatory compliance, and first capital raise.

Twenty-one chapters of substantive guidance, worked examples, framework tables, and cautionary scenarios amount to nothing unless the founding team translates that guidance into action. This final chapter is built to do that. It converts the handbook's content into a sequential, phase-by-phase roadmap that the founding team can use as its operational plan, from the day the partners decide to build a company together through the day they close their first investor capital.

The roadmap is organized into six phases, each with a specific set of decisions, documents, and actions that must be completed before the next phase can begin in earnest. The phases are sequential by design: decisions made in Phase 1 establish the parameters for Phase 2, and Phase 2's outputs are the inputs to Phase 3, and so on. A founding team that tries to shortcut this sequence, by drafting the operating agreement before the partners have actually aligned on the company's fundamental structure, or by starting investor outreach before the offering documents are complete, is building on a foundation that will eventually require expensive correction.

The Six Phases of Formation

The formation roadmap covers six phases spanning roughly six to nine months, from the first serious partner conversation to the closing of the company's first investor capital. The timeline is an estimate rather than a guarantee. Some founding teams move faster because they have prior experience forming professional partnerships; others move more slowly because the alignment work of Phase 1 surfaces disagreements that must be resolved before legal work can begin.

What cannot be compressed without cost is the quality of the decisions. The alignment conversations of Phase 1 cannot be conducted in a single weekend and checked off a list. The operating agreement negotiations of Phase 3 cannot be rushed to a signing without each partner understanding what they are agreeing to. The investor outreach of Phase 5 cannot begin before the offering documents of Phase 4 are complete. Each phase has its own internal logic, and the sequence is not arbitrary.

1 PHASE — **Partner Alignment and Strategic Foundation**
Weeks 1 to 6: The conversations that must happen before any legal work begins

▼

2 PHASE — **Business Design and Advisory Team Assembly**
Weeks 4 to 10: Defining the company, assembling the team, and building the planning framework

▼

3 PHASE **Entity Formation and Legal Documentation**
Weeks 8 to 18: Formation, operating agreements, and all founding-level legal documents

▼

4 PHASE **Regulatory Compliance and Operational Infrastructure**
Weeks 16 to 26: Tax registration, securities compliance, banking, insurance, and accounting

▼

5 PHASE **First Capital Raise and Deal Execution Readiness**
Weeks 22 to 36: Offering documents, investor outreach, and deal pipeline activation

▼

6 PHASE **Post-Launch Governance and Ongoing Compliance**
Month 6 onward: The governance habits and compliance calendar that sustain the company

Phase 1: Partner Alignment and Strategic Foundation

Phase 1 is the most important phase of the entire formation process, and the one most often treated as preliminary rather than foundational. The conversations that occur in Phase 1, or, more to the point, the conversations that fail to occur in Phase 1, determine the quality of every document that follows. An operating agreement that reflects a real, examined partnership is a governance document. An operating agreement drafted around assumptions the partners never examined is a liability waiting to surface.

The purpose of Phase 1 is not to produce documents. It is to reach real alignment on the questions the documents will eventually govern. No attorney should be retained to begin drafting until Phase 1 is substantially complete.

The Alignment Conversations

The partner alignment conversations address the foundational questions identified in Chapter 1 and elaborated throughout the handbook. They must be real conversations, not presentations that each partner makes to the others, and not assumptions each partner makes about the others, but two-way exchanges in which each partner shares an honest view and listens to the co-founders' honest responses.

The five domains of alignment the founding team must complete before Phase 2:

- Business vision and model: what kind of company are we building? Chapter 2's framework for choosing between balance sheet development, sponsor or manager, and integrated platform models must be resolved, not deferred. The founding partners must agree on the asset class, the geographic focus, the deal size range, and the long-term destination vision before any of the downstream decisions will cohere.
- Partner contributions and equity: what does each partner bring, and what does each partner deserve? The Contribution Matrix from Chapter 5 provides the framework, and completing it honestly and specifically is Phase 1's most important substantive task. The equity allocation conversation should not end with a number that everyone is uncomfortable with but no one challenges.
- Governance philosophy: does this partnership function as a true collaborative, where all major decisions are made jointly, or as a principal and agent structure, where one managing partner has operational authority and the others have oversight rights? The answer determines the governance framework of Chapter 8.

- Compensation and financial expectations: what does each partner need to earn from the company, and over what timeline? A founding partner who needs $250,000 per year in current income from the company is in a materially different position from one who can defer current income for two or three years in exchange for equity upside. These realities must be disclosed and addressed, not assumed or discovered after formation.
- Long-term exit vision: where does each partner see this company in ten years? Chapter 18's three destination visions, institutional platform, sale, and wind-down, may produce different answers from different partners, and those differences must be surfaced and reconciled in Phase 1, not discovered during the multi-year strategic review of Phase 6.

The Partners' Term Sheet

The output of Phase 1 is the Partners' Term Sheet: a written, non-binding summary of the fundamental terms the partners have agreed to, which becomes the instruction document for the attorneys who will draft the operating agreement in Phase 3. The Partners' Term Sheet is not a legal document; it is a communication and coordination tool. Its value is that it forces the founding partners to commit their agreements to writing before any legal document is drafted, which surfaces any remaining misalignments before they become legal disputes.

The Partners' Term Sheet should address:

- Entity structure: operating company entity type and state of formation; whether a separate GP entity is needed; the role of deal-level SPEs
- Equity allocation: each partner's ownership percentage, the basis for the allocation (referencing the Contribution Matrix results), and any scheduled vesting or milestone conditions
- Vesting structure: the agreed vesting schedule, cliff date, good leaver and bad leaver framework, and acceleration triggers
- Compensation: initial guaranteed payment amounts for each partner; whether payments begin immediately or at a defined milestone; the adjustment mechanism
- Governance: managing partner designation, management committee composition, and the preliminary list of decisions requiring committee approval rather than managing partner authority
- Promoted interest allocation: the agreed allocation of the GP entity's promoted interest among the founding partners, including the methodology (equal, equity-proportional, role-based, or hybrid) and any deal-specific adjustments
- Capital contributions: initial capital contribution from each partner and the agreed capitalization amount for the operating company
- Non-compete and non-solicitation parameters: the agreed scope, geography, and duration of post-departure restrictions

Phase 1 Checklist

PHASE 1: PARTNER ALIGNMENT & STRATEGIC FOUNDATION

Action Item	Primary Owner	Handbook Reference
Complete alignment conversations on all five foundational domains	All Partners	*Chapter 1*
Complete Contribution Matrix for each founding partner (specific, documented inputs)	All Partners	*Chapter 5*
Agree on equity allocation percentages and document the basis for the allocation	All Partners	*Chapter 5*

Action Item	Primary Owner	Handbook Reference
Agree on vesting schedule: total period, cliff date, hybrid or time-based approach	All Partners	*Chapter 5*
Agree on good leaver and bad leaver framework and the definition of cause	All Partners	*Chapter 5*
Agree on governance structure: managing partner, committee composition, approval thresholds	All Partners	*Chapter 8*
Agree on initial guaranteed payment levels and compensation philosophy	All Partners	*Chapter 7*
Agree on promoted interest allocation methodology among founding partners	All Partners	*Chapter 6*
Agree on initial capital contributions and company capitalization amount	All Partners	*Chapter 7*
Agree on post-departure restrictive covenant scope, geography, and duration	All Partners	*Chapter 14*
Agree on destination vision (platform, sale, or wind-down) and time horizon	All Partners	*Chapter 18*
Draft and circulate the Partners' Term Sheet; all partners sign off in writing	Managing Partner	*Earlier in this chapter*

Phase 2: Business Design and Advisory Team Assembly

Phase 2 converts the partner alignment of Phase 1 into the specific business design decisions that determine the company's operational and legal architecture. It also involves assembling the professional advisory team whose expertise will guide Phases 3 and 4. Phase 2 can overlap with the tail end of Phase 1 in companies where the alignment conversations are proceeding clearly and the business design choices become evident as the conversations progress.

Business Design Decisions

Phase 2 business design produces the inputs for the attorneys and accountants who will implement the structure in Phase 3. The core decisions:

- Entity structure: confirming the entity type (almost always a Delaware LLC or the appropriate state LLC for the primary market), the entity count (operating company, GP entity, and the Investment Company Act exclusion analysis for deal-level structures), and the state of formation for each entity
- Operating company capitalization: the specific amount, timing, and form of each partner's initial capital contribution to the operating company, and the bank account and treasury infrastructure needed to hold and deploy that capital
- Fee schedule: the specific fee rates, bases, and structures for each fee type the company will charge (referencing Chapter 10's framework), which will be disclosed in the first offering's PPM
- 24-month operating budget: the detailed two-year operating budget from Chapter 2, which must be complete before any partner capital is committed to the operating company and before the guaranteed payment levels established in Phase 1 are formalized in the operating agreement
- Investment Company Act exclusion analysis: the determination of which exclusion the deal-level entities will rely on (Section 3(c)(5)(C) for most real estate development companies, as established in Chapter 20), and the structural implications that determination creates

- Target deal type and market: finalizing the specific asset class, deal size, geographic market, and development strategy, the parameters that will appear in the operating agreement's investment criteria definition (for corporate opportunity purposes) and in the first offering's offering documents

Assembling the Advisory Team

The professional advisors the company needs from the outset of Phase 2:

- Securities and corporate counsel: a law firm with specific experience in real estate development company formation, private securities offerings, operating agreement drafting, and investment adviser regulatory analysis. This is not a role for a generalist business attorney or a real estate transaction attorney who handles closings but not fund and entity formation. The attorney who drafts the operating agreement determines whether the 22 chapters of this handbook are properly implemented in actual legal documents.
- Real estate CPA firm: a CPA firm with specific experience in real estate partnership taxation, development company accounting, cost segregation, K-1 preparation, and the multi-entity accounting architecture required for a company with separate deal-level entities. The CPA firm should be engaged in Phase 2 so it can provide input on entity structure, accounting basis, and tax planning considerations before those decisions are finalized.
- Insurance broker: a commercial insurance broker with specific real estate company expertise who can design the management company's initial insurance program (D&O, E&O, EPLI, CGL, cyber liability) and advise on the project-level Builder's Risk and key-person life insurance requirements. The insurance program should be in place before the first investor commitment is accepted.

Phase 2 Checklist

PHASE 2: BUSINESS DESIGN & ADVISORY TEAM ASSEMBLY

Action Item	Primary Owner	Handbook Reference
Select entity type and state of formation for operating company, GP entity, and deal-level structures	All Partners + Counsel	*Chapter 3*
Complete Investment Company Act exclusion analysis (confirm 3(c)(5)(C) applicability or alternative)	Counsel	*Chapter 20*
Finalize investment criteria: asset class, geography, deal size, development strategy	All Partners	*Chapters 2 and 13*
Complete 24-month operating budget with base case and downside scenario	Managing Partner	*Chapter 2*
Finalize fee schedule: rates, bases, timing for each fee type	All Partners	*Chapter 10*
Determine initial capital contribution amount and timing for each partner	All Partners	*Chapter 7*
Engage securities and corporate counsel with real estate formation experience	Managing Partner	*Chapters 4 and 19*
Engage real estate CPA firm with development company and partnership tax experience	Managing Partner	*Chapter 21*
Engage commercial insurance broker with real estate company expertise	Managing Partner	*Chapter 15*

Action Item	Primary Owner	Handbook Reference
Conduct preliminary bad actor background checks on all founding partners	Counsel	*Chapter 19*
Confirm spousal consent requirements for any married founding partners (community property states)	Counsel + Partners	*Chapter 16*
Identify and engage target CRM platform and investor relations infrastructure	Managing Partner	*Chapter 12*

Phase 3: Entity Formation and Legal Documentation

Phase 3 is where the partner alignment and business design decisions of Phases 1 and 2 are translated into enforceable legal documents. It is the most legally intensive phase of the formation process and the one that most directly determines whether the company's governance and economic arrangements will actually function as the partners intended.

Phase 3 is not a document production exercise. It is a legal negotiation and drafting process. The founding partners, working with their attorney, must review every significant provision of the operating agreement against the agreed terms in the Partners' Term Sheet, confirm that the legal language implements the agreed economics and governance correctly, and negotiate the provisions where the term sheet was ambiguous or where the partners' initial agreement needs refinement once translated into specific legal language.

The Document Set

The complete legal document set for the formation of a real estate development company includes:

- Operating Company LLC Operating Agreement: the foundational document governing the management company's governance, equity, compensation, vesting, departure mechanics, transfer restrictions, dispute resolution, and dissolution. This should be the operating agreement that Chapter 4 describes in detail, not a template and not a form, but a negotiated document that reflects the specific agreements of these specific founding partners for this specific company.
- GP Entity LLC Operating Agreement: the agreement governing the GP entity's economic arrangements, specifically the promoted interest allocation among the founding partners. This document must be executed and in place before the GP entity enters its first development management or GP role on any deal-level entity.
- Equity Grant Agreements: individual written agreements for each founding partner confirming their specific membership interest, the vesting schedule applicable to that interest, the consideration for the grant, and the Section 83(b) election notice.
- Section 83(b) Elections: filed by each founding partner whose equity is subject to vesting, within 30 days of the grant date. The 30-day deadline is absolute and cannot be extended.
- Spousal Consent Agreements: executed by the spouse of each married founding partner in a community property state, acknowledging the operating agreement's transfer restrictions and confirming that any community property interest in the membership interest is subject to those restrictions.
- Employment Agreements (if applicable): for any founding partner who is also a formal employee of the operating company, or for any key hires made in connection with the company's formation.
- Decision Authority Matrix: the complete DAM from Chapter 8, executed as Exhibit C to the operating agreement, specifying the approval level required for each category of significant decision.
- Partners' Exit Scenarios Table: the complete departure scenarios table from Chapter 16, executed as Exhibit E to the operating agreement or as a standalone reference document.

The Operating Agreement Review Process

No founding partner should sign an operating agreement they have not read in full and discussed with their own counsel. The operating agreement is the most consequential legal document the founding partners will sign in connection with the company's formation. It governs their economic relationship, their governance rights, their departure obligations, and their potential liability for the company's obligations for years. A partner who signs without reading has accepted terms they do not understand, which is a setup for disputes when those terms are eventually applied.

The recommended review process: the attorney sends a first draft to all partners; each partner reviews independently and prepares a written list of questions, concerns, and proposed changes; the partners meet, with the attorney present, to discuss all material issues; the attorney produces a revised draft incorporating the agreed changes; and the process repeats until every partner is satisfied with the document. This process typically takes four to eight weeks for a well-prepared founding team working with an experienced attorney.

Phase 3 Checklist

PHASE 3: ENTITY FORMATION & LEGAL DOCUMENTATION

Action Item	Primary Owner	Handbook Reference
Form operating company LLC: file Articles of Organization in state of formation	Counsel	*Chapter 3*
Form GP entity LLC: file Articles of Organization in state of formation	Counsel	*Chapter 3*
Obtain Employer Identification Numbers (EINs) for each newly formed entity	Counsel / CPA	*This chapter*
Draft and negotiate operating company operating agreement against Partners' Term Sheet	Counsel + All Partners	*Chapter 4*
Confirm operating agreement includes all required provisions from the Chapter 4 annotated checklist	Counsel	*Chapter 4*
Draft and negotiate GP entity operating agreement (promoted interest allocation, clawback, carry escrow)	Counsel + All Partners	*Chapter 6*
Draft and execute equity grant agreement for each founding partner	Counsel	*Chapter 5*
File Section 83(b) election for each partner receiving vesting-subject equity (within 30 days of grant)	Each Partner individually + Tax Advisor	*Chapters 5 and 6*
Obtain and file spousal consent agreements for each married partner in community property states	Counsel	*Chapter 16*
Complete and attach Decision Authority Matrix as Exhibit C to operating agreement	Counsel + All Partners	*Chapter 8*
Complete and attach Partner Exit Scenarios Table as operating agreement exhibit	Counsel + All Partners	*Chapter 16*
Draft employment agreements for any key employees hired at formation (if applicable)	Counsel	*Chapter 12*
Make initial capital contributions to operating company; document in writing	All Partners	*Chapter 7*

Action Item	Primary Owner	Handbook Reference
File qualifying/registration documents in any state where company will operate (foreign qualification)	Counsel	*Chapter 3*

Phase 4: Regulatory Compliance and Operational Infrastructure

Phase 4 builds the operational and compliance infrastructure the company needs to function as a professional business: the banking relationships, insurance program, accounting systems, payroll systems, and regulatory filings that must be in place before investor capital is accepted and before operations begin. Phase 4 runs in parallel with Phase 3 for many items, since the entity formation steps of Phase 3 are prerequisites for the banking and regulatory filings of Phase 4.

Banking and Financial Infrastructure

The management company needs a complete banking setup before it begins operations:

- Operating account: the management company's primary operating account, into which initial capital contributions are deposited and from which operating expenses are paid. This should be a business checking account at a reputable commercial bank, with online banking access, a two-authorized-signer requirement for ACH and wire transfers above defined thresholds, and monthly statements delivered to a non-signatory managing partner.
- Investment Company Act compliance: for companies relying on Section 3(c)(5)(C), the banking setup must support the asset composition monitoring described in Chapter 20. Cash held in operating accounts counts as a non-qualifying asset and must be tracked relative to the total asset portfolio.
- Credit card accounts: a corporate credit card program with transaction reporting by card and user, rather than individual partners using personal credit cards and seeking reimbursement, which creates expense reporting confusion and tax complications.

For each deal-level entity, separate bank accounts must be established at or before the first investor capital is accepted: an investor capital account (holding committed equity pending deployment), a construction account (from which project costs are paid), and potentially a reserve account (holding required project reserves).

The Investment Adviser Filing

If the company has determined that it qualifies as an Exempt Reporting Adviser under the Private Fund Adviser Exemption (because it manages 3(c)(1) or 3(c)(7) private funds), the ERA Form ADV Part 1A must be filed within 60 days of first relying on the exemption. The company should not accept its first investor capital before the ERA filing is complete. If the company's deal vehicles rely on Section 3(c)(5)(C) exclusively, the adviser registration analysis is more complex (as described in Chapter 20), and securities counsel must guide the determination.

Insurance Program

All insurance coverages must be bound before the first employee starts work and before the first investor capital is accepted. The minimum insurance program for an operating development company:

- D&O / Management Liability: bound before the company accepts any investor capital or makes any investment decision on behalf of investors
- EPLI: bound before the first employee starts work, as discussed in Chapter 15
- General Commercial Liability: bound when the company establishes any physical office presence and when any employee begins site visits
- Cyber Liability: bound before investor data is stored in any company system

- Workers' Compensation: bound before the first employee starts work (legally required in every state except Texas, where most private employers may elect nonsubscriber status and accept the resulting loss of the exclusive-remedy bar)

Phase 4 Checklist

PHASE 4: REGULATORY COMPLIANCE & OPERATIONAL INFRASTRUCTURE

Action Item	Primary Owner	Handbook Reference
Open management company operating bank account; establish two-signer controls for wire/ACH above threshold	Managing Partner + CPA	*Chapter 21*
Establish corporate credit card program for management company	Managing Partner	*Chapter 21*
Register for federal and state payroll tax accounts (FEIN already obtained in Phase 3)	CPA / Payroll Provider	*Chapter 12*
Select and implement accounting software for management company bookkeeping (accrual basis)	CPA + Managing Partner	*Chapter 21*
Engage payroll processing provider; set up guaranteed payment disbursement schedule	CPA / HR	*Chapter 7*
Bind D&O / Management Liability insurance policy	Insurance Broker	*Chapter 15*
Bind Employment Practices Liability insurance policy (before first employee starts)	Insurance Broker	*Chapter 15*
Bind General Commercial Liability insurance policy	Insurance Broker	*Chapter 15*
Bind Cyber Liability insurance policy (before investor data is stored)	Insurance Broker	*Chapter 15*
Bind Workers' Compensation insurance policy (before first employee starts)	Insurance Broker	*Chapter 15*
Obtain key-person life insurance policies and execute buy-sell agreement	Insurance Broker + Counsel	*Chapter 15*
File ERA Form ADV Part 1A if company qualifies as Exempt Reporting Adviser (within 60 days of first reliance)	Counsel	*Chapter 20*
Complete state investment adviser registration if required (RAUM below $100M)	Counsel	*Chapter 20*
Implement investor CRM system; import existing investor contacts and relationship records	Managing Partner / IR	*Chapter 12*
Draft employee handbook and anti-harassment policy; have counsel review before distribution	HR / Counsel	*Chapter 12*
Establish I-9 employment eligibility verification process for all new hires	HR	*Chapter 12*
Engage cost segregation firm (for use on first completed project)	CPA	*Chapter 21*
Select qualified intermediary for 1031 exchange capability (for use at future dispositions)	CPA + Counsel	*Chapter 21*

Phase 5: First Capital Raise and Deal Execution Readiness

Phase 5 is where the company transitions from a formation project to an operating business. The offering documents are prepared, investor outreach begins in earnest, the first deal pipeline is activated, and the company closes its first investor capital. This is the most operationally intensive phase of the six, because it requires the simultaneous management of the legal and compliance work of the offering, the business development work of investor relations, and the operational work of deal pursuit.

The Offering Document Package

Before a single investor conversation about a specific offering can occur, the following documents must be complete and counsel-reviewed:

- The Private Placement Memorandum (PPM): the foundational disclosure document covering all of the components identified in Chapter 19. The PPM must be complete before any investor sees the offering terms, regardless of the investor's sophistication, the size of their anticipated investment, or the informality of the investor relationship.
- The deal-level LLC Operating Agreement: the operating agreement for the specific deal entity into which investors will invest, governing governance, economics, waterfall mechanics, investor rights, and the management company's authority
- Subscription Agreement: the document by which each investor subscribes for their membership interest, makes their representations and warranties (including accredited investor status), and accepts the terms of the operating agreement
- Investor Questionnaire: a document completed by each investor confirming their accredited investor status and, if the offering is conducted under Rule 506(c), providing the information needed to verify that status
- Form D: filed with the SEC within 15 days of the first investor closing
- State blue sky notice filings: completed for each state in which an investor is resident, within the state-specific deadline following the first sale to a state investor

Investor Outreach Compliance

The investor outreach process must be designed from the first contact to comply with the applicable offering exemption. If the company is conducting the offering under Rule 506(b), every person who receives information about the specific offering must have a pre-existing, substantive relationship with the company. If the company is using Rule 506(c), every investor who ultimately participates must have their accredited investor status verified through documented review of financial records or written certification from a licensed professional.

The choice between Rule 506(b) and Rule 506(c) must be made before any outreach begins for a specific offering, because the two regimes cannot be mixed within the same offering. If there is any doubt about whether all intended recipients of offering information have qualifying pre-existing relationships, the company should use Rule 506(c).

Phase 5 Checklist

PHASE 5: FIRST CAPITAL RAISE & DEAL EXECUTION READINESS

Action Item	Primary Owner	Handbook Reference
Determine offering exemption: Rule 506(b) or Rule 506(c); confirm all outreach is consistent with the chosen exemption	Counsel	*Chapter 19*
Confirm bad actor disqualification checks are complete for all covered persons	Counsel	*Chapter 19*
Draft and counsel-review the Private Placement Memorandum for the first offering	Counsel + Managing Partner	*Chapter 19*
Draft deal-level LLC Operating Agreement with full waterfall, governance, and investor rights provisions	Counsel	*Chapters 4 and 11*
Draft Subscription Agreement, Investor Questionnaire, and all investor onboarding documents	Counsel	*Chapter 19*
If Rule 506(c): implement accredited investor verification process before accepting any subscription	Counsel + Managing Partner	*Chapter 19*
Open deal-level entity bank accounts: investor capital account, construction account, reserve account	Managing Partner + CPA	*Chapter 21*
Set up deal-level entity accounting on tax basis; confirm capital account maintenance from day one	CPA	*Chapter 21*
Begin investor outreach in compliance with the applicable offering exemption	Managing Partner / IR	*Chapter 19*
File Form D within 15 days of first investor closing	Counsel	*Chapter 19*
Complete state blue sky notice filings for all investor states within applicable deadlines	Counsel	*Chapter 19*
Send subscription documents to all subscribing investors; collect signed documents before accepting funds	Managing Partner / IR	*Chapter 19*
Implement construction draw control procedures before first draw request is submitted	Managing Partner / CPA	*Chapter 21*
Commission cost segregation study immediately after project is placed in service	CPA	*Chapter 21*
Establish investor reporting calendar: quarterly updates, annual financial statements, K-1 delivery target	Managing Partner / CPA	*Chapters 19 and 21*

Phase 6: Post-Launch Governance and Ongoing Compliance

Phase 6 is not a discrete phase with a completion date. It is the permanent operational posture the company adopts after launch. The governance habits and compliance practices of Phase 6 are what separate the company that builds institutional credibility over time from the one that runs well until a problem reveals the weakness of its infrastructure.

The following sections identify the recurring governance and compliance obligations that the management committee must treat as regular institutional practice rather than ad hoc responses to specific events.

The Quarterly Governance Rhythm

Every quarter, the management committee should conduct a formal meeting that addresses the following:

- Financial performance review: actual results against the approved annual business plan, with discussion of any material variances and the management committee's response
- Deal pipeline update: status of each active project and each deal in active pursuit, with any required committee approvals for new commitments
- Capital raise update: investor relationship status, outstanding subscription documents, and any planned new offerings
- Tax distribution review: quarterly calculation and approval of mandatory tax distributions to all partners and investors
- Compliance calendar review: upcoming regulatory filing deadlines, insurance renewal dates, and any new compliance obligations that have arisen

The Annual Governance Obligations

The recurring annual obligations that must be completed every calendar year without exception:

- Annual business plan process: completed by December 31, covering all six components described in Chapter 9
- Annual conflicts disclosure: each founding partner completes the written disclosure form identifying all outside business activities, personal investments, and potential conflicts
- Annual insurance review: all coverages reviewed against current AUM, deal volume, and contractual requirements, with limits adjusted as needed
- ERA Form ADV annual updating amendment: filed within 90 days of fiscal year end (or a full RIA Form ADV update if registered)
- Partnership tax returns (Form 1065) and K-1s: filed or extended by March 15, with final delivery to partners and investors by September 15 at the latest
- Annual financial statements: reviewed or audited financial statements for the management company and each deal-level entity, completed in time to meet investor reporting obligations
- Operating agreement review: is the operating agreement still consistent with how the company actually operates? Any material evolution in the company's structure, governance, or economics that is not reflected in the operating agreement should be addressed through a formal amendment.

Phase 6 Checklist: Recurring Compliance Calendar

PHASE 6: ONGOING GOVERNANCE & COMPLIANCE (RECURRING ANNUALLY)		
Action Item	**Primary Owner**	**Handbook Reference**
Q1: File Form 1065 extensions for all partnership entities (March 15 deadline)	CPA	*Chapter 21*
Q1: Deliver W-2s to all employees and 1099s to all contractors (January 31)	CPA / HR	*Chapter 21*
Q1: Begin annual K-1 preparation; collect all deal-level year-end financial information from CPA firm	CPA	*Chapter 21*
Q1: Conduct annual conflicts disclosure process; each partner completes written disclosure form	Managing Partner	*Chapter 13*

Action Item	Primary Owner	Handbook Reference
Q1: File ERA Form ADV annual updating amendment (within 90 days of fiscal year end)	Counsel	*Chapter 20*
Q2: Deliver final K-1s to all partners and investors (target: by June 30)	CPA	*Chapter 21*
Q2: Conduct annual insurance review; adjust limits based on current AUM and deal volume	Insurance Broker	*Chapter 15*
Q3: Begin annual business plan drafting process (October 1 kick-off)	Managing Partner	*Chapter 9*
Q3: Conduct prior-year performance review against business plan targets	All Partners	*Chapter 9*
Q4: Complete and formally approve annual business plan for coming year (by December 31)	Management Committee	*Chapter 9*
Q4: Review and approve guaranteed payment levels for coming year (as part of budget process)	Management Committee	*Chapter 7*
Q4: Review operating agreement for consistency with current operations; amend if needed	Counsel + All Partners	*Chapter 4*
Quarterly: Conduct management committee meeting; review financials, pipeline, and capital raise status	Management Committee	*Chapter 8*
Quarterly: Calculate and distribute mandatory tax distributions to all partners and investors	CPA + Managing Partner	*Chapter 7*
Quarterly: Conduct 3(c)(5)(C) asset composition test if deal vehicles rely on that exclusion	CPA + Counsel	*Chapter 20*
Ongoing: Monitor RAUM against ERA and RIA registration thresholds; notify counsel if approaching $100M or $150M	CPA + Managing Partner	*Chapter 20*
Ongoing: File state blue sky notice filings for any new investor states within applicable deadlines	Counsel	*Chapter 19*
Ongoing: Maintain Section 83(b) election records for all active equity grants; ensure the 30-day deadline is tracked for new grants	CPA + Counsel	*Chapter 5*

The Total Formation Investment: What This Costs

A complete and properly executed formation process, from Phase 1 partner alignment through Phase 5 first capital raise, requires a meaningful investment in professional services. The founding team should budget for this investment as a cost of doing business correctly, not as an expense to be minimized. Underinvesting in formation quality creates deficiencies that cost multiples of the original savings to correct under the pressure of a real dispute or a regulatory inquiry.

Professional Service	Emerging Company Range	Established Company Range	Primary Driver of Variance
Securities and Corporate Counsel (Formation)	$25,000 to $50,000	$40,000 to $90,000	Number of entities formed; complexity of equity and governance arrangements;

Professional Service	Emerging Company Range	Established Company Range	Primary Driver of Variance
			number of partners; state registrations required
Securities Counsel (First PPM)	$15,000 to $35,000	$35,000 to $80,000	Whether the offering is deal-by-deal (lower) or fund-level (higher); whether institutional investors require additional disclosure or side letters
CPA Firm (First-Year Accounting and Tax)	$20,000 to $45,000	$40,000 to $100,000	Number of active entities; whether financial statements require review or audit; K-1 count; cost segregation study cost
Commercial Insurance (Annual Premiums)	$30,000 to $70,000	$60,000 to $150,000+	AUM; number of employees; D&O and E&O limits required by institutional investors; claims history
Investment Adviser Counsel (ERA Filing and Analysis)	$5,000 to $15,000	$15,000 to $30,000	Complexity of entity structure; whether the company manages 3(c)(1) or 3(c)(7) entities or relies on 3(c)(5)(C); state registration requirements
Entity Formation Fees and State Registrations	$2,000 to $8,000	$5,000 to $20,000	Number of states; number of entities; state-specific fees and requirements
TOTAL (approximate)	$97,000 to $223,000	$195,000 to $470,000+	Total reflects first-year professional services investment from Phase 1 through Phase 5 closing

These ranges reflect the investment required for a complete, properly executed formation process with qualified professional advisors. The lower end assumes a simple entity structure, an experienced founding team that needs less hand-holding through the formation process, a deal-by-deal 506(b) offering, and a smaller initial investor base. The higher end reflects a more complex structure, institutional investor requirements, and a founding team accessing these services for the first time.

A company that tries to complete the formation process at a fraction of these costs, using template operating agreements, unreviewed PPMs, or general practitioners rather than specialists, is not saving money. It is deferring costs that arrive with interest when a partner dispute, an investor claim, or a regulatory inquiry requires reconstruction of documentation that was never properly done. The formation

investment is the cheapest professional services investment the company will ever make relative to what it protects.

The Closing Message: What the Handbook Has Built

Every chapter of this handbook has addressed a specific set of legal, financial, governance, and operational decisions that a founding team must navigate to build a real estate development company that works as intended. The breadth of that content can feel overwhelming at first reading. It is not meant to be read straight through in a single sitting; it is meant to be consulted as each phase of formation progresses and each set of decisions approaches.

What the handbook has built, taken together, is a framework of understanding that separates a founding team that knows what it is doing from one that does not. A team that has worked through Chapter 1's alignment conversations knows what its partners actually believe, not what it assumes they believe. A team that has completed Chapter 5's Contribution Matrix has an honest, documented basis for the equity split rather than a socially comfortable one that breeds resentment later. And a team that has absorbed Chapter 13's fiduciary duty framework understands the obligations the partners owe to each other and to their investors, instead of discovering them for the first time when a dispute arises.

The real estate development company built on this foundation, documented, examined, honestly negotiated, properly formed, and compliantly operated, is a company that can withstand the adversities that will inevitably arise: the partner conflict, the bad deal, the difficult investor, the regulatory inquiry, the market downturn. The adversities will come; the question is whether the company's foundation holds.

The work described in this handbook is the foundation that everything else is built on.

CHAPTER 22: KEY TAKEAWAYS

1. The formation roadmap covers six phases spanning roughly six to nine months from the first partner conversation to the closing of first investor capital. The phases are sequential by design: Phase 1's alignment outputs are Phase 2's inputs, Phase 2's business design decisions are Phase 3's instructions, and Phase 3's completed documents are Phase 4's prerequisites, and so on. Compressing or skipping phases creates deficiencies that eventually require expensive correction under the pressure of an operating company's real disputes and obligations.
2. Phase 1 is the most important and the most commonly underestimated. The five alignment domains (business vision, partner contributions and equity, governance philosophy, compensation expectations, and long-term exit vision) must be addressed through real, two-way conversations before legal work begins. The Partners' Term Sheet is Phase 1's primary output, a written, non-binding summary of the partners' agreements that serves as the instruction document for Phase 3's attorney-drafted documents.
3. Phase 3's complete document set includes the operating company operating agreement, the GP entity operating agreement, individual equity grant agreements, Section 83(b) elections (filed within the absolute 30-day deadline), spousal consent agreements, the Decision Authority Matrix as an operating agreement exhibit, and the Partner Exit Scenarios Table. No founding partner should sign any of these documents without having read them in full and having had the opportunity to discuss them with their own counsel.
4. Phase 4 builds the operational infrastructure before any investor capital is accepted or employee starts work: banking with two-signer controls, the insurance program (D&O, EPLI, CGL, cyber, and workers' compensation), accounting systems on the correct basis for each entity type, payroll processing, the ERA Form ADV filing (if applicable), and the investor CRM.
5. Phase 5's first capital raise requires a complete offering document package (PPM, deal-level operating agreement, subscription agreement, investor questionnaire) before any investor

conversation about the specific offering occurs. The offering exemption choice (Rule 506(b) or Rule 506(c)) must be made before outreach begins, and the two exemptions cannot be mixed within a single offering. Form D must be filed within 15 days of the first investor closing, and state blue sky notice filings must be completed for each investor state.

6. Phase 6 is permanent: the quarterly governance rhythm (management committee meetings, financial performance review, tax distribution calculation, compliance calendar review) and the annual obligations (business plan, conflicts disclosure, insurance review, ERA or RIA filing, partnership returns, K-1 delivery, financial statements, operating agreement review) must be institutionalized as regular practice, not treated as ad hoc responses.
7. The complete formation process requires a professional services investment of approximately $97,000 to $470,000 or more, depending on entity complexity, institutional investor requirements, and the company's stage. This investment is not overhead. It is the legal and operational foundation that protects the founders, the investors, and the company from the adversities that will inevitably arise. Template agreements, unreviewed PPMs, and general practitioners rather than specialists do not save money; they defer costs that arrive with interest when real disputes and regulatory inquiries require reconstruction of documentation that was never properly done.

See also: *All appendices (A through J), the supporting reference materials that accompany this handbook: the Partners' Term Sheet Template (Appendix A), the Decision Authority Matrix (Appendix D), the Partner Exit Scenarios Table (Appendix E), the Securities Law Compliance Checklist (Appendix F), the Regulatory Compliance Calendar (Appendix G), the Formation Documents Checklist (Appendix H), the Insurance Coverage Checklist (Appendix I), and the Glossary (Appendix J).*

APP. A

APPENDIX A

Partners' Term Sheet

Template and Completion Guide

A non-binding written record of the founding partners' agreed terms, the instruction document that governs all subsequent legal drafting. Complete this template before engaging legal counsel to draft the operating agreement.

IMPORTANT NOTICE

This document is a template, not a legal agreement. The Partners' Term Sheet is a non-binding written record of the founding partners' agreed terms on the principal issues governing their new company. Its purpose is to force real alignment before legal drafting begins and to provide attorneys with clear instructions that reduce the risk of the operating agreement drifting from what the partners actually intended. This template should be completed by the founding partners together, through the alignment conversations described in Chapters 1 and 22 of the handbook. No section should be completed by one partner and presented to the others as a fait accompli. Every entry is the product of a real conversation, not a unilateral decision. The completed Term Sheet is not the operating agreement. It does not create any binding legal obligations among the partners. It is the input to the attorney-drafting process; the operating agreement that results from that process is the binding document. Nonetheless, the more completely and honestly this template is filled out, the better the operating agreement will reflect the partners' actual intentions.

How to Use This Template

The Partners' Term Sheet Template is organized in thirteen sections that correspond to the major subject areas of the operating agreement. Work through the sections in order; do not skip ahead to the economic terms before the governance structure is settled, and do not attempt to settle the departure mechanics before the equity allocation is agreed. The sections build on each other, and the later sections presuppose that the earlier ones have been completed.

For each section, the template provides the specific information to be agreed upon; the handbook chapter that provides the substantive framework for that decision; drafting guidance that explains why the specific term matters and what the range of acceptable options looks like; and space for the partners to record their agreement.

When you have completed the full template and all partners have signed the acknowledgment at the end, provide a copy to your legal counsel as the instruction document for the operating agreement drafting process. Counsel will use the completed Term Sheet as their drafting mandate and will flag any provisions where the agreed terms require legal refinement or where state law imposes constraints that the parties' agreement must accommodate.

DRAFTING GUIDANCE

Estimated time to complete: two to four working sessions of two to three hours each, conducted as a group with all founding partners present. Some sections, particularly equity

allocation (Section 3) and departure mechanics (Section 8), should be scheduled as separate dedicated conversations rather than squeezed into a broader meeting agenda. These are the sections where unresolved disagreement is most likely to surface, and they deserve focused attention.

If a section generates significant disagreement that cannot be resolved in the session, do not fill in a placeholder answer. Note that the section requires further discussion and schedule a dedicated follow-up. A Term Sheet with blank sections that reflect real open questions is more useful, and more honest, than one with placeholder answers that paper over real disagreements.

1 Company Identification and Basic Information

Complete these basic identification fields before proceeding to the substantive sections. Having the company's name and principal location settled avoids confusion during the legal drafting process and ensures that the entity formation documents filed in Phase 3 reflect the agreed identity.

Proposed Company Name	
Alternate Name (if primary is unavailable)	
Principal Place of Business (City, State)	

Proposed State of Formation		**Target Launch Date**	

Primary Asset Class and Investment Strategy	
Target Geographic Market(s)	
Target Deal Size Range (minimum to maximum project cost)	

DRAFTING GUIDANCE

State of formation: Delaware is the most common choice for development companies planning to raise institutional capital, due to its well-developed LLC case law and sophisticated corporate governance statutes. For a company that will operate exclusively in one state with no institutional investor plans, forming in the home state may be simpler and less expensive. See Chapter 3 for the full analysis.

Investment strategy: be specific enough here that the description can serve as the basis for the corporate opportunity doctrine's investment criteria definition in the operating agreement. "Ground-up multifamily development in the Dallas-Fort Worth metropolitan area, with project costs between $10 million and $60 million" is a useful description. "Real estate development" is not.

2 Founding Partners

List each founding partner who will hold an equity interest in the operating company from inception. For each partner, record their full legal name, their primary role in the company, and the entity (if any) through which they will hold their interest. Partners who will receive profits interests rather than direct equity are addressed separately in Section 6.

Full legal name	Primary role in company	Holding entity (if any)	State of residence

Will any partner hold their interest through a trust or other estate planning vehicle? **If yes, identify the trust name and confirm the founding partner remains trustee and sole beneficial owner**	

DRAFTING GUIDANCE

Holding entities: a partner who will hold their equity interest through a family limited partnership, a revocable living trust, or a personal LLC should identify that entity here. Confirm with counsel that the proposed holding structure is permissible under the operating agreement's transfer restriction provisions and that the holding entity can properly execute the operating agreement and any required consents. See Chapters 3 and 16.

Married partners: partners who are married and reside in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, Wisconsin) should note that fact here. Spousal consent agreements will be required from their spouses before the operating agreement is signed. See Chapter 16.

3 Equity Allocation and the Contribution Matrix

The equity allocation is among the most important and most consequential agreements the founding partners will make. It must reflect an honest assessment of each partner's contribution to the company, not just their financial investment, but the full range of contributions identified in the Contribution Matrix framework from Chapter 5. Agreements reached in a spirit of politeness or social comfort, rather than honest assessment, consistently generate resentment when the company's operations make the contribution imbalances visible.

The Contribution Matrix

Complete the Contribution Matrix for each founding partner. Score each contribution category on a scale of 1 (minimal) to 5 (exceptional) and record the specific contributions that justify the score. The scores are not a formula for the equity split; they are a structured framework for an honest conversation about relative contributions.

Contribution category	P1	P2	P3	Specific contributions (partner who scores highest)
Capital, financial (cash contributed to operating company and deals)				
Capital, reputational (existing industry relationships and professional credibility)				

Contribution category	P1	P2	P3	Specific contributions (partner who scores highest)
Deal origination (existing pipeline, broker relationships, proprietary access)				
Investor relationships (existing LP relationships with documented capacity)				
Development execution (project management, entitlement, construction oversight)				
Financial expertise (underwriting, financial modeling, CPA or finance background)				
Legal and compliance (securities, real estate, corporate governance experience)				
Time commitment (percentage of professional time dedicated at launch)				
Risk assumed (financial guarantees, foregone compensation, non-compete risk)				

Agreed Equity Allocation

Record the agreed equity ownership percentage for each founding partner. The percentages must sum to 100 percent. Provide a brief written rationale for the allocation that references the Contribution Matrix results.

Partner name	Equity percentage	Primary basis for allocation (reference Contribution Matrix categories above)
	%	
	%	
	%	
	%	
Total	100%	

Initial Capital Contributions

Record the agreed initial capital contribution from each partner to the operating company. Capital contributions may be in cash, property, or services, though service contributions require careful tax analysis and should be reviewed with the CPA before the operating agreement is executed.

Partner name	Cash contribution ($)	Other contribution (describe)	Payment timeline
	$		
	$		
	$		
Total	$		

> **DRAFTING GUIDANCE**
>
> *Equity versus contribution: equity percentage and capital contribution are not the same thing. A partner may contribute 10 percent of the capital but deserve 30 percent of the equity based on their non-financial contributions. The Contribution Matrix is the tool for working through this distinction. See Chapter 5.*

Minimum capitalization: the operating company should be capitalized with enough working capital to fund at least 12 to 18 months of operations without deal-level fee income. Under-capitalized operating companies become financially dependent on deal flow before they have established the platform, which creates pressure to take deals that may not meet the investment criteria. See Chapter 2.

Service contributions: a partner who is contributing sweat equity rather than cash, who is receiving equity in exchange for past or future services rather than for cash or property, may have a taxable event at the time of the grant. Consult the CPA before the equity grant documents are executed. See Chapters 5 and 6.

4 Vesting Schedule and Cliff

All founding partner equity should be subject to a vesting schedule that creates real retention incentives and ensures that a partner who departs before making their full expected contribution does not walk away with full economic participation. Record the agreed vesting structure here; the specific mechanics will be implemented in the equity grant agreements prepared in Phase 3.

Total Vesting Period (years)		**Cliff Date (months from grant date)**	

Vesting type (select one):

Type	Description
Time-based (straight-line)	Equal percentage vests each month or quarter following the cliff date, with no performance conditions.
Performance-based	Vesting is tied to achievement of specific, measurable milestones rather than the passage of time.
Hybrid (time and performance)	A defined percentage vests on a time schedule; the remainder vests upon achievement of specific milestones.
Other (describe below)	Any alternative vesting structure agreed by the partners.

Selected vesting type and specific terms	
Performance milestones (if hybrid or performance-based; be specific and measurable)	
Agreed vesting schedule for each partner (note any partner-specific differences)	

DRAFTING GUIDANCE

Four-year vesting with a one-year cliff is the standard for professional services partnerships and has strong precedent in the real estate development company context. The one-year cliff protects the company against a partner who signs the operating agreement and departs within months; the four-year total period creates a long-term retention incentive. See Chapter 5.

Partner-specific vesting: it is permissible, and sometimes appropriate, for different partners to have different vesting schedules. A founder with a longer track record and more demonstrated contribution might have a shorter cliff or a more accelerated schedule than a newer partner who needs to prove their value to the enterprise. Any partner-specific differences should be agreed explicitly and documented here.

5 Good Leaver and Bad Leaver Framework

The good leaver and bad leaver framework determines the economic consequences of each partner's departure depending on the circumstances. It is the single provision of the operating agreement most commonly the subject of disputes after formation, because it is the provision that applies when the partnership relationship has already deteriorated. The time to agree on it is now, when the partners are aligned and can approach the question objectively.

Definition of Cause for Termination

The definition of cause must be specific and objective. Vague definitions ("conduct detrimental to the company's interests") can be weaponized; specific definitions protect all partners. Agree on the specific categories of conduct that constitute cause.

Category of conduct	Included as cause?	Notes and modifications
Fraud, theft, or intentional misappropriation of company assets	Yes / No	
Conviction of a felony involving moral turpitude	Yes / No	
Material and uncured breach of the operating agreement (after notice and cure)	Yes / No	
Willful misconduct causing material harm to the company	Yes / No	
Material breach of fiduciary duty (after applicable process)	Yes / No	
Securities law violation resulting in formal SEC or state action	Yes / No	
Material breach of non-compete or non-solicitation obligations	Yes / No	
Permanent disability (after defined period; see Section 9)	Yes / No	
Additional agreed categories (list below)	Yes / No	

Cure period for remediable breaches (number of days from written notice)	
Cause determination process (who decides; required approval threshold)	

Economic Consequences of Good Leaver Versus Bad Leaver Departure

For each departure category, record the agreed economic treatment of vested and unvested equity, and the applicable buyout price. The buyout price column should reference the valuation methodology agreed in Section 10.

Departure category	Unvested equity treatment	Vested equity buyout price	Notes
Good leaver: voluntary resignation after cliff	Forfeited	FMV or formula price	
Good leaver: retirement after minimum tenure	Full acceleration (all unvested vests)	FMV or formula price	
Good leaver: termination without cause	Full or partial acceleration (specify)	FMV	
Good leaver: death	Full acceleration always	FMV (funded by life insurance)	
Good leaver: permanent disability	Partial or full acceleration (specify)	FMV	
Bad leaver: voluntary resignation before cliff	100% forfeited	Lower of cost or nominal value	

Departure category	Unvested equity treatment	Vested equity buyout price	Notes
Bad leaver: termination for cause	100% forfeited	Lower of cost or nominal value, or zero	
Bad leaver: material non-compete breach	Forfeited (per OA terms)	Below-FMV penalty price	

DRAFTING GUIDANCE

The good leaver and bad leaver distinction is the most litigated provision in development company operating agreements. Protect it with specificity: the definition of cause, the required approval process, and the economic consequences must all be documented in writing before the first deal is done. See Chapter 5 for the full framework.

Minimum tenure for retirement treatment: the operating agreement should specify the minimum number of years of service that qualifies a voluntary departure as retirement rather than ordinary resignation, with the corresponding enhanced economic terms (typically five to ten years of service). Record the agreed minimum here.

The cure period for remediable breaches is a crucial protection for all partners. A breach that can be remedied, a missed reporting obligation or a delayed payment, should not trigger cause-termination consequences without first giving the breaching partner written notice and a real opportunity to cure. Thirty days is the standard cure period.

6 Promoted Interest and Carry Allocation

The promoted interest is the GP entity's share of profits above the investor preferred return, the equity upside that compensates the founding partners for the performance of the investments they manage. This section records the agreed allocation of the GP entity's carry among the founding partners. The specific waterfall mechanics are typically set deal by deal and are recorded in the deal-level operating agreement; this section records the allocation of whatever carry the GP entity earns across all deals.

Promoted Interest Rate

Standard promoted interest rate (% of profits above investor preferred return)	
Standard investor preferred return (annual IRR hurdle)	
Catch-up provision (does the GP receive a catch-up between the preferred return and the carry? Specify rate)	
Deal-specific variation authority (who may approve a deviation from the standard promote rate)	

Carry Allocation Among Founding Partners

Record the agreed allocation of the GP entity's promoted interest among the founding partners. The allocation may be equal, equity-proportional, role-weighted, deal-specific, or a hybrid of these approaches.

Carry allocation methodology (equal / equity-proportional / role-weighted / deal-specific / hybrid)	

Partner name	Carry allocation %	Basis for allocation (if not equal or equity-proportional)
	%	
	%	
	%	
Total	100%	

Deal-specific carry adjustments (when a partner may receive a different allocation on a deal, and the approval process)	

Clawback Provisions

Is a general partner clawback provision agreed? (Yes / No)	
If yes, describe the clawback trigger and calculation methodology	
Carry escrow: will a portion of promote distributions be escrowed to fund potential clawback? Specify percentage and duration	

> **DRAFTING GUIDANCE**
>
> *Section 1061 holding period: for taxable years beginning after December 31, 2017, a three-year holding period is required for carry distributions to be treated as long-term capital gain. Development companies whose typical hold period is less than three years should discuss the Section 1061 implications with their CPA before agreeing on the promote structure. See Chapter 6.*
>
> *Deal-specific carry allocations: for a two-partner company where one partner sources and manages a deal while the other plays a supporting role, a deal-specific allocation that gives the originating partner a higher carry percentage on that deal may be appropriate. The mechanism for approving deal-specific allocations must be specified, typically unanimous committee consent. See Chapter 6.*

7 Partner Compensation

This section records the agreed compensation for each founding partner, covering both the current compensation that begins at formation and the framework for future adjustments. Compensation transparency, each partner knowing what every other partner receives, and why, is a prerequisite for compensation arrangements that do not generate resentment.

Guaranteed Payments

Partner name	Initial annual guaranteed payment ($)	Commencement trigger (immediate / milestone / date)	Adjustment mechanism
	$		
	$		
	$		

Partner name	Initial annual guaranteed payment ($)	Commencement trigger (immediate / milestone / date)	Adjustment mechanism
	$		

Annual compensation review process (timing, who initiates, approval threshold for adjustments)	
Maximum annual increase without supermajority approval	

Mandatory Tax Distributions

Agreed tax distribution rate (the standard is the highest combined federal and state marginal rate applicable to any partner; confirm the specific rate)	
Tax distribution timing (quarterly / annually / within defined days of K-1 delivery)	
Priority of tax distributions relative to other obligations (typically paid before any discretionary distributions)	

Expense Reimbursement

Business expense reimbursement policy (reimbursable categories; documentation; approval for expenses above threshold)	
Pre-formation expenses: will the company reimburse expenses incurred before formation? If so, identify categories and amounts	

DRAFTING GUIDANCE

Phantom income protection: guaranteed payments create ordinary income tax obligations for each partner whether or not the company distributes cash to fund that obligation. The mandatory tax distribution provision exists precisely to prevent partners from being taxed on income they have not received in cash. Do not leave this provision blank or to be negotiated later. See Chapter 7.

Commencement trigger: partners who are unable to begin full-time participation immediately, because they have current employment obligations, transition periods, or other commitments, should agree in advance on the date or milestone that triggers their full guaranteed payment. A partner who is drawing a full salary before making a full contribution creates resentment; a partner who contributes full time but receives no compensation is a setup for financial stress that affects their professional performance.

8 Governance Structure

The governance provisions determine how the company makes decisions, who has authority to act without consultation, and which decisions require collective approval. The governance structure must reflect the founders' actual working relationship, not an idealized version of it.

Management Structure

Managing Partner or Managing Member designation (name and initial term, if any)	
Management Committee composition (all founding partners / select partners / combination)	
Decision-making standard for ordinary matters (majority / supermajority; specify quorum)	
Decision-making standard for major decisions (supermajority percentage; which decisions)	
Decisions requiring unanimous consent (list specifically; limit to truly foundational matters)	

Managing Partner Authority

Record the specific categories of decision the managing partner may make unilaterally, without committee approval, within the parameters of the approved annual business plan:

Single transaction threshold for managing partner authority (maximum dollar amount per transaction)	
Hiring authority (maximum compensation for hires without committee approval)	
Leasing and vendor contract authority (maximum commitment term and dollar threshold)	
Any additional categories of unilateral managing partner authority	

Voting Rights of Non-Managing Partners

Do non-managing partners vote on all committee decisions, or only on matters affecting their economic interests?	
What governance rights (if any) do non-managing members retain after resignation but before buyout?	

DRAFTING GUIDANCE

The approval threshold for compensation decisions, particularly decisions about the managing partner's own compensation, is one of the most contentious governance questions in a two-partner company. A supermajority threshold for any change in partner compensation prevents one partner from unilaterally increasing their own pay at the other partner's expense. See Chapter 8.

The Decision Authority Matrix: Section 8 of the Term Sheet provides the inputs for Appendix D's Decision Authority Matrix, which catalogues every significant decision category and its required approval level. After completing this section, use the completed terms to populate the matrix before the operating agreement drafting begins.

9 Transfer Restrictions and Exit Mechanics

Transfer restrictions protect the company against the introduction of unwanted third parties as new business partners through sale, divorce, bankruptcy, or other transfer mechanisms. Agree on these provisions now, while the partnership is healthy, rather than under the pressure of an actual transfer scenario.

Lock-Up Period

Lock-up period duration (months or years from formation)		**Unanimity required to override lock-up?**	

Permitted transfers during lock-up (estate planning trusts / wholly controlled entities / other)	

Right of First Refusal

ROFR exercise period (days from notice of proposed transfer)		**ROFR exercise priority (company first / partners pro-rata / other)**	

Payment matching for non-cash consideration (cash equivalent at FMV / installment matching / other)	
ROFR closing timeline after exercise (days)	

Involuntary Transfers

Treatment of bankruptcy: ROFR triggered at FMV? Specific process for seeking bankruptcy court approval?	
Treatment of divorce in community property state: spousal consent required? May non-member spouse receive economic interest only?	
Treatment of creditor charging order: company purchase right at FMV? Phantom income considerations addressed?	

Drag-Along and Tag-Along Rights

Drag-along trigger threshold (% of equity that must agree to exercise drag)	
Drag-along minimum price protection (minimum return on invested capital before drag can be exercised)	
Tag-along notification period (days from proposed transfer notice)	

10 Valuation Methodology for Buyouts

Every departure scenario that triggers a buyout requires a valuation of the departing partner's equity interest. Agreeing on the valuation methodology before any departure occurs, rather than litigating it at the time of a specific departure, is among the most practical governance protections the partners can implement.

Primary valuation methodology for FMV buyouts (independent appraisal / formula / agreed multiple / EBITDA / other)	
If formula-based: specify the formula in detail (multiple of trailing EBITDA / multiple of AUM / other basis)	
Appraiser selection process: how is the appraiser selected? Who pays? What if the parties disagree on the conclusion?	

Discount for minority interest (is FMV calculated with or without a minority discount for a departing non-managing interest)?	
Discount for lack of marketability (is a DLOM applied? If so, what range)?	
Buyout payment timeline (lump sum / installments; specify period and interest rate on deferred payments)	
Security for deferred buyout payments (promissory note / pledge of company interest / other)	

DRAFTING GUIDANCE

Formula versus appraisal: formula-based valuations are faster and less expensive than independent appraisals, and they eliminate the risk of a disputed appraisal outcome. But formulas can produce valuations that diverge significantly from market value in unusual circumstances, particularly for a young company with limited historical earnings. Consider using a formula as the primary method with an appraisal as a fallback if any party objects to the formula result by more than a defined percentage. See Chapter 5.

The installment payment timeline: if the company does not have the liquidity to fund a lump-sum buyout at the time of departure, which is common for an emerging development company, the installment timeline must be long enough to be practical (18 to 36 months is typical) but short enough to not leave the departing partner in economic limbo for years while the remaining partners continue to operate the company.

11 Restrictive Covenants

The restrictive covenants, non-compete, non-solicitation, and confidentiality, protect the company's most valuable assets from competitive appropriation by a departing partner. Their scope must be specific enough to be enforceable in the relevant jurisdiction and honest enough to reflect the company's real protective interests, not merely a desire to handicap a departing partner's future career.

Non-Compete

Non-compete scope (asset class / deal type / activity description, tied to the company's specific investment criteria)	
Non-compete geographic restriction (MSA / city / state / radius from target market, be specific)	

Non-compete duration post-departure (months)		**Governing law for enforcement**	

Does the governing state enforce non-competes for LLC members? (Confirm with counsel; see Chapter 14 state table)	

Non-Solicitation

Investor non-solicitation duration (months)		**Lookback for covered investors (months before departure)**	

Definition of solicitation for investor non-solicitation purposes (include both direct and indirect solicitation)	

Employee non-solicitation duration (months)		**Does the provision cover contractors as well as employees?**	

Confidentiality

Confidentiality period for non-trade-secret information (years; trade secrets are protected indefinitely)	
Return-of-information obligation (deadline for return and certification of deletion upon departure)	
Confirm the operating agreement includes the DTSA immunity notice required for exemplary damages and fee recovery	

12 Dispute Resolution and Deadlock

The dispute resolution and deadlock provisions govern how the company manages deep partner conflict without destroying the business in the process. These provisions are only needed when the partnership is under maximum stress, which is precisely when hastily made provisions will be most inadequate. Agree on them now.

Escalation Framework

Direct negotiation period (days before escalation required)		**Management committee escalation period (days)**	

Mediation provider (JAMS / AAA / independent mediator / other)	
Mediation: mandatory pre-condition to arbitration? (Recommended: yes)	
Binding arbitration provider (JAMS / AAA / other)	

Number of arbitrators (disputes below $1M: 1; $1M to $5M: party election; above $5M: 3-person panel)		**Seat of arbitration (city, state)**	

Cost allocation for arbitration (loser pays / modified loser pays / each party bears own fees)	

Deadlock Mechanisms

Definition of deadlock (tied vote / inability to achieve required supermajority / other)	

Agreed deadlock resolution mechanism (select all that apply and specify sequence):

Mechanism	Selected?	Specific parameters (duration, threshold, other)
Cooling-off period (mandatory waiting period before any mechanism is triggered)	Yes / No	

Mechanism	Selected?	Specific parameters (duration, threshold, other)
Independent tiebreaker (neutral expert with authority to break specific deadlocks)	Yes / No	
Buy-sell or shoot-out (one party names a price; the other elects to buy or sell)	Yes / No	
Texas shootout (simultaneous sealed bids; higher bidder acquires at their bid price)	Yes / No	
FMV appraisal buyout (independent appraisal sets price; separate process determines who exits)	Yes / No	

Deadlock trigger threshold (duration of deadlock before the mechanism activates; for example, 90 days after the matter first failed to achieve required approval)	

13 Additional Agreed Terms

Record any additional agreements among the founding partners that are not captured by the preceding sections. This section should be used for agreements specific to this partnership's particular circumstances: pre-formation arrangements, contingent provisions, specific side agreements between subsets of the partners, or any other term the partners have agreed should be incorporated into the operating agreement.

Agreed terms regarding pre-formation activities (deals sourced, expenses incurred, or IP developed before formation)	
Agreed terms regarding outside business activities (activities each partner will continue; disclosure; pre-approved exceptions)	
Agreed terms regarding partner office requirements (required hours / location / remote work policies)	
Agreed terms regarding company name and branding (ownership of name; use after departure)	
Any other agreed terms not captured in Sections 1 through 12	

OPEN ITEMS TRACKER

Record below any items that were not resolved during this Term Sheet completion process and that require a follow-up session before legal drafting can begin. A Term Sheet with documented open items is more useful than one with placeholder answers.

Open item (describe the disagreement or unresolved question)	Follow-up session scheduled	Partner responsible for position paper

Founding Partners' Acknowledgment

Each founding partner signing below acknowledges and confirms that:

1. They have participated in good faith in the partner alignment conversations that produced the agreements recorded in this document.
2. The entries recorded in this document reflect their considered agreement as of the date signed, and are not placeholders or approximations.
3. They understand that this document is not a legally binding contract and does not create enforceable rights or obligations among the partners.
4. They authorize the company's legal counsel to use the agreed terms recorded in this document as the primary instruction document for drafting the operating agreement.
5. They commit to reviewing the operating agreement draft carefully against the agreed terms recorded in this document and to raising any discrepancies with the other partners before signing the operating agreement.
6. Open items identified in the Open Items Tracker above are outstanding and must be resolved before the operating agreement is executed. No partner is bound by any entry in this document until all open items have been resolved and a final version of this document is signed by all partners.

Partner 1 Signature

Name: _____ Date: _____

Partner 2 Signature

Name: _____ Date: _____

Partner 3 Signature

Name: _____ Date: _____

Partner 4 Signature (if applicable)

Name: _____ Date: _____

Date of Final Agreement on All Terms		**Counsel Engagement Authorized**	

Completion Guide: Section-by-Section Handbook References

The following table provides a quick reference to the handbook chapters that address the substantive issues in each Term Sheet section. For any section where the partners have questions or need additional context before completing it, consult the referenced chapter and its worked examples.

Section	Topic	Primary handbook reference
1	Company identification	Chapter 1 (vision), Chapter 2 (business model), Chapter 3 (state of formation)
2	Founding partners	Chapter 3 (holding structures), Chapter 16 (community property)

Section	Topic	Primary handbook reference
3	Contribution Matrix	Chapter 5 (contribution categories and scoring)
3	Equity allocation	Chapter 5 (allocation approaches; equal versus unequal)
3	Capital contributions	Chapter 7 (capital contribution framework)
4	Vesting schedule	Chapter 5 (vesting structures, cliff, and hybrid vesting)
5	Definition of cause	Chapter 5 (cause definition specificity), Chapter 8 (removal authority)
5	Good and bad leaver economics	Chapter 5 (leaver framework), Chapter 16 (all departure scenarios)
6	Promoted interest and carry	Chapter 6 (profits interests), Chapter 11 (waterfall), Chapter 6 (Section 1061)
7	Partner compensation	Chapter 7 (guaranteed payments, tax distributions, expense reimbursement)
8	Governance	Chapter 8 (Decision Authority Matrix, committee structure, approval thresholds)
9	Transfer restrictions and exit	Chapter 16 (lock-up, ROFR, drag-along, tag-along, involuntary transfers)
10	Valuation for buyouts	Chapter 5 (buyout valuation), Chapter 16 (payment timeline)
11	Restrictive covenants	Chapter 14 (non-compete, non-solicitation, confidentiality, DTSA)
12	Dispute resolution and deadlock	Chapter 17 (escalation, mediation, arbitration, deadlock mechanisms)
13	Additional terms	Chapter 13 (outside business activities, fiduciary duties)

End of Appendix A

APP. B

APPENDIX B

Entity Structure Comparison

Choosing the Right Legal Form for Each Layer of a Real Estate Development Company

A reference comparing every entity structure a real estate development and sponsor company encounters, at the management company level, the GP level, and the deal-level SPE, across liability, taxation, governance, investor eligibility, regulatory status, and operational considerations.

A real estate development company is not a single entity; it is an architecture of entities, each chosen for a specific purpose and each subject to a specific legal and tax framework. Understanding those choices, and why a particular structure is right for each layer of the company, is a prerequisite for making the formation decisions described in Chapter 3 and throughout the handbook.

This appendix addresses every entity type a development company encounters: the operating company (management company), the GP entity, and the deal-level SPE. For each entity type, it identifies the available legal forms, compares them across the dimensions that matter most to a real estate sponsor, and provides a recommended structure with the rationale. Green-shaded cells indicate advantageous characteristics; red-shaded cells indicate disadvantages or limitations. Read this appendix alongside Chapter 3's narrative analysis for the fullest picture.

Part I: The Three-Layer Entity Architecture

Before comparing individual entity types, the founding team needs a clear picture of the three-layer entity architecture that a professionally structured development company maintains. Each layer serves a distinct function, and the entity structure at each layer is chosen to serve that function optimally.

Layer	Entity name	Primary function	What it holds
Layer 1: Management Company	Operating Company LLC	Operates the development business; employs staff; receives management fees; is owned by the founding partners	The development platform's operating assets: fee income, intellectual property, brand, employees, banking relationships, investor relationships
Layer 2: GP Entity	GP or Carry Entity LLC	Holds the promoted interest in each deal; acts as general partner or managing member of deal-level entities; keeps carry economics separate from management company operations	The carried interest allocation in each deal-level entity; sometimes the GP co-investment capital as well
Layer 3: Deal-Level SPE	Project LLC (one per deal)	Holds the specific real estate asset or development project; receives investor equity; draws on construction debt; is managed by the GP entity	The real property (land and improvements), the construction loan, the investor equity capital, the project-level operating accounts

The separation of these three layers is not a legal technicality. It is the structural mechanism that protects the management company's assets from project-level creditors; protects each project's assets from the liabilities of other projects; keeps the promoted interest in a separate entity to facilitate tax-efficient allocation of carry; and allows each project to have a distinct capital structure and investor base without contaminating the management company's balance sheet.

Part II: Entity Type Comparison, Operating Company

The operating company is the founding partners' primary business entity, the entity they own, the entity that employs the team, earns the fee income, and builds the platform. The entity type chosen for the operating company determines the governance flexibility available to the partners, the tax treatment of operating income, the liability protection afforded to the founding partners, and the entity's attractiveness to sophisticated investors and joint venture partners.

MANAGEMENT COMPANY: HEAD-TO-HEAD ENTITY COMPARISON

Characteristic	Delaware LLC	Texas LLC	C corporation	S corporation
Liability protection (partners or shareholders)	Full	Full	Full	Full
Piercing risk if formalities ignored	Low (minimal formality required)	Low	Moderate (corporate formalities required)	Moderate
Federal tax treatment	Pass-through	Pass-through	Entity-level tax plus double taxation on dividends	Pass-through
Self-employment tax on earnings	Applies to guaranteed payments; managing member may be subject on distributive share	Same as Delaware LLC	W-2 wages plus payroll taxes for officer-employees	Reasonable salary required; distributions not subject to SE tax
State tax treatment	No Delaware state tax if no operations in Delaware	Texas franchise tax applies (0.375% to 0.75% of revenue above the no-tax-due threshold)	Corporate income tax varies by state	Pass-through for federal; state treatment varies
Governance flexibility	Maximum (operating agreement governs almost everything)	Very high (Texas Business Organizations Code is permissive)	Board of directors; rigid statutory structure; annual meetings	Same corporate structure; more restrictive than C corporation in some ways
Manager-managed structure available	Yes	Yes	No (managed by board)	No (managed by board)
Fiduciary duty modification	Broad modification permitted under the Delaware LLC Act	Permitted under the Texas Business Organizations Code	Limited modification for directors	Limited modification
Institutional investor preference	Strong preference for Delaware	Acceptable for Texas-based deals	UBTI issues for tax-exempt investors; requires tax equity structures	Cannot have corporate shareholders or more than 100 shareholders
Number of members or shareholders	Unlimited	Unlimited	Unlimited	100 maximum; one class of stock
Foreign (non-U.S.) investors permitted	Yes	Yes	Yes, with FIRPTA considerations	No non-resident alien shareholders
Required annual formalities	Minimal (no mandatory meetings, resolutions, or minutes)	Minimal	Annual meetings, board resolutions, minutes, registered agent	Same as C corporation
Equity compensation vehicles	Profits interests available; no ISO or NSO stock options	Same as Delaware LLC	Full range including ISOs, NSOs, restricted stock	Options available but complex due to single-class-of-stock requirement
Ease of capital structure modification	Very high (operating agreement amendment)	High	Moderate (requires board and shareholder action)	Low (single-class restriction limits flexibility)

★ RECOMMENDED STRUCTURE: MANAGEMENT COMPANY

Delaware LLC for any company anticipating institutional investor relationships, joint venture partners, or potential platform sale. Texas LLC (or other home-state LLC) for smaller companies operating exclusively within one state with no institutional capital plans.

The additional cost of Delaware formation ($500 to $2,000 in state fees plus registered agent fees) is trivial compared to the governance flexibility and institutional credibility it provides. See Chapter 3 for the full analysis.

Part III: Entity Type Comparison, GP or Carry Entity

The GP entity is the entity that holds the promoted interest in each deal-level SPE and acts as the general partner or managing member of those entities. Its primary purposes are to separate the carried interest economics from the management company's operations, providing cleaner accounting and tax reporting; and to provide an additional liability buffer between the managing partner's personal assets and the project-level entities' obligations.

In most development company structures, the GP entity is an LLC that is itself owned by the founding partners in proportions reflecting the agreed carry allocation from Section 6 of the Partners' Term Sheet. The GP entity should always be a separate entity from the management company. Co-mingling the carry economics with the management company's fee income creates accounting complexity, potential securities disclosure complications, and the risk of inadvertently co-mingling carry obligations with management company liabilities.

GP ENTITY: STRUCTURE OPTIONS

Characteristic	Separate LLC (recommended)	Management company acting as GP (not recommended)	Limited partnership (historical)
Liability insulation	Full LLC liability protection between project-level claims and founding partners' personal assets	Management company assets directly exposed to project-level GP liability	LP interests protected; GP (which should be an LLC) exposed
Carry accounting separation	Carry income and distributions clearly segregated from fee income on separate books	Carry and fee income commingled; complex accounting required to separate	LP distributions clearly separable from GP carry if GP is itself an LLC
Tax treatment of carry	Pass-through to founding partners; long-term capital gain treatment available for carry meeting the Section 1061 holding period	Same tax treatment but accounting complexity increases error risk	Same pass-through treatment
Governance flexibility	LLC operating agreement governs carry allocation, clawback, and partner-level provisions	Management company OA must cover both management and carry provisions; creates complexity	LP agreement must comply with LP statutory requirements; less flexible than LLC
Institutional investor acceptance	Standard structure; expected by sophisticated LPs	Non-standard; raises LP governance concerns	Acceptable but increasingly replaced by LLC structure
Ease of carry reallocation among partners	Amendment to GP LLC operating agreement	Amendment to management company OA; affects all management company provisions	Amendment to LP agreement; generally workable
Required annual formalities	Minimal for LLC	Same minimal formalities but accounting burden is higher	Moderate (LP agreements typically require more formal process)

> ★ **RECOMMENDED STRUCTURE: GP ENTITY**
>
> A separate single-purpose LLC organized in Delaware (or the operating state), owned by the founding partners in proportions reflecting the agreed carry allocation. Never use the management company as the GP entity directly.
>
> The incremental cost of forming a separate GP LLC (typically $500 to $1,500 in filing fees) is immaterial compared to the accounting clarity, liability protection, and institutional credibility it provides. See Chapter 3 for the full two-entity architecture analysis.

Part IV: Entity Type Comparison, Deal-Level SPE

The deal-level SPE is the entity that directly holds each real estate development project, the legal owner of the land and improvements, the borrower on the construction loan, and the entity into which investor equity is contributed. Each deal gets its own SPE, which is among the most important structural disciplines of a professionally managed development company.

The SPE structure achieves two critical objectives simultaneously: it limits each project's creditors to the assets of that project (so a failed deal does not expose other projects or the management company to the failed project's debts), and it gives each project's investors a clean, direct economic interest in that specific project without commingling with other investors' projects.

DEAL-LEVEL SPE: ENTITY TYPE OPTIONS

Characteristic	Multi-member LLC (most common)	LP (limited partnership)	Tenancy in common	Contractual JV
Liability protection for investors	Full for non-managing members	Full for limited partners	None (TIC owners personally exposed)	Depends on contract; generally weaker
Pass-through taxation	Yes (partnership tax treatment)	Yes (partnership tax treatment)	Yes, but complex; each co-owner files separately	Typically yes if not a corporation
Investment Company Act exclusions	All three: 3(c)(1), 3(c)(7), 3(c)(5)(C)	All three exclusions available	TIC interests are not an LLC; ICA analysis more complex	Depends on specific JV structure
Governance flexibility	Maximum through operating agreement	High through LP agreement	Minimal (governed by state property law)	Depends on contract; less predictable
Investor admission process	Standard subscription documents	Subscription documents; standard	Deed transfer; title insurance issues	Contract amendment typically required
Capital account maintenance	Standard partnership tax rules	Standard partnership tax rules	No capital accounts; each owner separate basis	Depends on structure
Section 1031 exchange eligibility	Entity-level exchange available; investor-level complex	Entity-level exchange available	Each co-owner can independently exchange	Depends on structure
Lender acceptance	Universally accepted	Generally accepted; some prefer LLC	Accepted but additional documentation	Non-standard; many lenders will not accept
FIRPTA withholding (foreign investors)	Applies at entity level on disposition	Same as LLC	Each co-owner separately subject	Depends on structure
Required annual filings	Form 1065; state filing in state of operation	Form 1065; state LP registration	No entity return; each co-owner files	Form 1065 if treated as partnership

> ★ **RECOMMENDED STRUCTURE: DEAL-LEVEL SPE**
>
> A single-purpose multi-member LLC, with the GP entity as the managing member and investors as non-managing members. This is the universal standard for private real estate development projects in the United States for well-founded reasons: maximum flexibility, clean liability insulation, standard lender acceptance, clear capital account mechanics, and access to all three Investment Company Act exclusions.
>
> Deviations from this structure (TIC or contractual JV) should only be considered for specific tax planning reasons (TIC for facilitating investor-level 1031 exchanges) after consultation with tax counsel. See Chapter 3 for the full deal-level entity analysis.

Part V: State-by-State LLC Formation Comparison

The state of formation determines which state's LLC law governs the entity's internal affairs, its fiduciary duty framework, the permissible operating agreement modifications, the statutory default provisions that apply when the operating agreement is silent, and the judicial system available to resolve disputes. The choice of formation state is one of the most consequential early decisions in the company's formation process.

The following comparison addresses the six states most commonly considered for development company formation, with analysis of the key dimensions that matter for a real estate development and sponsor company.

Dimension	Delaware	Texas	New York	California	Florida	Wyoming
LLC statute quality	Excellent (most developed LLC statute in the U.S.)	Very good (modern, flexible)	Good (less flexible than Delaware)	Good (modernized in 2014; more investor-protective)	Very good (modern and flexible)	Good (pioneered the LLC; less comprehensive development)
Fiduciary duty flexibility	Maximum (duty of loyalty broadly modifiable; care reducible to gross negligence)	High (broad modification permitted)	Moderate (courts more skeptical of broad waivers)	Lower (implied covenant more expansive)	High (broad modification allowed)	Moderate (modification allowed; less case law)
Judicial system quality	Exceptional (Court of Chancery)	Good (business courts in major metros)	Good (Commercial Division of NY Supreme Court)	Adequate (competent but slower, more litigation-friendly)	Good (reasonable commercial courts)	Limited (small court system)

Dimension	Delaware	Texas	New York	California	Florida	Wyoming
Annual fees and maintenance	Low ($300 LLC tax plus registered agent ~$150/year)	Low (revenue-based franchise tax; small companies pay little)	Moderate ($25 biennial; NYC unincorporated business tax if operating in NYC, ~4%)	High ($800 minimum annual LLC tax; among the highest)	Low ($138.75 annual report; no income tax on LLCs)	Very low ($60 annual fee; no corporate or personal income tax)
Privacy and disclosure	Minimal (only registered agent identified)	Moderate (members not in certificate)	Lower (member disclosure in some filings at 25%+)	Lower (Statement of Information discloses manager or member)	Moderate (registered agent disclosed)	High (one of the most privacy-protective states)
Institutional investor familiarity	Maximum (the default expectation)	Good (accepted; may require explanation)	Good for NY investors; less familiar elsewhere	Acceptable for CA investors; less preferred nationally	Acceptable for FL investors and deals	Limited (associated with anonymity rather than institutional vehicles)
Non-compete enforcement (members)	Strong contract enforcement; sophisticated-party non-competes generally respected	Enforceable under the Texas Covenants Not to Compete Act with reasonableness requirements	Reasonableness standard; legislative risk of further restriction	Near-total ban under Bus. & Prof. Code 16600, with narrow sale-of-business and member exceptions	Employer-favorable under Fla. Stat. 542.335	Enforceable under general principles; limited LLC-member case law

★ FORMATION STATE DECISION FRAMEWORK

Form in Delaware if: the company anticipates raising institutional LP capital; the founders want the most developed fiduciary duty framework; the company may be sold or acquired; or the founders value access to the Court of Chancery for any future disputes.

Form in the home state if: the company will operate exclusively in one state with no institutional capital plans; the operating cost of dual registration (Delaware plus home-state foreign qualification) is a meaningful concern; or the founding partners are already familiar with the home state's LLC law and are comfortable with its provisions.

Avoid California as the formation state for any company that anticipates out-of-state operations, non-California investors, or future platform sale. The $800 minimum franchise tax and the more expansive good-faith obligations create ongoing cost and governance constraints that the other states do not impose.

Part VI: Investment Company Act Exclusion by Entity Layer

As established in Chapter 20, the Investment Company Act of 1940 imposes registration requirements on entities that are primarily engaged in investing, reinvesting, or trading in securities unless a specific statutory exclusion applies. The applicable exclusion varies by entity layer and by the specific assets and activities of each entity. The following comparison summarizes the exclusion analysis at each layer of the development company's architecture.

Entity layer	Primary applicable exclusion	Why this exclusion applies	Key structural requirements
Management company	Not an investment company; no exclusion needed	The management company is not primarily engaged in investing, reinvesting, or trading in securities; it is primarily engaged in operating a real estate development business (providing services, earning fee income, employing a team). It does not hold investor securities as its primary asset.	The management company must not hold a portfolio of investor securities as its primary asset. If it holds co-investment interests in deal-level entities, those interests should constitute a small proportion of its overall asset base.
GP entity	Not an investment company, or Section 3(c)(5)(C)	The GP entity holds the promoted interest in deal-level entities. If those deal-level entities hold qualifying real estate assets (and themselves qualify for 3(c)(5)(C)), the GP entity's interest in them may be treated as a qualifying real estate interest rather than a security.	GP entity should hold controlling interests in deal-level 3(c)(5)(C) entities, not passive minority interests. The controlling interest characterization is what converts the GP's interest from a security into a qualifying real estate asset. See Chapter 20.
Deal-level SPE (direct property holder)	Section 3(c)(5)(C), primary recommended exclusion	The deal-level entity directly owns real property (land and improvements), which are qualifying assets under 3(c)(5)(C). At least 55% of total assets must be qualifying assets; at least 80% must be qualifying plus real estate-related assets.	Do not allow non-qualifying assets to exceed 20% of total assets. Monitor asset composition quarterly. Treat controlling interests in single-asset property-owning entities as qualifying; treat passive minority interests as non-qualifying. Commission legal analysis before formation.
Deal-level SPE (investor count concern)	Section 3(c)(1), fallback if 3(c)(5)(C) unavailable	If the deal-level entity's assets include meaningful non-qualifying assets (for example, passive minority interests in other entities), 3(c)(5)(C) may not be satisfied and 3(c)(1) becomes the applicable exclusion.	100 beneficial owner cap (hard limit). Beneficial owner counting rules must be applied at each entity level. The count must be tracked continuously and cannot be exceeded by any amount without registering as an investment company.

Entity layer	Primary applicable exclusion	Why this exclusion applies	Key structural requirements
Fund-level vehicle (if used)	Section 3(c)(1) or Section 3(c)(7)	A fund that holds interests in deal-level SPEs, rather than directly holding real property, may not qualify for 3(c)(5)(C) because its primary assets are interests in entities rather than direct real estate. 3(c)(1) or 3(c)(7) are the appropriate exclusions.	3(c)(1): 100 beneficial owner maximum; accredited investors preferred (no regulatory requirement but standard practice). 3(c)(7): no investor count cap; all investors must be qualified purchasers ($5 million in investments for natural persons).

Part VII: Tax Classification Comparison

The federal income tax classification of each entity in the development company's structure determines how income, gain, loss, and deduction flow to the ultimate taxpayers, the founding partners and their investors. Every LLC must make a tax classification election (or accept the default classification), and the election has lasting consequences for how the entity's economics are reported on tax returns.

Tax classification	Default rule or election process	Who typically uses it	Primary advantage for real estate sponsors
Partnership (Form 1065)	Default for multi-member LLCs with two or more members. No election needed.	All multi-member LLC deal-level entities; management company with two or more founding partners; GP entity with two or more principals.	Pass-through of all income, gain, loss, depreciation, and credits. Capital account framework permits special allocations. Profits interests available as employee equity. No entity-level tax. Partnership tax flexibility is the foundation of all real estate tax planning.
Disregarded entity	Default for single-member LLCs. No election needed; the activity is reported on the owner's return.	Single-member deal-level SPEs where the parent (fund or management company) is the sole owner. Intermediate holding LLCs in layered structures.	Simplicity: no separate tax return required for the disregarded entity. All items flow directly to the owner's return. Useful for holding entities and subsidiary structures where a separate filing would add cost without tax benefit.
S corporation	Must file Form 2553 with the IRS. Available to LLCs that elect corporation treatment first.	Rarely used for development company entities. Occasionally used by management companies where founders want to limit self-employment tax on distributions above a reasonable salary.	Distributions above the required reasonable salary are not subject to self-employment tax. However, the single-class-of-stock restriction, 100-shareholder cap, and prohibition on non-resident alien shareholders make S-corp election impractical for development company structures.
C corporation	Must file Form 8832 or incorporate as a corporation. Pays entity-level tax at 21%.	Venture-backed technology companies; entities seeking to issue qualified small business stock (QSBS) under IRC Section 1202. Not appropriate for real estate development companies.	Lowest entity-level corporate tax rate (21% federal) and the QSBS gain exclusion (expanded by the One Big Beautiful Bill Act in 2025). But double taxation of dividends, inability to pass through real estate losses, and the prohibition on partnership-style waterfall structures make C-corp classification incompatible with the economics of a real estate development company.

Self-Employment Tax Note for Managing Partners

A founding partner who actively participates in the management of a partnership (including an LLC taxed as a partnership) may be subject to self-employment tax not just on their guaranteed payments but on their entire distributive share of business income. The IRS has long contested the position that managing members of LLCs taxed as partnerships can avoid self-employment tax on their distributive share by characterizing themselves as limited partners. Development company founders should discuss their specific self-employment tax exposure with the CPA before finalizing the management company's compensation structure. See Chapter 7 for the full guaranteed payment analysis.

Part VIII: The Two-Entity Architecture in Practice

Chapter 3 describes the two-entity architecture that separates the management company from the GP entity. The following example illustrates how this architecture works in practice for a specific

deal, tracing the flow of economics through each entity layer from the project's closing through disposition.

Worked Example: Two-Entity Architecture on a $20M Multifamily Development

Structure

- Management Company LLC ("DevCo"): 50/50 between Partner A and Partner B; earns development management fees and asset management fees.
- GP Entity LLC ("DevCo GP"): 60% Partner A / 40% Partner B; holds the 20% promoted interest above a 9% preferred return in each deal.
- Deal Entity LLC ("Project I LLC"): DevCo GP holds a 1% managing member interest plus the 20% promoted interest; 12 investors hold the 99% non-managing member interests.

Fee Flow

Project I LLC pays DevCo a development management fee (2.5% of total project cost, which is $500,000) and an asset management fee (1.0% per year of AUM during the hold). These fees are DevCo's ordinary income, taxable to Partners A and B on their K-1s from DevCo as their distributive shares of ordinary business income.

Promote Flow at Disposition

Project I LLC sells for a $5.0M profit after return of investor capital and the 9% preferred return. DevCo GP's 20% promoted interest entitles it to $1.0M of that profit (20% of $5.0M). DevCo GP allocates $600,000 to Partner A (60%) and $400,000 to Partner B (40%). Both partners receive their allocations as long-term capital gain on their K-1s from DevCo GP, subject to the three-year Section 1061 holding period requirement.

Liability Isolation

If Project I LLC has a construction dispute that results in a judgment against the entity, the judgment creditor's recourse is limited to Project I LLC's assets. DevCo's fee income, DevCo GP's promoted interests in other deals, and the founding partners' personal assets are all insulated from Project I LLC's liabilities by the entity structure. No single project's legal problems contaminate the management platform or the founding partners' net worth.

Part IX: Quick-Reference Decision Chart

The following decision chart is intended as a rapid-reference tool when the founding team is evaluating a specific entity structure question. For each common scenario, it identifies the recommended entity approach and the primary handbook chapter where the analysis is developed in full.

Scenario	Recommended approach	Handbook reference
Forming the management company for two founding partners in Texas with plans to raise individual investor capital	Texas LLC or Delaware LLC taxed as a partnership. Two founding partners means a multi-member LLC (default partnership tax). Delaware if institutional capital is anticipated.	Chapter 3; Parts II and V above
Forming the GP entity to hold the promoted interest	Separate single-purpose Delaware LLC, distinct from the management company; owned by founding partners in carry allocation proportions.	Chapter 3; Part III above
Forming the deal-level SPE for a ground-up multifamily project with 15 accredited investors	Single-purpose multi-member LLC; qualify for the Section 3(c)(5)(C) exclusion based on direct real property ownership; Rule 506(b) offering to existing investor relationships.	Chapters 3, 19, and 20
Forming a fund that will pool capital and invest across multiple deals	Fund entity structured as a 3(c)(1) or 3(c)(7) entity (not 3(c)(5)(C), since the fund holds interests in deal entities rather than direct real estate); GP entity as the fund's managing member.	Chapter 20
Existing deal has exceeded 100 investors and the 3(c)(1) exclusion is at risk	Analyze whether 3(c)(5)(C) is available based on the entity's actual asset composition (direct real estate versus interests in entities). If not, seek securities counsel advice immediately.	Chapter 20

Scenario	Recommended approach	Handbook reference
Founding partner wants to hold equity through a family LLC or revocable living trust	Permissible if the founding partner retains full control; the transferee entity executes a joinder to the operating agreement; the founding partner remains personally responsible for capital call obligations.	Chapters 3 and 16
Company is considering California as the formation state because that is where it operates	Form in Delaware instead; foreign-qualify in California. The $800 California annual franchise tax still applies to a Delaware LLC qualified in California, but the Delaware governance framework is superior.	Chapter 3; Part V above
Company has grown to $150M or more in RAUM and needs to assess investment adviser registration	Full RIA registration with the SEC is likely required. Engage securities counsel to file Form ADV and implement the written compliance program before the registration deadline.	Chapter 20
Deal-level entity will have a foreign (non-U.S.) investor	Review FIRPTA withholding requirements; consider whether treaty benefits apply; ensure the entity structure supports any FIRPTA certificate or withholding procedures. No structural change required but additional documentation and withholding mechanics needed.	Chapter 3; FIRPTA analysis with tax counsel
Company wants to execute a Section 1031 exchange on a completed project	The deal-level LLC can execute an exchange if it qualifies as holding the property for investment or business use (not as a dealer). Engage a qualified intermediary before the sale closing. Confirm dealer status with tax counsel.	Chapter 21

End of Appendix B

APP. C

APPENDIX C

Contribution Matrix

and Equity Allocation Worksheet

A structured, category-by-category framework for assessing each founding partner's contributions across nine dimensions and translating that assessment into an honest, documented equity allocation that reflects what each partner actually brings to the enterprise.

The equity split is the single most consequential economic decision the founding partners make. It is also the decision most commonly driven by social pressure, false equivalence, or simple avoidance of a difficult conversation. The founding team that divides equity equally because the conversation about unequal splits feels uncomfortable has deferred a fair decision in exchange for a comfortable one, at the cost of resentment that compounds over time as the contribution imbalances become visible in the company's operations.

This worksheet provides a structured alternative to both approaches: a category-by-category assessment of each partner's contributions across the nine dimensions that drive value creation in a real estate development company, with scoring rubrics that define what each level of contribution looks like in concrete terms, and a synthesis worksheet that translates the assessment into a documented, honest equity allocation. The worksheet does not produce the equity split mechanically; the scores are inputs to a conversation, not a formula. But they make the conversation specific, concrete, and documented in a way that reduces the risk of post-formation disputes about whether the equity split was fair.

How to Use This Worksheet

Work through the nine contribution categories sequentially, completing the scoring rubric and evidence documentation for each before moving to the next. Each category contains a description of why it matters, a scoring rubric that defines what scores of 1 through 5 mean in concrete terms for that specific category, and a space for each partner to document the specific contributions that justify their score.

After completing all nine category assessments, the synthesis worksheet provides the category weighting decision (which contributions matter most for this specific company at this specific stage), the weighted score calculation, and the translation from weighted scores to equity percentages. The final equity allocation record is where the founding partners document their agreed allocation and the primary basis for it.

CRITICAL PROCESS NOTE

Do not score in isolation. The scoring process is most useful when each partner assesses all partners, including themselves, and then the partners compare their assessments openly. A partner who assigns themselves a 5 in every category and assigns their co-founders a 2 or 3 is telling you something important about their self-perception, and that information is valuable in the conversation that follows. The comparison of each partner's

self-assessment with the others' assessment of them is often more revealing than the scores themselves.

Score each category independently before looking at the implications for equity. Partners who calculate as they score will unconsciously bias their category assessments toward the equity outcome they want. Complete all nine category sections first, then work through the synthesis.

The Nine Contribution Categories

Real estate development companies create value through nine distinct categories of contribution. Each category is independently important; the relative weight of each for a specific company at a specific stage is a judgment the founding team makes together in the synthesis worksheet. The nine categories are presented below in the order in which they typically manifest during the company's growth, from the foundational contributions that make the company possible to the execution contributions that make it work.

#	Category	Why this category matters for a development company
1	Financial Capital	Cash and other tangible assets contributed to the operating company or deployed as equity in deals. The company cannot operate without capital, and cash is the most fungible and measurable form of contribution. However, cash is also the most replaceable form: a partner who brings nothing but money may ultimately be replaced by an investor at a lower economic cost than a founding partner.
2	Reputational Capital	The professional standing, industry relationships, and personal credibility that a partner brings on the first day. Reputational capital is what allows the company to be taken seriously before it has a track record of its own; it is the bridge between the company's aspiration and the world's willingness to extend credit, trust, and opportunity.
3	Deal Origination Capability	The ability to identify, source, and control development opportunities that meet the company's investment criteria. Deal flow is the company's lifeblood; a partner with a demonstrable, pre-existing network of deal sources brings something that cannot be built overnight and that has direct economic value to the company's first years.
4	Investor Relationships	The depth and breadth of relationships with investors who would commit capital to a deal based on the partner's introduction and recommendation. Investor capital is the fuel for every deal; a partner who can bring committed investors from the first offering reduces the company's dependence on building an investor base from scratch.
5	Development Execution	The practical capability to manage development projects from site control through certificate of occupancy: entitlement, permitting, design management, contractor selection, construction oversight, schedule and budget management, and lease-up or sale. Execution capability is what turns deal origination into realized returns.
6	Financial and Analytical Expertise	Underwriting capability, financial modeling, capital markets knowledge, and the analytical sophistication to evaluate development opportunities accurately and to manage the company's financial operations and reporting. Analytical errors in real estate development are expensive; a partner who brings deep financial expertise reduces those errors materially.
7	Legal and Regulatory Knowledge	Understanding of real estate transaction structures, securities compliance, development company formation, and the regulatory environment in which the company operates. Legal knowledge reduces the company's dependence on outside counsel for everyday decisions and informs better structural choices at every stage.
8	Time Commitment	The percentage of each partner's professional time that will be dedicated to the company's operations from the first day. A partner who is bringing 100% of their professional time has a different cost and risk profile than one bringing 50%; the equity allocation must reflect this difference or generate resentment quickly.
9	Risk Assumed	The specific financial, professional, and personal risks each partner is accepting in order to participate in the company. Risk includes but is not limited to personal financial guarantees on company obligations; foregone employment income or deferred compensation; non-compete exposure from prior employment; bridge funding of company expenses before the operating company is capitalized; and reputational exposure if the venture fails.

CAT 1 FINANCIAL CAPITAL

Financial capital encompasses any cash or cash-equivalent asset contributed directly to the operating company as initial capital, committed to be contributed to deal-level entities as co-investment equity alongside investors, or pledged as a personal guarantee on company obligations. It includes cash already contributed, committed future cash contributions with a documented timeline, and any real property or other tangible asset transferred to the company for its use.

Financial capital is the most objective and quantifiable of the nine categories, but it should not be weighted disproportionately simply because it is easy to measure. The correct weighting reflects how important financial capital actually is to this specific company's success, which depends on the company's capitalization needs, the availability of other funding sources, and the relative scarcity of the other contribution categories among the founding partners.

Scoring Rubric: Financial Capital

Score	Level	What this looks like in concrete terms
1	**Minimal**	Contributing nominal or token capital (under $25,000 to the operating company and no committed co-investment). May have limited personal liquidity; is contributing primarily through non-financial means.
2	**Below average**	Contributing modest capital ($25,000 to $100,000) to the operating company; limited or no committed co-investment beyond what is typical for a managing partner with no third-party investors.
3	**Average**	Contributing meaningful capital ($100,000 to $500,000) to the operating company; some committed co-investment capacity alongside investors on deals; no personal guarantee obligations.
4	**Above average**	Substantial capital contribution ($500,000 to $1,500,000) and meaningful committed co-investment on all or most deals; may be providing personal guarantees on initial company banking or credit facilities.
5	**Exceptional**	Transformative financial contribution: seeding the company with $1,500,000 or more; providing personal completion guarantees on construction loans; funding operating losses during the company's pre-revenue period; providing letters of credit or other credit support the company could not otherwise obtain.

Assessment: Financial Capital

Partner name	Score (1 to 5)	Specific evidence supporting the score (cash amounts, guarantees, co-investment commitments)

CAT 2 REPUTATIONAL CAPITAL

Reputational capital is the professional standing, industry credibility, and established relationships that a partner brings on the first day of the company's existence. It is what allows the company to attract lender interest, broker attention, investor consideration, and contractor cooperation before the company has its own track record to offer. A development company founded by a recognized professional with an established reputation in the target market starts from a meaningfully different position than one founded by capable but unknown practitioners.

Reputational capital is difficult to quantify and easy to overstate. A partner who claims everyone knows them in Dallas is making an assertion that requires verification: How many active broker relationships have produced deal referrals? What is the partner's name recognition among institutional lenders in the market? Have prior employers publicly associated the partner with deals that generated strong returns? The scoring rubric below provides a more specific framework.

Scoring Rubric: Reputational Capital

Score	Level	What this looks like in concrete terms
1	Early career	Limited professional history; few established relationships in the target market; no prior employer track record to reference; name not recognized by brokers, lenders, or investors in the market.
2	Developing	Three to six years of experience; some established relationships in the target market; may be associated with deals done at a prior employer but in a subordinate rather than lead capacity; lenders and some brokers would be able to place the name.
3	Established	Six to twelve years of experience; recognized by brokers, lenders, and investors in the target market as a competent professional with a solid track record; lead credit on at least one prior successful project publicly associated with the partner's name; positive reputation with no material adverse history.
4	Well-known	Twelve or more years of experience; well-known in the target market; name recognition extends beyond the immediate professional circle to include institutional lenders, family office investors, and active deal participants; track record of successful projects in a lead role that investors and lenders can independently verify.
5	Industry leader	Established as a leader in the target market or asset class; national or regional recognition; name opens doors that would otherwise require years to open; relationships with institutional capital sources, major lenders, and senior municipal contacts that provide material near-term benefit and could not be replicated through any other means.

Assessment: Reputational Capital

Partner name	Score (1 to 5)	Specific evidence (prior employer, lead roles, market recognition, lender and broker relationships)

CAT 3 DEAL ORIGINATION CAPABILITY

Deal origination is the ability to identify and secure development opportunities that meet the company's investment criteria before they are broadly marketed. In real estate development, the best deals are rarely found through public listings or widely distributed offering memoranda; they come from deep relationships with landowners, active brokers who trust the developer to close, municipal officials who prefer dealing with known quantities, and institutional sellers who value discretion. A partner who brings active, demonstrable deal origination capability provides an asset that has direct and immediate economic value to the company.

The key distinction in assessing deal origination is between relationships that could plausibly produce deal flow and relationships that have actually produced deal flow. A large professional network does not equal deal origination capability; a history of off-market deals sourced through specific relationships does.

Scoring Rubric: Deal Origination Capability

Score	Level	What this looks like in concrete terms
1	Minimal	Limited broker relationships in the target market; no history of sourcing off-market opportunities; deal flow would be primarily generated through publicly marketed transactions.
2	Developing	Some active broker relationships; has participated in off-market transactions but primarily in a secondary role; limited landowner or institutional seller relationships.
3	Capable	Active relationships with multiple brokers who have provided off-market deal flow in the last 24 months; some direct landowner relationships; has sourced or co-sourced at least two qualifying transactions independently.
4	Strong	A recognized participant in the deal community in the target market; brokers proactively bring off-market opportunities; active landowner and institutional seller relationships; has been the primary deal originator on three or more qualifying transactions in the last three years.
5	Exceptional	The company's first year of deal flow is materially dependent on this partner's relationships; this partner has an existing pipeline of identified opportunities the company can begin pursuing immediately; their deal origination network would represent years of relationship-building for anyone starting from scratch.

Assessment: Deal Origination Capability

Partner name	Score (1 to 5)	Specific evidence (named brokers, off-market deals sourced in last 24 months, existing pipeline)

CAT 4 INVESTOR RELATIONSHIPS

Investor capital is the equity that funds every development project alongside construction debt. A founding partner who can bring committed investors to the first offering provides a contribution that has direct, immediate economic value to the company and that is among the most difficult to build from scratch. The investor relationship assessment must go beyond a broad claim of knowing a lot of high-net-worth people to specifically examine which relationships would realistically produce investment commitments in the company's first two years.

The distinction between a social network and an investor network is significant. A partner with 500 LinkedIn connections who has never discussed investment opportunities with any of them has a different investor relationship profile from a partner who has raised $8 million across two prior deals from a group of investors who have already expressed interest in the next opportunity. Be specific and honest about which relationships are actually investor relationships and which are professional acquaintances who might or might not become investors.

Scoring Rubric: Investor Relationships

Score	Level	What this looks like in concrete terms
1	**Minimal**	No prior experience raising private capital; no investor relationships developed through prior investment activity; would be starting from scratch on investor development.
2	**Developing**	Some professional contacts who are accredited investors; has co-sponsored a deal with investor capital but was not the primary relationship manager; limited investor relationship depth beyond a small handful of people.
3	**Capable**	Has participated in raising investor capital in a meaningful role; maintains active relationships with 10 to 25 investors who have committed to prior deals; investors have expressed interest in future opportunities; realistic expectation of raising $2 million to $5 million from existing relationships in the first offering.
4	**Strong**	Primary investor relationship manager for a portfolio of prior deals; active relationships with 25 to 75 investors representing $5 million to $20 million in prior commitments; high relationship continuity; realistic expectation of raising $5 million to $15 million from existing relationships.
5	**Exceptional**	The company's first capital raise is materially funded by this partner's investor relationships; has raised and managed equity capital from multiple investor groups; relationships include institutional-quality investors (family offices, RIAs, private bank relationships) who can write $1 million or larger checks; track record of investor retention across multiple deals.

Assessment: Investor Relationships

Partner name	Score (1 to 5)	Specific evidence (number of investor relationships, capital raised in prior roles, family office connections, expected first-raise total)

CAT 5 DEVELOPMENT EXECUTION CAPABILITY

Development execution is the practical capability to manage a ground-up development project from site control through delivery and stabilization. It encompasses the specific, hands-on skills of entitlement strategy, design management, contractor procurement and oversight, construction cost management, schedule management, draw management, and the relationship skills required to manage the complex web of consultants, contractors, subcontractors, inspectors, and municipal officials that a development project requires.

Execution capability is what converts a pipeline into delivered projects and investor returns. A company with excellent deal origination, investor relationships, and financial sophistication that lacks real execution capability will eventually fail at the delivery stage, which is where deals are won or lost on a fundamental basis. The scoring rubric below is deliberately rigorous about the difference between observational experience and operational responsibility.

Scoring Rubric: Development Execution Capability

Score	Level	What this looks like in concrete terms
1	Limited	Has worked in real estate but not in a development execution capacity; understands development conceptually but has not managed a project's construction or entitlement process.
2	Supporting role	Has participated in development projects in a supporting capacity (underwriting, financial reporting, investor relations) but has not directly managed the construction, entitlement, or design management process.
3	Project-level manager	Has directly managed one or two development projects from permit through construction completion; understands the entitlement process in the target market; has direct relationships with at least two general contractors; has managed a construction draw process.
4	Experienced developer	Has independently managed three or more development projects of similar size and complexity to the company's target deal type; has navigated at least one significant construction challenge (major cost overrun, schedule delay, contractor default) successfully; has established relationships with a deep pool of qualified contractors, architects, and consultants.
5	Expert practitioner	Has independently delivered five or more comparable development projects with documented on-budget and on-schedule performance; is the partner whose execution capability is the primary reason investors and lenders have confidence in the company's ability to deliver; has managed simultaneous projects and can lead the execution function without significant external hiring to begin operations.

Assessment: Development Execution Capability

Partner name	Score (1 to 5)	Specific evidence (named projects, project sizes, project types, construction management experience, contractor relationships)

CAT 6 FINANCIAL AND ANALYTICAL EXPERTISE

Financial and analytical expertise encompasses the quantitative and strategic capabilities required to evaluate development opportunities accurately, to structure the company's investments optimally, to communicate financial performance to investors and lenders with precision, and to manage the company's own financial operations with discipline. This category is distinct from deal origination (which is about finding opportunities) and from development execution (which is about delivering them); it is about accurately understanding the economics of what the company is doing.

In a development company context, analytical errors are expensive. An underwriting model that misestimates construction costs by 10% on a $15 million project has created a $1.5 million error before the first shovel is in the ground. A partner who brings deep, tested financial and analytical

expertise reduces the frequency and magnitude of these errors in a way that compounds favorably over time.

Scoring Rubric: Financial and Analytical Expertise

Score	Level	What this looks like in concrete terms
1	**Basic**	Understands basic real estate financial concepts; can read a pro forma but did not build it; has not managed financial reporting or investor reporting for a development project.
2	**Developing**	Comfortable building basic development pro formas; some experience with financial reporting or accounting; understands the waterfall structure and preferred return mechanics at a conceptual level.
3	**Proficient**	Builds detailed development financial models independently; understands capital markets and debt structuring; has managed or reviewed investor reporting and K-1 coordination; CPA or finance background with real estate application.
4	**Advanced**	Deep financial modeling capability in the company's specific asset class and deal type; experience with complex capital structures (mezzanine debt, preferred equity, construction-to-permanent financing); leads financial reporting and investor communications independently; has prepared or supervised audited financial statements.
5	**Expert**	Recognized financial expertise in the target asset class; has structured and closed complex capital stacks that typical developers cannot access; may have a CFA, CPA, or MBA with deep real estate finance specialization; brings institutional-quality financial capabilities that would otherwise require a senior CFO-level hire.

Assessment: Financial and Analytical Expertise

Partner name	Score (1 to 5)	Specific evidence (financial credentials, modeling examples, capital structures managed, financial reporting experience)

CAT 7 LEGAL AND REGULATORY KNOWLEDGE

Legal and regulatory knowledge covers the partner's understanding of real estate transactional structures, development company formation, securities law and investor compliance, investment adviser regulation, employment law, and the specific regulatory environment in which the company's projects will operate. This knowledge is distinct from having access to outside legal counsel; it is the internal capability to recognize when legal issues arise, to understand the options available, and to make better-informed decisions with and without the benefit of outside counsel.

A founding partner with real legal and regulatory expertise reduces the company's outside counsel costs, catches issues before they become problems, and makes the company's legal and compliance infrastructure more robust. This category is often underweighted relative to its actual contribution to the company's operations.

Scoring Rubric: Legal and Regulatory Knowledge

Score	Level	What this looks like in concrete terms
1	**General awareness**	Understands that legal issues exist but relies entirely on outside counsel for identification and resolution; has not participated in legal document review or negotiation beyond signing documents prepared by others.
2	**Transactional exposure**	Has reviewed real estate purchase agreements, loan documents, and operating agreements in a business capacity; understands what these documents say but is not equipped to identify legal risks independently.
3	**Operational competence**	Has managed real estate transactions with active legal document involvement; understands operating agreement mechanics, securities offering basics, and the regulatory environment for private real estate investments; can identify when a legal issue requires outside counsel attention without needing counsel to first identify the issue.
4	**Significant expertise**	Deep understanding of real estate partnership structures, securities compliance (Regulation D, PPM requirements, accredited investor standards), and investment company and adviser regulatory status; has negotiated complex real estate transaction documents; actively manages the company's legal and regulatory compliance calendar.

Score	Level	What this looks like in concrete terms
5	**Professional level**	A licensed attorney with active real estate or securities law practice; brings a professional-level understanding of all legal and regulatory dimensions of the company's operations; their legal expertise substitutes for a meaningful portion of outside legal spend and provides an internal compliance capability that most development companies of comparable size must purchase externally.

Assessment: Legal and Regulatory Knowledge

Partner name	Score (1 to 5)	Specific evidence (legal education or license, document review experience, regulatory compliance management, securities law familiarity)

CAT 8 TIME COMMITMENT

Time commitment is the most directly observable contribution category and the one that most directly affects day-to-day company operations. A partner who brings 100% of their professional time to the company from the first day has a fundamentally different operational impact than one who brings 50%, regardless of the quality of the contribution that 50% represents. The equity split must reflect the time commitment split; a partner who works full-time and receives the same equity as one who works half-time has accepted an arrangement that will generate resentment as soon as the disparity in daily contribution becomes visible.

Time commitment should be assessed both at launch (the initial time dedication the partner can commit to on the first day) and on a projected basis (the timeline for reaching full-time commitment if it is not available at launch). Partners with current employment, transition agreements, or other professional obligations that prevent full-time participation from day one should document those constraints honestly, including the specific date or milestone at which full-time participation is expected.

Scoring Rubric: Time Commitment

Score	Level	What this looks like in concrete terms
1	**Advisory only (under 20%)**	This partner has significant other professional commitments that will occupy the majority of their time; their role is primarily advisory and they cannot be counted on for day-to-day operational execution.
2	**Part-time (20% to 49%)**	This partner is dedicating between one and two days per week; has specific other professional commitments that take priority; can participate in strategy, deal evaluation, and key decisions but cannot manage day-to-day operations.
3	**Substantial (50% to 74%)**	This partner is dedicating roughly half to three-quarters of their professional time; may have transitional employment or other limited commitments that prevent full-time participation at launch but has a clear timeline for reaching full dedication.
4	**Full-time (75% to 99%)**	This partner is dedicating their primary professional time to the company; may have minor consulting or advisory commitments that take no more than a few hours per week; is functionally a full-time participant in operations.
5	**Exclusive commitment (100%)**	This partner has no other professional commitments; is dedicating their full professional time and attention from the first day; is available for all operational requirements without qualification.

Assessment: Time Commitment

Partner name	Score at launch (1 to 5)	Current time % at launch, expected full-time date, and other commitments that limit time

Partner name	Score at launch (1 to 5)	Current time % at launch, expected full-time date, and other commitments that limit time

CAT 9 RISK ASSUMED

Risk assumed captures the specific downside exposures a partner is accepting in order to participate in the company that are not already captured by the other contribution categories. Financial capital captures the cash contributed; risk assumed captures the exposure beyond that cash. A partner who is personally guaranteeing the company's construction loan, who left a high-paying position with a guaranteed bonus to join the company, who has a non-compete that makes returning to their prior employer difficult if the venture fails, or who is publicly associated with the company in a way that creates reputational risk if it does not succeed is assuming a different risk profile than one who is contributing from a position of financial security with limited personal exposure.

Risk is the most underweighted of the nine contribution categories in most partnership equity conversations, partly because risk is inherently uncertain and partly because no one wants to dwell on the possibility of failure. But the partner who is most exposed if the company fails has made a contribution that deserves recognition in the equity split, and failing to recognize it creates an imbalance between equity ownership and skin in the game that can generate significant resentment in difficult times.

Scoring Rubric: Risk Assumed

Score	Level	What this looks like in concrete terms
1	**Minimal**	No personal financial guarantees; no material foregone income; no non-compete exposure; participating from a position of personal financial security with a ready fallback employment option.
2	**Moderate**	Some foregone income relative to prior employment (20% to 30% pay reduction); minor transitional financial exposure; limited non-compete risk from prior employer; could return to a comparable employment position within six months if the company fails.
3	**Meaningful**	Material foregone income (30% to 50% pay reduction); non-compete exposure from prior employer that limits near-term alternative employment; has personally funded some pre-formation company expenses; may have provided a limited personal guarantee on a company banking facility.
4	**Substantial**	Significant foregone income or foregone equity from a prior employer (more than 50% pay reduction or vested equity forfeited); strong non-compete that effectively prevents returning to the prior field for 12 to 24 months; has provided personal guarantees on company credit or banking facilities; has personally funded significant pre-formation expenses that are at risk if the company fails.
5	**Transformative risk**	This partner has put their personal financial security on the line: personal completion guarantees on construction loans; bridging the company's operations personally before the operating company is capitalized; accepting a position publicly identified with the company in a way that makes a future change in direction professionally difficult; non-compete exposure that effectively prevents any competing employment for the duration; concentrated personal financial exposure to the company's success or failure.

Assessment: Risk Assumed

Partner name	Score (1 to 5)	Specific evidence (personal guarantees, foregone compensation amount, non-compete restrictions, pre-formation expenses, other exposures)

Synthesis Worksheet

With all nine category assessments completed, the synthesis worksheet converts those assessments into a weighted equity allocation. The process has three steps: determining category weights that reflect the company's priorities at this stage; calculating each partner's weighted score; and translating weighted scores into an equity allocation the partners agree is fair, with the scores as the documented basis for that agreement.

Step One: Determine Category Weights

Category weights reflect how important each contribution category is to this specific company's success at this specific stage. Weights should sum to 100%. The weight assignment should be a group decision, not a calculation: the partners should discuss which categories are most important to the company's near-term success before assigning weights. A company in its first year that needs to close its first deal immediately might weight deal origination and investor relationships very heavily; a company that has deal flow but needs execution capability might weight development execution most heavily.

Category	Partner 1 proposal	Partner 2 proposal	Partner 3 proposal	Agreed weight
Financial Capital				
Reputational Capital				
Deal Origination Capability				
Investor Relationships				
Development Execution Capability				
Financial and Analytical Expertise				
Legal and Regulatory Knowledge				
Time Commitment				
Risk Assumed				
Total (must sum to 100%)				

Step Two: Calculate Weighted Scores

For each partner, multiply their score in each category by the agreed category weight and sum the results. This produces each partner's weighted score. The weighted score is the analytical input to the equity allocation conversation; it is not the equity percentage itself.

Category and weight	C1	C2	C3	C4	C5	C6	C7	C8	C9
Partner 1: score									
Partner 1: weighted									
Partner 2: score									
Partner 2: weighted									
Partner 3: score									
Partner 3: weighted									

Step Three: Total Weighted Scores and Implied Allocation

Sum each partner's weighted scores across all nine categories. Then calculate each partner's share of the total weighted score pool to determine the implied equity percentage. This implied percentage is the starting point for the equity conversation, not the final answer.

Partner	Total weighted score (sum of 9 categories)	Share of total score pool	Implied equity percentage
Partner 1		%	%
Partner 2		%	%
Partner 3		%	%
Total		100%	100%

USING THE IMPLIED PERCENTAGE AS A STARTING POINT, NOT AN ANSWER

The implied equity percentage is a mathematically derived starting point for the equity allocation conversation. It is almost never the final answer, and it should not be treated as one. The process of completing the nine-category assessment and calculating the implied percentages is valuable because it makes the equity conversation specific, concrete, and evidence-based, not because it produces a mechanical output the partners must accept.

After calculating the implied percentages, the partners should discuss: Do these percentages feel right? Are there factors not captured in the nine categories that should affect the allocation? Are there strong practical reasons to round, simplify, or modify the implied percentages? Equal splits are often defensible on practical grounds even when the implied scores are not exactly equal. The administrative simplicity, the signal of equal commitment, and the avoidance of resentment from a partner who receives 48% instead of 50% may outweigh the analytical case for the unequal split.

What the implied percentages should prevent is the avoidance of careful analysis. A founding team that agrees to a 50/50 split because it is easier, without having completed this worksheet, does not know whether 50/50 is fair. A founding team that completes this worksheet and still agrees to 50/50 has made an informed decision with documented evidence that the split is defensible.

Final Equity Allocation Record

After completing the nine-category assessment and the synthesis worksheet, record the founding partners' final agreed equity allocation below. The final allocation should reference the implied percentages from the synthesis worksheet, document any adjustments made and the reasoning for them, and be signed by all founding partners as the agreed basis for the equity grant agreements that will be executed in Phase 3.

Final Allocation Table

Partner name	Implied % (from synthesis)	Agreed final %	Basis for any adjustment from implied percentage
	%	%	
	%	%	
	%	%	
	%	%	

Partner name	Implied % (from synthesis)	Agreed final %	Basis for any adjustment from implied percentage
Total	**100%**	**100%**	

Category Weight Summary

Record the agreed category weights for the company's reference. These weights reflect the partners' view of which contributions matter most to the company's success at this stage and should be revisited if a new partner is admitted or if the company's stage materially changes.

Category	Agreed weight	Rationale for weight (brief)
Financial Capital	%	
Reputational Capital	%	
Deal Origination Capability	%	
Investor Relationships	%	
Development Execution Capability	%	
Financial and Analytical Expertise	%	
Legal and Regulatory Knowledge	%	
Time Commitment	%	
Risk Assumed	%	
Total	**100%**	

Founding Partners' Acknowledgment

Each founding partner signing below confirms:

1. They participated in the nine-category scoring process honestly and in good faith.
2. The agreed category weights reflect the group's considered view of which contributions matter most to the company's success.
3. The final equity allocation is their considered agreement and provides a fair basis for the equity grant agreements to be executed in the company's formation process.
4. Any adjustments from the implied percentages are based on legitimate business considerations that all partners have discussed openly.
5. They authorize legal counsel to use the agreed allocation as the basis for the equity grant agreements prepared in connection with the company's formation.

Partner 1	Partner 2	Partner 3
Signature: _____	Signature: _____	Signature: _____
Name: _____	Name: _____	Name: _____
Date: _____	Date: _____	Date: _____

Worked Example

The following worked example demonstrates the worksheet's application for a hypothetical two-partner development company. The example is illustrative only; the scores, weights, and equity split shown are appropriate for this hypothetical scenario and would not necessarily be appropriate for a different partnership with different circumstances.

Hypothetical: Two-Partner Ground-Up Multifamily Company in Dallas

Partner A: a 12-year veteran of a regional multifamily developer; deep broker relationships; has led the development of three prior projects in Dallas; limited personal liquidity; currently has employment that will transition in six months.

Partner B: a former investment banking analyst with five years in real estate private equity; deep investor relationships; strong financial modeling; limited development execution experience; is ready to commit full-time immediately; contributing $500,000 in initial capital.

Category	Score A	Score B	Weight	Wtd A / Wtd B	Reasoning
Financial Capital	2	4	10%	0.20 / 0.40	Partner B contributing $500K cash; Partner A contributing minimal capital. Weighted at 10% because both partners recognize the company can attract additional investor capital as needed.
Reputational Capital	4	2	15%	0.60 / 0.30	Partner A has a strong market-recognized reputation in Dallas multifamily; Partner B is not known in the Dallas development market.
Deal Origination	5	1	20%	1.00 / 0.20	Partner A has active broker relationships that are the company's primary near-term deal flow source; Partner B has no active deal origination relationships.
Investor Relationships	2	5	20%	0.40 / 1.00	Partner B has raised capital in prior roles and maintains active investor relationships; Partner A's investor network is limited.
Development Execution	5	1	15%	0.75 / 0.15	Partner A has directly managed three comparable projects; Partner B has no construction management experience.
Financial and Analytical	2	5	8%	0.16 / 0.40	Partner B brings CFA-level financial expertise; Partner A is operationally strong but analytically less sophisticated.
Legal and Regulatory	2	3	4%	0.08 / 0.12	Partner B has more securities compliance exposure from a PE background; neither partner is a lawyer.
Time Commitment	3	5	5%	0.15 / 0.25	Partner A is transitioning and will reach full-time in six months; Partner B is full-time immediately.
Risk Assumed	3	3	3%	0.09 / 0.09	Both partners are accepting meaningful but comparable risk; Partner A has non-compete risk from a prior employer; Partner B is forgoing a significant salary.
Total weighted score			**100%**	**3.43 / 2.91**	**Implied: A = 54% / B = 46%**

FINAL AGREED ALLOCATION: PARTNER A 55% / PARTNER B 45%

The partners agreed to round the implied percentages slightly in Partner A's favor, reflecting Partner A's longer transition timeline (which currently creates a time commitment gap) offset by their deal origination network being the company's primary near-term deal flow source. Both partners agreed the split is fair given the documented contributions. The allocation is recorded in the equity grant agreements with a four-year vesting schedule and a one-year cliff.

End of Appendix C

APP. D

APPENDIX D

Decision Authority Matrix

Standalone Exhibit for the Operating Agreement

A catalogue of every significant management decision a real estate development company faces, organized by category and mapped to the required approval level, from Managing Partner authority through unanimous consent. Designed to be executed as Exhibit C to the operating agreement.

A governance framework is only as effective as the precision with which it allocates decision-making authority. An operating agreement that broadly states that major decisions require committee approval, without defining what major means, what percentage constitutes a supermajority, and what decisions fall outside the committee's authority entirely, is a governance framework in name only. When a real decision arrives under time pressure, a deal that must be executed today, a contractor who needs an immediate answer, an investor requesting a response by the end of the week, a vague governance provision produces exactly the wrong outcome: a procedural dispute about authority at the moment when operational speed is most needed.

The Decision Authority Matrix resolves this by cataloguing every significant management decision category and assigning it a specific, pre-agreed approval requirement. The matrix is not a corporate bureaucracy tool; it is a clarity tool. Partners who have agreed in advance on the approval level for every significant decision type spend less time in procedural disputes and more time on the substantive decisions themselves.

How to Use This Matrix

This matrix is designed to be completed by the founding partners during Phase 3 of the formation process, after the operating agreement's governance structure has been agreed and before the operating agreement is executed. The matrix becomes Exhibit C to the operating agreement by reference; the operating agreement's governance section specifies that all decisions shall be made at the approval level specified in the attached Decision Authority Matrix.

For each decision row, the founding partners agree which authority level applies by marking the appropriate column. The four authority levels are defined below. Where a decision falls in a category with a dollar threshold (a contract above a certain amount requires committee approval; below that amount the Managing Partner can act alone), the threshold should be filled in the Notes column rather than left as an absolute rule.

The matrix should be reviewed annually as part of the annual business plan process and updated whenever the company's scale, deal volume, or team structure changes in a way that makes the existing authority levels impractical. A matrix designed for a two-partner company with no employees may allocate too much to the Managing Partner and too little to committee review as the company grows; the reverse may be true if the company's operations slow.

Authority Level Legend

MP	**Managing Partner**	The designated Managing Partner may take this action unilaterally within the parameters of the approved annual business plan, without seeking committee approval. This authority level reflects routine operational decisions within the company's established strategy.
MAJ	**Committee Majority**	A simple majority of the management committee members entitled to vote on the matter (a majority of the disinterested members for any decision involving a conflict of interest). For a two-partner company, majority is unanimity; for three or more partners, majority is more than 50%.
SUP	**Committee Supermajority**	A supermajority of the management committee, typically defined as 66.7% or 75% of all committee members (not just those present at a meeting). The specific supermajority percentage should be defined in the operating agreement and referenced in the Notes column where applicable.
UNA	**Unanimous Consent**	All founding partners must affirmatively consent, regardless of whether they are managing members or voting committee members. Unanimous consent is reserved for foundational decisions that affect every partner's fundamental rights and that should not be made over any partner's objection.

Completing the Matrix: Threshold Guidance

For each decision category with a dollar threshold (such as contract approvals or capital expenditures), record the agreed threshold in the Notes column. The threshold should be high enough that the Managing Partner can execute routine business without constant committee approvals, and low enough that significant financial commitments receive appropriate oversight. For an emerging development company, a $25,000 threshold for Managing Partner unilateral authority on routine transactions, with committee majority required above $25,000 and supermajority above $250,000, is a common starting structure.

The filled-in dot marks the required approval level for each decision. Only one dot should appear per row. If a decision requires different approval levels depending on the dollar amount or circumstances, use two rows with specific conditions in the Notes column (for example, contracts under $25,000 and contracts $25,000 to $250,000 as separate rows).

The Decision Authority Matrix

The matrix below covers eleven decision categories encompassing more than 75 specific decision types. The founding partners should complete the matrix by marking each row with the agreed authority level, adding dollar thresholds and conditions in the Notes column, and then attaching the completed matrix to the operating agreement as Exhibit C.

Decision	MP	MAJ	SUP	UNA	Notes, dollar thresholds, and conditions
A. DEAL ORIGINATION AND ACQUISITION					
Approve pursuit of a new development opportunity (initial go/no-go before LOI)		●			*Majority required to authorize formal pursuit, including engagement of due diligence consultants and negotiation time. Align with the annual pipeline approval in the business plan.*
Execute a non-disclosure agreement with a landowner or seller	●				*MP may execute standard NDAs using the company's approved form. Non-standard NDAs or those with unusual indemnification provisions require majority approval.*
Execute a letter of intent to acquire a development site		●			*All LOIs require committee majority regardless of deal size; the LOI is the commitment point where committee visibility is essential. LOIs above $_____ in projected total deal cost require supermajority.*
Approve the purchase price or negotiated acquisition terms		●			*Final purchase price and material deal terms require majority approval. Any material deviation from the underwriting assumptions presented to the committee requires re-approval.*

Decision	MP	MAJ	SUP	UNA	Notes, dollar thresholds, and conditions
Execute a purchase and sale agreement for a development site acquisition			●		*Supermajority required; the PSA is a binding contractual commitment. Attach the approved deal summary and underwriting to the committee meeting record.*
Authorize an earnest money deposit (non-refundable or hard money)			●		*Any hard earnest money deposit requires supermajority approval before the money goes hard. Record the specific non-refundable amount and date in committee minutes.*
Approve assignment of an existing purchase contract to the deal-level entity		●			*Majority sufficient if the deal was already approved; supermajority required if the assignment involves material changes to the originally approved deal terms.*
Reject a deal opportunity after formal pursuit has been authorized		●			*Majority required to formally abandon a deal opportunity that has been authorized; maintains accountability for the go/no-go decision.*
B. CAPITAL STRUCTURE AND FINANCING					
Select the construction lender and approve loan terms for a deal			●		*Supermajority required for any construction financing commitment. Attach the approved loan summary (rate, LTC, draw schedule, recourse terms) to the committee record.*
Authorize a personal guaranty by any founding partner on company or project debt				●	*Unanimous consent always required. No founding partner may be required to provide a personal guaranty without their affirmative consent.*
Approve a bridge loan or mezzanine financing at the deal level			●		*Supermajority required for any mezzanine or bridge financing given its subordinate position and higher cost. Concurrent approval of the source-of-repayment plan required.*
Authorize equity raise terms for a specific deal (promote rate, preferred return, fee structure)			●		*Supermajority required; these terms govern the economic relationship with investors for the life of the deal and must reflect the company's considered judgment.*
Authorize an equity capital call from deal-level investors		●			*Majority required before any capital call notice is issued to investors. The call must be consistent with the approved project budget and the operating agreement's capital call provisions.*
Issue a partner capital call at the management company level			●		*Supermajority required for any capital call on the founding partners. Attach the budget and cash flow analysis supporting the call.*
Authorize a partner loan to the company			●		*Supermajority required; partner loans are related-party transactions and create governance complexity if not properly authorized and documented.*
Refinance an existing project debt facility (permanent loan take-out or refinance)			●		*Supermajority required; refinancing changes the project's capital structure and investment return profile and must be compared to disposition alternatives.*
C. PROJECT DEVELOPMENT AND CONSTRUCTION					
Approve design and schematic plans for a development project		●			*Majority required before design development proceeds; schematic approval defines the project's program, unit mix, and approximate cost envelope.*
Award the general contractor contract (GMP or lump sum) for a project			●		*Supermajority required; GC selection is among the most consequential project decisions. Attach the bid comparison and reference check summary.*
Approve the project budget (total development cost budget)			●		*Supermajority required; the approved budget is the baseline against which all cost control is measured. Any subsequent change to the total budget requires re-approval at the same level.*
Approve change orders below the agreed threshold	●				*MP may approve change orders below the agreed threshold. Fill in threshold: $_____. All change orders must be logged monthly and reviewed by the committee.*
Approve change orders between the agreed thresholds		●			*Majority required for change orders in this range. Fill in thresholds: $_____ to $_____. Present the cumulative change order log with each approval request.*
Approve change orders above the upper threshold			●		*Supermajority required for change orders above the upper threshold. Fill in threshold: $_____. Requires analysis of impact on projected return and lender covenant compliance.*
Authorize contractor termination or replacement during construction			●		*Supermajority required; GC termination is a high-risk decision with significant cost, schedule, and legal consequences. Require an in-person committee meeting if at all possible.*
Approve a construction schedule extension of more than 30 days		●			*Majority required; extensions affect project economics, lender covenants, and investor return projections. Lender notification requirements may also be triggered.*
Authorize early access to a project site before construction financing is in place			●		*Supermajority required; pre-construction site access creates liability exposure before the project's insurance program is fully activated.*
D. DEAL-LEVEL ASSET MANAGEMENT AND DISPOSITION					
Approve the annual operating budget for a stabilized or partially stabilized project		●			*Majority required annually; sets the performance baseline against which asset management decisions are measured throughout the year.*

Decision	MP	MAJ	SUP	UNA	Notes, dollar thresholds, and conditions
Authorize lease-up marketing terms and broker commission structure	●				*MP may authorize standard lease-up marketing terms consistent with the approved project budget. Non-standard commission structures require majority approval.*
Authorize execution of individual lease agreements (residential units)	●				*MP may execute lease agreements consistent with the approved lease form and market rate parameters. Leases with material non-standard terms require majority approval.*
Authorize property management company selection and contract		●			*Majority required; property management affects investor returns and asset performance throughout the hold period.*
Authorize listing a project for sale (initiation of the disposition process)			●		*Supermajority required to authorize the disposition process; once the project is listed, the company is operationally committed to a sale process that is difficult to reverse.*
Approve the sale of a completed project to a third party				●	*Unanimous consent required; asset disposition is the primary value realization event for investors and should reflect the collective judgment of all founding partners.*
Accept a purchase offer and execute a sale PSA for a completed project				●	*Unanimous consent required to execute the sale PSA; this is the binding commitment point for disposition.*
Authorize an extension of a project's hold period beyond the original business plan			●		*Supermajority required; extending the hold period affects investor IRR and must be compared to immediate disposition alternatives. Investor notification obligations may be triggered.*
E. MANAGEMENT COMPANY OPERATIONS					
Approve the annual business plan and operating budget			●		*Supermajority required; the annual business plan is the foundational authorization document for all activities during the coming year. No subsequent action should be taken without reference to the approved plan.*
Authorize expenditures within the approved annual budget below the per-transaction threshold	●				*MP may authorize routine expenditures within the approved budget below this threshold. Fill in threshold: $_____. Examples: office supplies, professional subscriptions, routine vendor invoices.*
Authorize expenditures within the approved annual budget in the mid-range band		●			*Majority required for expenditures in this range within the approved budget. Fill in thresholds: $_____ to $_____. Attach the invoice or contract summary to the committee record.*
Authorize expenditures above the upper threshold or outside the approved annual budget			●		*Supermajority required for any unbudgeted expenditure above the threshold or any expenditure that deviates materially from the approved budget line. Fill in threshold: $_____.*
Authorize the company to enter into any office lease or long-term facility commitment			●		*Supermajority required; long-term facility commitments create fixed obligations that continue regardless of deal volume or revenue.*
Open a new bank account in the management company's name		●			*Majority required; all bank accounts must have properly established dual-authorization controls before they are opened.*
Authorize a wire transfer or ACH above the threshold from the management company account		●			*Majority or two-partner sign-off required above this threshold. Fill in threshold: $_____. For smaller companies, this may mean both founding partners must authorize.*
F. HUMAN CAPITAL AND COMPENSATION					
Hire an employee with total compensation below the lower threshold	●				*MP may hire employees with total annual compensation (salary, expected bonus, and benefits) below this threshold. Fill in threshold: $_____.*
Hire an employee with total compensation in the mid-range band		●			*Majority required for hires in this compensation range. Fill in thresholds: $_____ to $_____. Attach the job description and compensation analysis to the committee record.*
Hire any employee above the upper compensation threshold, or any C-suite hire			●		*Supermajority required for senior hires or any hire above the upper compensation threshold. Fill in threshold: $_____.*
Grant a profits interest or other equity award to any employee				●	*Unanimous consent required; equity grants affect all founding partners' economic interests and governance rights and must reflect collective agreement.*
Adjust founding partner guaranteed payments (increase or decrease)			●		*Supermajority required; adjustments to founding partner compensation are among the most sensitive governance decisions and require broad committee consensus.*
Terminate any employee with total compensation above the threshold		●			*Majority required for termination of any employee above this compensation threshold. Fill in threshold: $_____. Attach documentation supporting the termination rationale.*
Engage any outside contractor or professional services firm above the threshold		●			*Majority required for significant professional services engagements above this threshold. Fill in threshold: $_____. Applies to law firms, CPA firms, consultants, and similar engagements.*
G. INVESTOR RELATIONS AND SECURITIES COMPLIANCE					
Approve the PPM and offering documents for a new investment offering			●		*Supermajority required; the PPM creates securities disclosure obligations and establishes the economic terms for all investors in the offering. Legal counsel review is a prerequisite.*

Decision	MP	MAJ	SUP	UNA	Notes, dollar thresholds, and conditions
Authorize commencement of investor outreach for a specific offering		●			*Majority required before any investor outreach begins for a specific offering; must confirm that the PPM is complete and the offering exemption has been determined.*
Admit a new investor to a deal-level entity (accept a subscription)	●				*MP may accept investor subscriptions consistent with approved investor qualification requirements and offering terms. Non-standard investors or non-standard terms require majority approval.*
Approve material amendments to investor reporting obligations or reporting schedules		●			*Majority required; investor reporting obligations are a fiduciary commitment that should not be unilaterally reduced.*
Make any material disclosure or notification to investors regarding a project or the company		●			*Majority required for all material investor disclosures. The Managing Partner may send routine project updates; notifications of material events or adverse developments require committee review before distribution.*
Authorize legal counsel to respond to an investor complaint or legal threat			●		*Supermajority required; investor legal disputes have securities law dimensions and must reflect the company's collective position.*
H. LEGAL, REGULATORY, AND COMPLIANCE					
Engage new outside legal counsel for any matter		●			*Majority required to engage any new law firm or outside attorney. MP may direct ongoing work to existing approved outside counsel.*
Authorize settlement of any litigation, arbitration, or dispute below the threshold		●			*Majority required for settlements below this threshold. Fill in threshold: $_____. Attach the settlement summary and legal analysis.*
Authorize settlement of any litigation, arbitration, or dispute above the threshold			●		*Supermajority required for settlements above this threshold. Fill in threshold: $_____. Require an in-person or synchronous committee session before any settlement commitment.*
Authorize initiation of litigation or arbitration on behalf of the company			●		*Supermajority required; initiating litigation is a major company commitment with significant cost, reputational, and counterparty relationship implications.*
Approve the company's annual regulatory filings (Form D, ERA Form ADV update, state filings)		●			*Majority required; all regulatory filings should be reviewed and approved by the committee before submission, not delegated entirely to outside counsel.*
Authorize any material change in the company's investment adviser registration status				●	*Unanimous consent required; registration status changes have far-reaching compliance implications for all partners and the company's investor relationships.*
Authorize any response to an SEC, FINRA, or state regulatory inquiry or examination			●		*Supermajority required; regulatory responses must represent the company's collective position and require outside securities counsel involvement.*
I. STRATEGIC DECISIONS AND PARTNERSHIP MATTERS					
Admit a new founding partner or managing member to the company				●	*Unanimous consent always required; the admission of a new founding partner changes every existing partner's economic interest, governance rights, and working relationship.*
Remove a founding partner from their management role (for cause)			●		*Supermajority of disinterested committee members required. The partner whose removal is proposed is not entitled to vote. Cause must meet the operating agreement's specific definition.*
Remove a founding partner from their management role (without cause)			●		*Supermajority of disinterested committee members required. Without-cause removal triggers good leaver economic consequences including an FMV buyout.*
Modify the company's investment criteria or target market			●		*Supermajority required; changes to investment criteria affect the corporate opportunity doctrine framework and may require amendment of investor disclosure documents.*
Approve the company's annual conflicts disclosure process and results		●			*Majority required to review and approve each partner's annual conflicts disclosure. Any disclosed item that raises a governance concern requires further committee action.*
Authorize any related-party transaction above the threshold			●		*Supermajority of disinterested committee members required. The conflicted partner must recuse from the discussion and the vote. Fill in threshold: $_____. See Chapter 13.*
Authorize a co-investment between the management company and an affiliated entity				●	*Unanimous consent required; co-investments with affiliated entities create fiduciary complexity and must be reviewed carefully against the company's conflict-of-interest framework.*
Approve a joint venture with a third-party development or capital partner			●		*Supermajority required; joint venture arrangements create shared governance obligations and economic interdependencies that affect all founding partners.*
Authorize a sale of the company or substantially all of its assets				●	*Unanimous consent required; a company sale is the most fundamental strategic decision a development company can make and must represent the collective decision of all founding partners.*
J. FINANCIAL REPORTING AND TAX					

Decision	MP	MAJ	SUP	UNA	Notes, dollar thresholds, and conditions
Select and engage the company's primary CPA firm		●			*Majority required; the CPA firm relationship is a long-term advisory relationship that affects the company's financial reporting, tax compliance, and investor K-1 delivery quality.*
Approve annual financial statements (management company and deal entities)		●			*Majority required before any financial statements are distributed to investors or lenders. Committee review of financial statements should occur before the audit or review is finalized.*
Approve and authorize distributions to partners or investors		●			*Majority required for all discretionary distributions. Tax distributions in accordance with the operating agreement's mandatory tax distribution provision may be authorized by the Managing Partner.*
Select the company's accounting software and establish accounting controls		●			*Majority required; accounting system and internal control decisions affect the integrity of all financial reporting.*
Approve significant tax elections affecting all partners (Section 754 election, and similar)				●	*Unanimous consent required; partnership tax elections have different economic consequences for different partners and must reflect all partners' informed agreement.*
K. DISSOLUTION AND WIND-DOWN					
Elect voluntary dissolution of the company				●	*Unanimous consent required for voluntary dissolution elected outside of a deadlock context. See Chapters 17 and 18 for deadlock-triggered dissolution thresholds.*
Authorize commencement of the winding-up process				●	*Unanimous consent required before any winding-up activities begin, including investor notification and project disposition planning.*
Authorize sale or transfer of active projects as part of a dissolution wind-down			●		*Supermajority required; during wind-down, the Managing Partner must have authority to act expeditiously on project dispositions, but material below-market dispositions require committee oversight.*
Appoint a successor manager for active investor commitments during dissolution			●		*Supermajority required; the successor manager selection affects all active investors and is one of the most important decisions in an orderly wind-down.*

DAM Completion Record

The founding partners complete this section after reviewing and agreeing on the authority level for each decision row in the matrix above. By signing below, each founding partner confirms that the allocations in the matrix reflect their agreement and authorizes the attachment of this completed matrix to the operating agreement as Exhibit C.

Company Name		**Date of Agreement**	
Operating Agreement Date		**Managing Partner at Adoption**	
Supermajority Percentage Defined (per the operating agreement)		**Annual Review Date (review is due annually)**	

Founding Partner 1	Founding Partner 2	Founding Partner 3
Signature: _____	Signature: _____	Signature: _____
Name: _____	Name: _____	Name: _____
Date: _____	Date: _____	Date: _____

Annual Review Log

The matrix should be reviewed annually as part of the business plan process and updated whenever the company's stage, headcount, or operational scale requires changes to the authority thresholds. Record each review below.

Review date	Reviewed by	Material changes made	Next review date or trigger

End of Appendix D

APP. E

APPENDIX E

Partner Exit Scenarios Table

Complete Reference Guide with Worked Calculations

Every departure trigger a development company partnership may face, from voluntary resignation through death, bankruptcy, and termination for cause, mapped against the six variables that determine a departing partner's economic and governance outcome, with worked calculations showing how each scenario plays out in practice.

A partner departure is rarely a clean event. By the time one occurs, the working relationship has usually been under strain for some time, at least one partner has retained legal counsel, and both sides are looking for any advantage the operating agreement's language might provide. The quality of the exit mechanics provisions, how specifically the operating agreement defines each departure scenario, how clearly it specifies the economic consequences, and how unambiguously it describes the process, determines whether the departure is resolved relatively efficiently or becomes a multi-year litigation.

This appendix serves three functions: it provides the complete exit scenarios reference table that should be adopted as an operating agreement exhibit (or used as the template for one); it explains the substantive rationale for each scenario's treatment in sufficient depth that the founding partners understand what they are agreeing to and why; and it provides worked numerical calculations showing how the exit mechanics actually play out in a specific hypothetical partnership, so the consequences of each scenario are concrete rather than abstract.

Part I: Understanding the Six Exit Variables

Every partner departure is determined by six variables. Each variable must be specified in the operating agreement with enough precision to apply without judicial construction. The six variables are:

Variable	The question	Why precision matters
Departure trigger	What event or decision caused this departure?	The trigger determines which leaver classification applies and initiates the entire exit mechanics process. A vaguely defined trigger (resignation without distinguishing pre-cliff from post-cliff, or termination without distinguishing for cause from without cause) creates ambiguity that is exploited in disputes.
Leaver classification	Is this a good leaver or bad leaver departure?	The leaver classification is the most consequential single determination in the exit mechanics framework. It governs both the treatment of unvested equity and the buyout price for vested equity. The boundary must be defined by specific, objective criteria, not by the management committee's subjective judgment about whether the departure was acceptable.
Unvested equity treatment	What happens to the equity that has not yet vested?	Unvested equity is forfeited in all bad leaver scenarios and in some good leaver scenarios (voluntary resignation before the cliff). The degree of acceleration in good leaver scenarios, from none to full, reflects the circumstances of the departure and the company's obligations to a departing partner.
Vested equity buyout price	At what price does the company purchase the departing partner's vested equity?	Fair market value for good leavers; a below-FMV price (cost, nominal, or zero) for bad leavers. The specific valuation methodology, whether independent appraisal, formula, or agreed multiple, must be specified in advance, not negotiated under the pressure of a specific departure.
Payment timeline	How quickly must the buyout be funded, and in what form?	A lump-sum buyout at FMV may be impossible for an emerging company without significant cash reserves. An installment structure with interest on deferred payments is the standard for companies that cannot fund an immediate buyout. The timeline, the interest rate on deferred payments, and the security for those payments must all be specified.

Variable	The question	Why precision matters
Governance consequences	What management authority and voting rights does the departing partner retain during the transition?	A departing partner who retains full governance authority during a lengthy buyout period creates ongoing management friction. A partner who is stripped of all governance authority immediately may have legitimate concerns about decisions affecting their residual economic interest. The transition governance framework must balance these competing interests.

Part II: The Master Exit Scenarios Reference Table

The following table is designed to be adopted as a standalone exhibit to the operating agreement. The founding partners should review each row, confirm that the agreed treatment matches the terms established in the Partners' Term Sheet (Appendix A), and adapt any row where the company's specific circumstances require a different approach. Each row should be read in conjunction with the substantive analysis in Part III, which explains the rationale for each scenario's treatment.

> **Color coding:** a green leaver classification indicates good leaver treatment; a red leaver classification indicates bad leaver treatment. The shading indicates the general favorability of the economic outcome for the departing partner, not a moral judgment about the departure.

Departure trigger	Leaver class	Unvested equity	Vested buyout price	Payment timeline	Governance after departure	Operational obligations
Voluntary resignation: after cliff, after full vesting	**Good Leaver**	No unvested equity remaining; vesting complete	FMV, valued as of departure date using agreed methodology	Installments over 12 to 24 months; interest at prime on deferred balance; promissory note required	Management authority ends on departure; economic rights retained until buyout complete; limited information rights	60 to 90 day transition; investor handovers; project completion per transition plan
Voluntary resignation: after cliff, before full vesting	**Good Leaver**	Unvested portion forfeited; no acceleration; vested portion proceeds to buyout	FMV for vested portion only	Installments over 12 to 24 months; interest at prime on deferred balance	Management authority ends on resignation; governance rights proportional to vested interest	Same 60 to 90 day transition obligations apply regardless of vesting status
Voluntary resignation: before cliff (pre-cliff)	**Bad Leaver**	100% forfeited; cliff not reached and no equity economically vested	Lower of original cost or nominal value; often zero for forfeited unvested equity	Expedited; within 30 to 60 days; no installment structure required for minimal consideration	All management and governance rights end on resignation; no ongoing access to company information	Transition obligations still apply; breach is a separate operating agreement violation with its own remedies
Retirement: after agreed minimum tenure (for example, seven or more years)	**Good Leaver (enhanced)**	Full acceleration regardless of vesting status; minimum tenure earns full economic credit	FMV with no minority discount; some agreements add a tenure premium	Installments over 18 to 36 months reflecting larger expected amount; interest at prime	Negotiated transition role (consulting or advisory); authority transitions on retirement; investor introductions over 6 to 12 months	Extended transition of 6 to 12 months; active investor handovers; completion of in-progress deal responsibilities
Termination without cause by the management committee	**Good Leaver**	Full acceleration; all unvested equity vests immediately; the removal should not penalize the partner's equity	FMV; company obligated to purchase at FMV; departing partner may demand the buyout	Lump sum if company has liquidity; installments over 12 to 24 months if not; interest at prime	Authority ends immediately on committee vote; economic and limited governance rights during buyout proportional to ownership	Reasonable transition; introduction to successor management; cooperation with handover
Termination for cause (after required process; supermajority of disinterested committee; specific cause met)	**Bad Leaver**	100% forfeited regardless of vesting status	Lower of cost or nominal value; some agreements provide zero where fraud or misappropriation is the cause	Expedited; within 30 to 60 days; company may withhold payment pending resolution of damage claims	All rights end immediately on cause determination; information access restricted to prevent interference	Cooperation with any regulatory or compliance investigation; certification of return of all company property and data
Death of a founding partner	**Good Leaver (always)**	Full acceleration always; estate receives 100% regardless of vesting status; death is never a bad leaver event	FMV; funded by key-person life insurance from the buy-sell agreement	90 to 180 days post-death; insurance claim processing determines practical funding date	Estate has economic rights only; executor has no management authority; surviving partners manage; estate receives same distributions	No operational transition obligations on the estate; surviving partners assume management; successor relationship manager introduced promptly
Permanent disability (after defined period, for example 120 to 180 days, confirmed by independent medical evaluation)	**Good Leaver**	Partial or full acceleration per operating agreement; typically full after extended disability	FMV; either party may elect buyout after disability period confirmed	Installments over 12 to 24 months; interest at prime; 90 to 120 days to close after election	Authority passes to remaining partners on confirmation; voting rights may be suspended or pass to a designated representative	Disabled partner's representative cooperates with transition; investor notification and successor introduction by remaining partners
Bankruptcy of a founding partner	**Bad Leaver (effectively)**	Vesting continues; trustee takes interest subject to operating agreement restrictions; no automatic forfeiture (ipso facto clauses unenforceable)	ROFR at FMV applies; company may petition for relief from stay to purchase at FMV; trustee cannot force above-FMV sale without ROFR compliance	Company ROFR exercise: 60 to 90 days from bankruptcy court approval; installments subject to court approval of terms	Trustee has economic rights to distributions only; governance rights do not transfer; remaining partners retain authority; trustee may have proportional information rights	Company petitions for relief from the automatic stay to exercise ROFR; outside bankruptcy counsel required; operations continue normally
Divorce in community property state: non-member spouse receives interest per decree	**Not a departure per se**	Vesting of the founding partner's interest is unaffected by the decree	Non-member spouse's interest subject to ROFR at FMV; company elects within 60 to 90 days; or	ROFR exercise within 60 to 90 days; installments if needed; interest at prime	Non-member spouse receives economic rights only (assignee); no governance rights; must	Company engages outside community-property and partnership counsel; partner encouraged to structure the

Departure trigger	Leaver class	Unvested equity	Vested buyout price	Payment timeline	Governance after departure	Operational obligations
			partner funds the settlement personally and retains full interest		execute a joinder; remains subject to transfer restrictions	settlement to avoid an actual transfer of the interest
Material breach of non-compete, non-solicitation, or confidentiality post-departure	**Bad Leaver (post-departure enforcement)**	Any equity forfeiture already complete at departure; additional forfeiture may apply to amounts in escrow or pending distribution	Penalty provisions may apply; company may claw back distributions made after departure if breach occurred; disgorgement of profits in violation	Emergency relief sought immediately; arbitration on damages follows; pending installments may be withheld pending resolution	All post-departure rights may be suspended pending resolution; emergency injunctive relief sought in court without prior mediation	Company files for emergency injunctive relief on discovery; restricts system access; sends formal cease-and-desist; engages litigation counsel

Part III: Scenario-by-Scenario Substantive Analysis

The reference table above identifies what happens in each departure scenario. This section explains why each scenario is treated as it is, the substantive rationale the founding partners should understand and agree with before adopting the table as their operating agreement exhibit. Departure mechanics that are agreed without real understanding are departure mechanics that will be challenged when they are applied.

Voluntary Resignation: The Cliff and Its Significance

The cliff date is the single most important threshold in the exit mechanics framework because it determines whether a departing partner has earned any economic participation in the company's value. A partner who departs before the cliff has not yet demonstrated the commitment and contribution that justifies an ongoing economic interest; a partner who departs after the cliff has crossed the threshold that the founding partners agreed would represent a minimum meaningful commitment.

The cliff does not mean that a pre-cliff departure should leave the departing partner with nothing of economic value. If the partner made a capital contribution, that contribution must be returned (subject to the company's ability to fund the return). What the cliff establishes is that no equity value beyond the return of contributed capital is owed to a partner who departs before the minimum commitment period is complete. This reflects the original agreement about what minimum commitment the equity requires.

For post-cliff voluntary resignations, the good leaver treatment (FMV buyout for vested equity, installment payment with interest) reflects the principle that a partner who completes the minimum commitment and then decides to pursue other opportunities has fulfilled their initial obligation. The company should not profit from the departure by paying below-market value for the departing partner's vested equity interest.

Retirement: The Enhanced Good Leaver

The retirement scenario deserves different treatment from ordinary voluntary resignation because it reflects a fundamentally different relationship between the partner and the company. A founding partner who has served for seven or ten years has contributed far more to the company's foundation, culture, and investor relationships than the vesting schedule's cliff-and-time structure can fully capture. The enhanced good leaver treatment (full vesting acceleration, an extended transition period, and potentially a tenure premium on the buyout price) reflects the company's recognition of that long-term contribution.

The minimum tenure threshold for retirement treatment should be set at a level that represents real long-term commitment. A five-year threshold reflects the minimum period needed to build the company's investor relationships and deal track record to a point where the company has institutional value; a seven-year threshold reflects a full development cycle plus continued contribution to the platform's growth. Whatever threshold is agreed, it should be specific and non-

negotiable: a partner who resigns at six years and eleven months is resigning, not retiring, regardless of the circumstances.

Termination Without Cause: The Company's Choice, Not the Partner's Fault

Termination without cause is the most important scenario for understanding why the good leaver and bad leaver distinction is properly a fault analysis rather than a departure-type analysis. A partner who is terminated without cause has done nothing wrong; the remaining partners have simply decided that the partnership relationship is no longer in the company's interest. The economic consequences of that decision must reflect the fact that it was the company's choice, not the departing partner's.

Full acceleration of unvested equity on without-cause termination is the appropriate economic consequence of the company's decision, not a gift to the departing partner. A partner who committed to a four-year vesting schedule and is terminated without cause at year two has not failed to earn their equity; the company has decided to end the relationship before the vesting schedule ran its course. Allowing the company to benefit from that decision by forfeiting the partner's unvested equity would create a powerful incentive for bad-faith without-cause terminations designed to recover equity at below-market cost.

Termination for Cause: Specificity Protects Everyone

The cause termination's bad leaver consequences (100% forfeiture of unvested equity, below-market-value buyout of vested equity) are appropriate when real cause exists. They are deeply unfair and potentially legally vulnerable when applied to a partner whose departure was motivated by interpersonal friction, strategic disagreement, or the majority's desire to recover equity at a discounted price, and where cause was constructed after the fact to justify a predetermined outcome.

This is why the specificity of the cause definition is the most important protective provision in the entire exit mechanics framework. Cause defined as conduct detrimental to the company's interests can mean anything. Cause defined as fraud, theft, conviction of a felony involving moral turpitude, or material and uncured breach of the operating agreement means something specific that either happened or did not. The departing partner can understand what they are alleged to have done; the court can evaluate whether the conduct meets the standard; and the process protects the company against liability for wrongful termination while protecting the partner against a pretextual cause determination.

The required process (written notice specifying the alleged cause, a cure period for remediable breaches, and a supermajority of disinterested committee members making the cause determination) provides the procedural safeguard that makes the substantive bad leaver consequences defensible when they are applied to real cause.

Death: The Non-Negotiable Good Leaver

Death is the only departure scenario where the good leaver classification is mandatory and not subject to any conditions or qualifications. No operating agreement should treat a founding partner's death as a bad leaver event, and any provision that does so is both legally vulnerable and morally indefensible. The deceased partner's estate receives the full economic value of their equity, fully vested, at fair market value, funded by the key-person life insurance that the partners obtained precisely for this purpose.

The operational challenge of a partner's death is not primarily legal or economic; those dimensions are addressed by the operating agreement's provisions and the buy-sell agreement's insurance funding. The operational challenge is the relationship and management continuity that the deceased partner's participation provided. The transition plan requirement from Chapters 16 and 22 is designed to ensure that the company has a documented succession plan for each partner that

can be activated immediately when a departure of any kind occurs, including one that occurs with no warning.

Bankruptcy: Navigating the Bankruptcy Code's Constraints

Partner bankruptcy is the departure scenario that most consistently surprises founding partners who are not familiar with the Bankruptcy Code's constraints on operating agreement enforcement. Two specific provisions of the Bankruptcy Code affect the exit mechanics.

First, the automatic stay prevents the company from exercising any right that would constitute a transfer of the bankrupt partner's interest without bankruptcy court approval. This includes the exercise of the ROFR, a forced buyout, and any other mechanism that would remove the interest from the bankruptcy estate. The company must petition the bankruptcy court for relief from the automatic stay before exercising these rights.

Second, ipso facto clauses, operating agreement provisions that automatically trigger adverse consequences (including forfeiture or expulsion) based solely on the filing of a bankruptcy petition, are not enforceable in bankruptcy. A provision stating that any partner who files for bankruptcy automatically forfeits their membership interest will not be enforced by a bankruptcy court.

What the operating agreement can and should do is specify that a bankruptcy filing triggers the company's ROFR at fair market value; require that the company's attorney file a motion for relief from the automatic stay promptly after the filing; and ensure that the company can demonstrate to the bankruptcy court that exercising the ROFR at FMV is in the best interest of all parties (which it generally is, because the trustee receives fair market value for an otherwise illiquid asset).

Non-Compete Breach: The Post-Departure Enforcement Scenario

The non-compete breach scenario is unique in the exit table because it is not a departure scenario per se; it is a post-departure enforcement scenario where the departing partner's conduct after leaving violates the obligations they accepted in connection with their departure. The exit mechanics for this scenario are primarily procedural rather than economic, because the economic stakes are whatever damages the breach has caused plus whatever equity-forfeiture or claw-back provisions the operating agreement specifies.

The most important aspect of this scenario is the speed of the company's response. A departing partner who begins soliciting the company's investors on the first day of their new venture is causing harm that compounds every day the company does not act. The emergency injunctive relief carve-out from the mandatory arbitration process, which the operating agreement must include to be effective against non-compete and trade secret violations, allows the company to seek a court order stopping the violation immediately, before any arbitration proceeding is initiated or concluded.

Part IV: Worked Calculations

Abstract descriptions of good leaver and bad leaver treatment become concrete when applied to specific numbers. The following calculations use a hypothetical two-partner development company to show exactly how the exit mechanics produce economic outcomes in four representative scenarios.

Hypothetical Partnership Parameters

- Company: DevCo LLC, two founding partners (Partner A: 60%, Partner B: 40%).
- Formation: January 1, Year 1.
- Vesting: four-year total, one-year cliff, monthly vesting after the cliff.

- Initial capital contribution: Partner A: $300,000; Partner B: $200,000.
- Company valuation at the exit scenarios (assumed): $2,000,000 (management company equity value only; excludes deal-level promoted interests).
- FMV methodology: agreed EBITDA multiple (3.5 times trailing twelve-month EBITDA of $571,429 = $2,000,000).
- Buyout payment: installments over 18 months; interest at 6% per annum on the outstanding balance.
- Scenario date: July 1, Year 3 (18 months after the cliff, 30 months into the vesting schedule).
- Vested percentage at July 1, Year 3: cliff vested at 25% (12 of 48 months) plus 18 additional months at 1/48 per month = 25% + 37.5% = 62.5% total vested.

Scenario 1: Partner B Resigns Voluntarily (Post-Cliff, Mid-Vesting), Good Leaver

Item	Calculation	Result
Partner B's total equity ownership	40% of company	**40%**
Vesting percentage as of July 1, Year 3	Cliff (25%) plus 18 post-cliff months at 75%/36 months	**62.5% vested**
Vested equity (of B's total 40%)	62.5% of 40%	**25.0% of company**
Unvested equity (forfeited)	37.5% of 40%	**15.0% of company (forfeited)**
Company FMV at departure	3.5 times EBITDA methodology	**$2,000,000**
FMV of Partner B's vested equity (25% of company)	25.0% of $2,000,000	**$500,000**
Buyout structure: 18 level monthly installments at 6% per annum	$500,000 amortized over 18 months	**approximately $29,116 per month**
Total paid to Partner B (principal plus interest over 18 months)	**Principal $500,000 plus interest of approximately $24,100**	**approximately $524,100**
Forfeited unvested equity (15% of company)	Redistributed to Partner A, increasing A's ownership from 60% to 75%	**15% redistributed to Partner A**

Scenario 2: Partner B Is Terminated for Cause, Bad Leaver

Item	Calculation	Result
Vesting percentage as of July 1, Year 3	Same as Scenario 1	**62.5% vested**
Unvested equity (forfeited)	37.5% of 40%	**15.0% of company (forfeited)**
Vested equity (40% times 62.5%), bad leaver buyout	Bad leaver price: original cost or nominal value	**At cost: $200,000 original contribution**
Effective buyout price for vested equity	Lower of cost or nominal; 62.5% of B's $200,000 invested	**$125,000**
Difference between FMV ($500,000) and bad leaver price ($125,000)	The economic penalty of bad leaver status	**$375,000 forfeited relative to the good leaver outcome**
Total received by Partner B, Scenario 2 versus Scenario 1	**Scenario 1: approximately $524,100; Scenario 2: approximately $125,000**	**Difference of approximately $399,100, the cost of bad leaver classification**
Partner A's benefit	Both the unvested 15% and the difference between FMV and cost for vested equity remain in the company; A's ownership increases from 60% to 75%	**A's effective ownership increases at minimal cost**

The difference of approximately $399,100 between the Scenario 1 and Scenario 2 outcomes is what makes the cause definition so important. A bad leaver determination produces a large economic transfer from the departing partner to the remaining partners. If that determination can be made on a pretextual basis, if cause is defined broadly enough to encompass any disagreement, the majority partner has a roughly $400,000 incentive to manufacture a cause finding rather than use the honest good-leaver framework. Specific cause definitions and required process protections exist precisely to prevent this outcome.

Scenario 3: Partner B Dies, Good Leaver, Full Acceleration

Item	Calculation	Result
Death triggers full vesting acceleration	100% of B's equity vests immediately regardless of schedule	**40% of company fully vested to the estate**
Estate's equity interest	Full 40% ownership; no forfeiture	**40% of company**
Buyout price	FMV of the 40% ownership interest	**$800,000 (40% of $2,000,000)**
Key-person life insurance coverage	Buy-sell agreement provides $800,000 face value (updated annually to match FMV)	**$800,000 insurance proceeds available**
Payment source	Insurance proceeds fund the buyout; no installment payment required; estate receives a lump sum	**Lump sum within 90 to 180 days of death**
Partner A's ownership after buyout	Acquires the estate's 40% interest; owns 100% of company	**100%, at a cost equal to the insurance premium, not the FMV**
Annual insurance premium to fund this scenario	Term life on Partner B's life at $800,000 face; premium based on age and health	**approximately $2,000 to $5,000 per year**

The death scenario illustrates precisely why key-person life insurance is not optional for a development company partnership. Without insurance, Partner A must find $800,000 to buy out the estate at a time when the company has just lost a key partner and may have reduced capacity to borrow or to generate fee income. With insurance, the same $800,000 buyout is funded by premiums that represent a fraction of the coverage. The annual insurance cost of $2,000 to $5,000 is the most cost-effective risk management investment the company can make.

Scenario 4: Partner B Resigns Before the Cliff (Pre-Cliff), Bad Leaver

Item	Calculation	Result
Departure date	Month 8 of Year 1, eight months into the 12-month cliff period	**Pre-cliff**
Vested equity	Zero; the cliff has not been reached	**0% vested**
Unvested equity fate	100% forfeited; all of Partner B's 40% interest reverts	**40% forfeited**
Buyout amount	Return of capital contribution at lower of cost or nominal value; some agreements return cost	**$200,000 (original capital contribution)**
Timing of return	Expedited; within 30 to 60 days of resignation	**$200,000 lump sum**
Economic consequence for Partner B	Lost 40% equity; received only capital back; no equity appreciation	**40% equity, worth $800,000 at the current valuation, is forfeited**
Economic consequence for Partner A	Acquires Partner B's 40% interest for nothing (the company retained the equity); A now owns 100%	**Significant economic gain relative to Scenario 1**
Key planning note	If a pre-cliff departure is anticipated, the company and Partner B both have strong incentives to negotiate an exit that accommodates the cliff's economic significance. Pre-cliff departures that are actually management-initiated (constructive termination) should be treated as without-cause terminations.	**Anti-abuse: if the facts suggest Partner B was pressured to resign before the cliff to deprive them of equity, a court may treat the departure as a without-cause termination with good leaver consequences.**

Part V: Adaptation Guide

The reference table in Part II represents a standard approach to exit mechanics that is appropriate for most two-to-four partner real estate development companies at the emerging stage. The following guidance identifies the provisions most likely to require modification based on specific partnership characteristics.

Provision	Standard approach	When to modify
Cliff period	12 months	Shorten to 6 months if one founding partner has a later start date and the partners want faster equity alignment; extend to 18 months where a longer proving period is appropriate.
Cause definition	Enumerated specific categories (fraud, felony, material uncured breach, willful misconduct, fiduciary breach)	Add or remove categories to reflect the company's specific risk profile. Add securities law violations if securities compliance is particularly critical. Remove categories the founding partners agree are over-broad for their context.

Provision	Standard approach	When to modify
Retirement tenure threshold	7 years of continuous service	Lower to 5 years where the founding partners anticipate a shorter active management period; raise to 10 years for companies with long-term institutional ambitions.
Without-cause acceleration	Full acceleration of all unvested equity	Partial acceleration (for example, 50% of unvested equity) is sometimes negotiated, particularly when the remaining partners are concerned about the dilutive effect of full acceleration on a company with significant unvested equity outstanding.
FMV methodology	EBITDA multiple or independent appraisal	For companies with very limited EBITDA (early stage), a net asset value approach or an agreed formula based on AUM may be more appropriate than an EBITDA multiple that produces volatile results.
Buyout payment timeline	18 to 24 months installments; 6% interest	Extend to 36 months if the company is unlikely to have sufficient liquidity for a shorter payoff; shorten if both partners agree the company has adequate resources and the shorter timeline is more equitable to the departing partner.
Disability definition	120 to 180 days unable to perform material duties; confirmed by independent medical evaluation	Shorten the period if the operational impact of a partner's absence is particularly acute; extend if the company has the organizational depth to absorb a longer absence without triggering the buyout provisions.

Adoption as Operating Agreement Exhibit

The founding partners who sign below adopt this Partner Exit Scenarios Table as a reference exhibit to the operating agreement and confirm that the departure scenarios and economic treatments described here reflect their agreement. Where the operating agreement's text conflicts with this table, the operating agreement text controls; where the operating agreement is ambiguous, this table shall be used as interpretive guidance reflecting the parties' intentions at the time of formation.

Founding Partner 1	Founding Partner 2	Founding Partner 3 (if applicable)
Name: _____	Name: _____	Name: _____
Date: _____	Date: _____	Date: _____

End of Appendix E

APP. F

APPENDIX F

Securities Law Compliance Checklist

For Every Private Capital Raise and Offering Lifecycle Stage

An actionable checklist covering every securities compliance obligation from the pre-offering assessment through ongoing post-closing reporting, organized by lifecycle stage, annotated with legal context, and structured for use by the founding team in coordination with outside securities counsel.

Securities compliance is not a task that is finished when the offering documents are signed. It is a continuous obligation that begins before the first investor conversation and does not end until the last investor has received their final distribution and the offering is wound down. A development company that treats securities compliance as a pre-closing checklist rather than a lifecycle obligation will eventually discover, at the worst possible moment, that the obligations it thought it had satisfied continue to run.

This checklist is organized across five lifecycle stages: pre-offering assessment, offering preparation and documentation, investor qualification and subscription, post-closing regulatory filings, and ongoing investor reporting and compliance. Each item identifies whether the obligation is required in all circumstances, conditional on specific facts, ongoing throughout the offering's life, or optional but strongly recommended. The risk level identifies the consequence of non-compliance. This checklist supplements but does not replace the engagement of qualified securities counsel for each offering.

How to Use This Checklist

Each checklist item identifies the task, the legal context, the deadline, the responsible party, a status classification, and a risk rating. Complete the checklist sequentially for each new offering; revisit the ongoing items quarterly and annually. Items marked high risk require immediate action and should not be deferred without specific legal advice about the consequences of delay.

Code	Status label	Meaning
REQUIRED	Always required	This obligation applies to every Regulation D offering regardless of investor count, deal size, or structure. Non-compliance is a securities violation.
IF APPLICABLE	Conditional	This obligation applies when specific conditions are present, such as Rule 506(c) offerings, offerings to non-accredited investors, or specific state investor locations.
ONGOING	Continuous obligation	This obligation does not expire at closing. It continues throughout the life of the offering and must be monitored and maintained proactively.
OPTIONAL	Best practice	Not legally required in all cases but strongly recommended to reduce exposure to investor claims and regulatory inquiry.

STAGE 1: PRE-OFFERING ASSESSMENT (COMPLETE BEFORE ANY INVESTOR OUTREACH BEGINS)

Every compliance failure that produces an SEC enforcement action or an investor lawsuit can be traced to something that was not done before the first investor conversation. The pre-offering assessment stage is the most important and the most consistently rushed. Allow at minimum three to six weeks for this stage before any investor outreach begins.

☐ **Confirm that the offering constitutes a securities offering under the Howey test** REQUIRED HIGH RISK

Every offering of membership interests to outside investors who will not actively manage the project satisfies the Howey test (investment of money, common enterprise, expectation of profits, derived from the efforts of others). Do not proceed on the assumption that the Howey test is not met without a written legal opinion from securities counsel.

Deadline: Before any investor discussion about a specific offering **Responsible:** Founding Partner and Securities Counsel

☐ **Select the applicable offering exemption: Rule 506(b) or Rule 506(c)** REQUIRED HIGH RISK

This decision must be made before any outreach begins. Rule 506(b): no general solicitation; unlimited accredited investors plus up to 35 sophisticated non-accredited investors; investor representations sufficient. Rule 506(c): general solicitation permitted; accredited investors only; documented verification required for each investor.

Deadline: Before any investor outreach for this specific offering **Responsible:** Securities Counsel and Managing Partner

☐ **Conduct bad actor background checks on all covered persons** REQUIRED HIGH RISK

Covered persons: the issuing entity, each managing member and executive officer, each 20% or greater beneficial owner, and any person compensated for soliciting investors. Run background checks through a qualified provider before the offering begins. Document and retain results. If any potential disqualifying event is found, engage securities counsel before proceeding.

Deadline: Before the offering commences; results documented and retained **Responsible:** Securities Counsel

☐ **Analyze the Investment Company Act exclusion for the deal-level entity** REQUIRED HIGH RISK

Confirm whether Section 3(c)(5)(C) (direct real estate holdings), Section 3(c)(1) (100 investor limit), or Section 3(c)(7) (qualified purchasers) is the applicable exclusion for the deal-level entity. Record the analysis and retain it for future reference. See Chapter 20 and Appendix B.

Deadline: Before the deal-level entity is formed and the offering commences **Responsible:** Securities Counsel

☐ **Analyze investment adviser registration status (ERA, RIA, state registration, or none required)** REQUIRED HIGH RISK

Apply the decision framework from Chapter 20. Determine whether the GP entity is an investment adviser, which registration or exemption applies, and whether the ERA Form ADV filing has been or must be made. Do not proceed without this analysis documented.

Deadline: Before commencement of advisory activities with any investor **Responsible:** Securities Counsel

☐ **Confirm pre-existing relationships with all investors (Rule 506(b) offerings only)** IF APPLICABLE HIGH RISK

Document the specific nature and timing of the pre-existing relationship with each investor who will receive offering information. If any investor was first contacted in connection with this specific offering, do not include them in a Rule 506(b) offering; use Rule 506(c) instead.

Deadline: Rule 506(b) offerings: before the first investor contact about the offering **Responsible:** Managing Partner and Securities Counsel

☐ **Determine the accredited-status verification method for each investor (Rule 506(c) offerings)** IF APPLICABLE HIGH RISK

For Rule 506(c), determine the verification method for each investor's accredited status before any subscription is accepted. Choose among income verification through W-2s or tax returns; net worth verification through financial statements; or written certification from the investor's attorney, CPA, or registered investment adviser.

Deadline: Rule 506(c) offerings: before offering documents are issued to any investor **Responsible:** Securities Counsel and Managing Partner

☐ **Identify all states in which investors are located and research state blue sky notice requirements** REQUIRED MED RISK

Each state where an investor resides has separate notice filing requirements. Some states require filing before any offer is made in that state; most require filing within 15 days of the first sale to an investor in that state. Identify all target investor states before the offering begins.

Deadline: Before the offering commences; state-by-state filing calendar prepared **Responsible:** Securities Counsel

☐ **Assess suitability requirements for any non-accredited sophisticated investors (Rule 506(b) only)** IF APPLICABLE MED RISK

If any non-accredited investor will participate (up to 35 permitted under Rule 506(b)), the company must reasonably believe they are sophisticated. The company must also provide specific disclosure documents including audited financial statements. Strongly consider limiting the offering to accredited investors only to avoid this complexity.

Deadline: Rule 506(b) offerings with non-accredited investors: before offering **Responsible:** Securities Counsel

STAGE 2: OFFERING PREPARATION AND DOCUMENTATION

No investor subscription should be accepted without a counsel-reviewed Private Placement Memorandum having been delivered to the investor in advance. The PPM's preparation is not a boilerplate exercise; every provision must be accurate for this specific offering, this specific company, and these specific principals at the time of the offering.

☐ **Draft, review, and finalize the Private Placement Memorandum (PPM)** REQUIRED HIGH RISK

The PPM must address all required components: cover page and offering summary; executive summary; offering terms; business description and investment strategy; management team biographies; complete track record including underperforming deals; use of proceeds; fee schedule (all fees, all rates, all conditions); risk factors specific to this offering; complete conflict of interest disclosure; investment structure; tax considerations; investor qualifications; and subscription procedures.

Deadline: Before the first investor receives offering information **Responsible:** Securities Counsel and Managing Partner

☐ **Confirm track record disclosure is complete and includes all prior deals, not just successful ones** REQUIRED HIGH RISK

The PPM's track record section must present the management team's complete investment history, including deals that underperformed, failed to achieve projected returns, or resulted in losses. Selectively presenting only successful deals violates the anti-fraud rules' prohibition on material omissions. Each deal should show the investment date, strategy, actual versus projected return, and status.

Deadline: Before the PPM is distributed **Responsible:** Managing Partner and Securities Counsel

☐ **Confirm that all material conflicts of interest are disclosed in the PPM** REQUIRED HIGH RISK

Identify every conflict between the management company's interests and the investors' interests: fee structures that create perverse incentives; related-party transactions; outside business activities; co-investments; competing funds or investment vehicles. Each conflict must be described specifically, not generically.

Deadline: Before the PPM is distributed **Responsible:** Securities Counsel

☐ **Confirm that the fee schedule in the PPM is complete and accurate** REQUIRED HIGH RISK

Every fee that any affiliated entity will earn in connection with the offering must be disclosed: acquisition fees, development management fees, asset management fees, disposition fees, construction management fees, loan origination fees, guaranty fees, and promoted interest. Rates, calculation bases, and payment timing must all be specified. Vague fee descriptions ("customary fees") are inadequate disclosure.

Deadline: Before the PPM is distributed **Responsible:** Securities Counsel and Managing Partner

☐ **Draft and finalize the deal-level LLC operating agreement** REQUIRED HIGH RISK

The operating agreement must address the governance structure (GP authority, LP information rights, major decision approval); economic terms (preferred return, promote waterfall, tax distributions); investor protections (withdrawal rights if any, information rights, anti-dilution); capital call provisions; exit mechanics; and the full distribution waterfall with a worked example.

Deadline: Before any investor subscription is accepted **Responsible:** Securities Counsel

☐ **Draft and finalize the subscription agreement and investor questionnaire** REQUIRED HIGH RISK

The subscription agreement must include investor representations and warranties (accredited investor status, investment experience, financial condition, suitability); acknowledgment of receipt of the PPM; confirmation of the opportunity for independent legal and tax advice; representations regarding no general solicitation; and the mechanics of subscription funding and closing.

Deadline: Before any investor subscription is accepted **Responsible:** Securities Counsel

☐ **Prepare investor accredited-status verification materials (Rule 506(c) offerings only)** IF APPLICABLE HIGH RISK

Identify which verification method each investor will use and prepare the specific document request for each: W-2s and tax returns for income verification; bank, brokerage, and credit report for net worth verification; an attorney, CPA, or RIA certification form for professional certification. Verify that the materials comply with Rule 506(c)'s specific requirements.

Deadline: Rule 506(c) offerings: before the first subscription is accepted **Responsible:** Securities Counsel and Managing Partner

☐ **Confirm the PPM is current and reflects all material facts as of the date of distribution** REQUIRED MED RISK

If the PPM was drafted more than 60 days before it is distributed to investors, review it for material changes. Any change in the management team, the specific project, the fee structure, or the company's legal or regulatory status since the PPM was prepared must be addressed through an amendment or supplement before distribution.

Deadline: Before each subsequent closing in a multiple-closing offering **Responsible:** Securities Counsel and Managing Partner

☐ **Prepare the bad actor disclosure if any disqualifying event occurred before September 23, 2013** IF APPLICABLE MED RISK

If any covered person experienced a disqualifying event before September 23, 2013 (the rule's effective date), that event must be disclosed to investors in the PPM's risk factors section under Rule 506(e), even though it does not disqualify the offering. Prepare the specific disclosure language with securities counsel.

Deadline: If applicable: before PPM distribution **Responsible:** Securities Counsel

STAGE 3: INVESTOR QUALIFICATION AND SUBSCRIPTION PROCESS

The subscription process is where the most common procedural compliance failures occur. Every investor must receive the PPM before they commit; every investor must execute a complete subscription package before funds are accepted; and every investor's accredited status must be assessed through the appropriate process for the offering exemption being used.

☐ **Deliver the PPM to each prospective investor before any subscription commitment is made** REQUIRED HIGH RISK

No investor should commit to an investment or make any subscription payment before receiving the complete PPM. Maintain a written record of the PPM delivery date for each investor: an email with a read receipt, a signed delivery acknowledgment, or a dated confirmation from the investor. This record is your primary defense against a later claim of inadequate disclosure.

Deadline: Before any investor commits or pays **Responsible:** Managing Partner or Investor Relations

☐ **Collect complete, signed subscription documents from each investor before accepting any funds** REQUIRED HIGH RISK

Collect the signed subscription agreement with all representations and warranties completed; the signed investor questionnaire; any verification documents required under Rule 506(c); and an executed counterpart signature page to the operating agreement. Do not accept any funds before the subscription package is complete.

Deadline: Before accepting any subscription funds **Responsible:** Managing Partner or IR, and Securities Counsel

☐ **Verify accredited investor status for each investor (Rule 506(c) offerings)** IF APPLICABLE HIGH RISK

Review and document the accredited investor verification materials provided by each investor. Record the verification method used, the documents reviewed, and the conclusion. Maintain the verification record for each investor for at least three years after the last investment. A verbal assurance of accredited status is not sufficient verification under Rule 506(c).

Deadline: Rule 506(c) offerings: before accepting subscription funds from each investor **Responsible:** Securities Counsel and Managing Partner

☐ **Assess investor representations under Rule 506(b) for any non-accredited sophisticated investors** IF APPLICABLE MED RISK

If any non-accredited investor is participating under the sophisticated investor exception, confirm they have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the investment. Document the specific basis for this determination.

Deadline: Rule 506(b) offerings with non-accredited investors: before each subscription acceptance **Responsible:** Securities Counsel

☐ **Deposit subscription funds into the correct entity bank account immediately upon receipt** REQUIRED HIGH RISK

Subscription funds belong to the deal-level entity, not to the management company. Funds received must be deposited immediately into the deal-level entity's designated investor capital account, not into the management company's operating account. Commingling subscription funds with management company operating funds is both a securities violation and a securities fraud risk factor.

Deadline: On the date subscription funds are received **Responsible:** Managing Partner, CFO, or CPA

☐ **Issue a subscription acceptance confirmation to each investor** OPTIONAL LOW RISK

After reviewing and accepting a subscription, confirm the investor's membership interest, their capital account balance, the anticipated closing date, and any conditions to the closing. This confirmation creates a clear record of the investment terms and the company's acceptance of the investor's subscription.

Deadline: Within 5 business days of subscription acceptance **Responsible:** Managing Partner or Investor Relations

☐ **Provide non-accredited investors with the required disclosure documents (Rule 506(b))** IF APPLICABLE HIGH RISK

If any non-accredited investor participates, provide the same information given to accredited investors; audited financial statements of the issuing entity for the two most recent fiscal years (or the period since inception if shorter); and a brief narrative description of any material facts known to management that would make the audited financial statements materially misleading.

Deadline: Rule 506(b) with non-accredited investors: before accepting subscription **Responsible:** Securities Counsel and CPA

STAGE 4: POST-CLOSING REGULATORY FILINGS

The regulatory filing obligations that arise after the first closing are specific, time-sensitive, and penalized. Missing a filing deadline does not automatically invalidate the exemption, but it is a technical violation that creates legal exposure and that regulators may cite in connection with other enforcement actions. File on time.

☐ **File Form D with the SEC through EDGAR within 15 days of the first sale** REQUIRED MED RISK

Form D must be filed electronically through the SEC's EDGAR system. The filing identifies the issuer; the exemption being relied upon; the amount of the offering; the amount sold; the number of investors; and the contact information for the principal. Form D is a public document. Late filing is a technical violation but does not alone invalidate the exemption.

Deadline: Within 15 calendar days of the date of first sale **Responsible:** Securities Counsel

☐ **File state blue sky notice filings in each investor's state of residence** REQUIRED HIGH RISK

Most states require a notice filing within 15 days of the first sale to a resident of that state. The filing typically consists of submitting a copy of the federal Form D (or the state's own notice form), paying the state filing fee, and complying with any additional state-specific requirements. Track each investor's state of residence and calendar each state's deadline from the date of the first sale to that state's investor.

Deadline: Within 15 days of first sale to an investor in each state (timing varies by state) **Responsible:** Securities Counsel

☐ **File ERA Form ADV Part 1A if relying on the Private Fund Adviser Exemption for the first time** IF APPLICABLE HIGH RISK

If the GP entity is relying on the Private Fund Adviser Exemption for the first time with this offering, file Form ADV Part 1A within 60 days of first reliance on the exemption. If the ERA Form ADV was already filed in connection with a prior offering, update it to include the new fund information in the next annual amendment.

Deadline: Within 60 days of first reliance on the Private Fund Adviser Exemption **Responsible:** Securities Counsel

☐ **File the Form ADV annual updating amendment if a filing has already been made** REQUIRED MED RISK

The ERA's Form ADV must be updated annually within 90 days after the end of the adviser's fiscal year. If the new offering occurred within the annual amendment filing period, include the new fund in the annual amendment rather than filing a separate interim amendment.

Deadline: Within 90 days of fiscal year end (annually) **Responsible:** Securities Counsel

☐ **Complete state investment adviser registration if required** IF APPLICABLE HIGH RISK

If the GP entity's total RAUM is below $100 million and state registration is required, file the required state registration forms through the IARD system and pay all state fees before the adviser begins providing advisory services to investors in that state.

Deadline: Before providing advisory services in states where registration is required **Responsible:** Securities Counsel

☐ **File any required amendments to Form D for material changes to the offering** ONGOING MED RISK

File an amendment to Form D if the offering remains open and a new closing has occurred; if there is a material change to the information in the original Form D filing; or if an annual update is required for an offering that remains open one year after the initial filing. Most Regulation D offerings require an annual amendment if the offering remains open.

Deadline: Annually for open offerings; within 30 days of a material change **Responsible:** Securities Counsel

☐ **Retain all offering documents, investor subscriptions, and compliance records** ONGOING MED RISK

The SEC's books and records rules require registered investment advisers to retain specific records for defined periods. Even for non-RIA exempt reporting advisers, retaining all offering-related documentation for at least six years from the close of the offering is a best practice that provides critical protection in any investor dispute or regulatory inquiry.

Deadline: Throughout the offering's life and for 6 years after the final closing **Responsible:** Managing Partner, CFO, or CPA

STAGE 5: ONGOING INVESTOR REPORTING AND COMPLIANCE

Post-closing investor reporting obligations arise from three distinct sources: the offering documents' representations about reporting frequency and content; the anti-fraud rules' ongoing prohibition on material misstatements and omissions in investor communications; and, for registered investment advisers, the specific reporting obligations of the Advisers Act. All three apply simultaneously throughout the life of the offering.

☐ **Deliver quarterly financial reports and project updates to all investors** ONGOING HIGH RISK

Each quarterly report should address the project's actual financial performance versus the original underwriting for the quarter; construction progress (if applicable) including actual versus projected schedule and budget; lease-up status (if applicable); any material changes in the project's risk profile; and the current projected return versus the original projection. Maintain records of each report's distribution date.

Deadline: Within 45 days of each quarter end **Responsible:** Managing Partner or CFO

☐ **Provide prompt notification of material events to all investors** ONGOING HIGH RISK

A material event is any development that a reasonable investor would consider important in evaluating their investment: construction cost overruns above a defined threshold (typically 10% of total budget); schedule delays exceeding 60 days; lender covenant violations or defaults; management team changes; regulatory actions; and material changes in the projected investment return. Notification should occur within 15 to 30 days of the company becoming aware of the event.

Deadline: Within 15 to 30 days of the company becoming aware of the material event **Responsible:** Managing Partner

☐ **Deliver annual financial statements (reviewed or audited) to all investors** ONGOING HIGH RISK

For individual investor relationships without specific audit requirements, deliver reviewed financial statements prepared by a qualified CPA. For institutional investor relationships, RIA Custody Rule compliance, or specific offering document commitments, deliver audited financial statements prepared by a PCAOB-registered CPA firm. Deliver within 120 days of fiscal year end (or as required by the offering documents).

Deadline: Within 120 days of fiscal year end (or as specified in offering documents) **Responsible:** CPA and Managing Partner

☐ **Deliver Schedule K-1 to each investor by the extended filing deadline (September 15 or applicable state deadline)** ONGOING HIGH RISK

The partnership return (Form 1065) and all K-1s must be filed or extended by March 15. With an extension, the final delivery deadline is September 15. Late K-1 delivery triggers investor complaints, tax filing delays, and potential investor claims for any penalties the investor incurs as a result. Investors should be notified by March 15 whether an extension will be filed and what the expected K-1 delivery date is.

Deadline: By September 15 at the latest (or March 15 if no extension filed) **Responsible:** CPA

☐ **Assess whether the PPM requires amendment or supplementation for subsequent closings** ONGOING HIGH RISK

If a subsequent closing occurs more than 60 days after the initial PPM was distributed, and if any material fact has changed in the interim (management team, project status, market conditions, regulatory environment), prepare a PPM amendment or supplement and deliver it to all investors who subscribed in the prior closing and all prospective investors in the subsequent closing.

Deadline: Before each subsequent closing; assessed 60 days after the prior closing **Responsible:** Securities Counsel and Managing Partner

☐ **Annually assess RAUM against the ERA and RIA registration thresholds** ONGOING HIGH RISK

Calculate total RAUM across all managed investment vehicles as of December 31 of each year. If RAUM approaches $100 million (the state registration threshold) or $110 million (the SEC registration threshold), engage securities counsel to assess whether registration is required before the next annual Form ADV amendment is filed. Do not wait until the threshold is crossed before beginning the registration process.

Deadline: Annually as part of the fiscal year-end process **Responsible:** CPA and Securities Counsel

☐ **Conduct an annual review of all offering documents for accuracy and completeness** ONGOING MED RISK

Each year, review the PPM, operating agreement, and subscription documents for any provisions that no longer accurately reflect the company's operations, fee structure, management team, or regulatory status. Update documents that have become materially inaccurate before they are used in any subsequent investor communication or offering.

Deadline: Annually as part of the annual business plan process **Responsible:** Securities Counsel and Managing Partner

☐ **Conduct an annual investor relationship audit: confirm investor data accuracy and accredited-status currency** ONGOING LOW RISK

Review the investor database for data accuracy and completeness. For Rule 506(c) investors, consider whether the verification conducted at subscription is still current (accredited status can change); if investors will participate in a future offering or capital call, refresh verification if more than two years have passed since the original verification.

Deadline: Annually **Responsible:** Managing Partner or Investor Relations

☐ **Review cybersecurity controls and data protection practices for investor data** ONGOING MED RISK

Assess the company's cybersecurity posture for the investor data it holds, consistent with SEC cybersecurity compliance expectations for exempt reporting advisers and registered investment advisers. Review access controls, data encryption, backup procedures, the incident response plan, and employee cybersecurity training annually. Update the cybersecurity insurance coverage to reflect current AUM and data holdings.

Deadline: Annually **Responsible:** Managing Partner and IT or Cybersecurity Consultant

Quick Reference: Critical Deadlines

The following table summarizes the most time-sensitive securities compliance deadlines. Every item in this table requires a calendared reminder with sufficient lead time for counsel review and preparation.

Obligation	Trigger event	Deadline	Consequence of missing
File Form D with the SEC (EDGAR)	First sale of securities in the offering	15 calendar days after first sale	Technical violation of Rule 503; can be cited in enforcement actions; state regulators may monitor
State blue sky notice filings	First sale to an investor resident in that state	15 days (most states); some require earlier filing	Securities law violation in that state; potential investor rescission rights; state enforcement action
ERA Form ADV Part 1A initial filing	First date of reliance on the Private Fund Adviser Exemption	60 days after first reliance	Unregistered adviser status; SEC enforcement; investor rescission
ERA Form ADV annual amendment	End of the adviser's fiscal year	90 days after fiscal year end	Inaccurate public filing; potential SEC examination finding
Partnership return (Form 1065) and K-1s	End of the partnership fiscal year	March 15; September 15 with extension	$255 per partner per month late filing penalty; investor tax filing delays
Material event investor notification	Company becomes aware of a material adverse event	15 to 30 days (per offering documents)	Anti-fraud violation; investor claims for inadequate disclosure
Annual financial statements to investors	End of fiscal year	120 days after fiscal year end (or as specified)	Breach of reporting obligation; investor relations damage; RIA Custody Rule violation if applicable
PPM delivery to each investor	Before any investor subscription commitment	Before subscription is made	Anti-fraud violation; investor rescission rights; SEC enforcement
Accredited investor verification (Rule 506(c))	Before accepting a subscription from each investor	Before accepting subscription funds	Loss of the Rule 506(c) exemption; offering treated as public; rescission liability
Bad actor background checks	Before each offering commences	Before the offering begins	Potential disqualification from Rule 506 exemptions; SEC enforcement if a disqualified person participates

Checklist Completion Record

Complete this section at the close of each offering's initial compliance review, and retain this record as part of the offering's compliance documentation. This record should be reviewed by securities counsel as part of the annual compliance audit.

Field	Entry	Notes
Offering name / entity		
Applicable exemption		Rule 506(b) or Rule 506(c)
Deal-level ICA exclusion		3(c)(5)(C), 3(c)(1), or 3(c)(7)
Adviser registration status		ERA, RIA, state registered, or none required
Form D filed (date)		
State blue sky filings complete		List states where filings have been completed
Bad actor check complete		Date completed; provider used
PPM distributed (date / method)		
Securities counsel (firm and lead attorney)		
CPA firm (lead contact)		
Annual compliance review date		Calendar the next annual review date here

End of Appendix F

APP. G

APPENDIX G

Regulatory Compliance Calendar

Month-by-Month Filing, Reporting, and Governance Obligations

A month-by-month regulatory compliance calendar covering securities filings, tax obligations, investment adviser reporting, governance requirements, insurance renewals, and employment compliance, with specific deadlines, responsible parties, and penalty consequences for every recurring obligation a real estate development company faces.

A development company's regulatory obligations do not arrive in a convenient single annual bundle. They are distributed unevenly across the calendar, clustered heavily in the first quarter but present in every month of the year, with some triggered by fixed calendar dates and others by variable events whose timing the company controls (a new offering, a construction project placed in service, the first hire). The penalty for missing any of them is rarely trivial; it ranges from modest filing fees to criminal referrals, and the consequences of non-compliance compound when multiple obligations are missed simultaneously.

This calendar consolidates every recurring regulatory obligation a real estate development company faces across six compliance categories into a month-by-month action plan. Use it to build the company's compliance calendar in whatever project management or calendar system the team uses, ensuring that each obligation is assigned to a specific responsible party and that preparation begins far enough in advance that the deadline is never the first moment of awareness. The circle in each calendar entry is a completion checkbox: mark it when the obligation is complete, and retain this calendar as part of the annual compliance record.

Category Legend

Each calendar entry is marked by compliance category. The categories and their significance for a development company:

■	**Securities**	SEC and state securities filings; offering exemption compliance; Form D; blue sky notices; PPM updates and investor disclosure obligations under the Securities Act and Exchange Act anti-fraud rules.
■	**Tax**	Federal and state tax return filings and deadlines; estimated tax payments; K-1 preparation and delivery; FBAR and foreign information reporting where applicable.
■	**Investment Adviser**	Investment Company Act compliance; ERA Form ADV filing and annual update; Investment Advisers Act obligations for ERAs and RIAs; RAUM monitoring and registration threshold assessment.
■	**Governance / Operations**	Annual business plan; management committee governance; operating agreement review; conflict of interest disclosures; Decision Authority Matrix review; partner compensation review.
■	**Insurance**	Annual policy renewals; coverage adequacy review; key-person life insurance updates; Builder's Risk policy management; workers' compensation audit.
■	**Employment / HR**	Payroll tax filings; W-2 and 1099 delivery; employment law training; employee handbook review; I-9 record audit; wage and hour compliance review.

How to Build Your Compliance Calendar from This Appendix

1. Transfer every item into your team's project management system or shared calendar with the specific deadline date for the current year.
2. For each item, set a preparation-start reminder 30 to 60 days before the deadline (60 days for tax filings, 30 days for routine regulatory filings).
3. Assign each item to a specific person with a specific completion deadline. Items with no named responsible party will not be completed.
4. At the start of each quarter, review the upcoming quarter's obligations and confirm that preparation is on track for each item.
5. At year-end, use the completion record at the end of this appendix to confirm every item was completed, document any items that were deferred and the reason, and build next year's calendar.

Part I: Month-by-Month Compliance Calendar

The calendar below covers all calendar-year obligations. Event-driven obligations (Form D within 15 days of first sale; state blue sky filings; ERA Form ADV initial filing) are addressed in the event-triggered table later in this appendix and in Appendix F, and are not repeated here unless they have a recurring annual component.

JANUARY — *7 action items*

Jan 15	■ **Estimated tax payment, Q4 of the prior year** *The fourth quarterly estimated tax payment for the prior tax year is due. Founding partners who have had insufficient withholding throughout the year must make this payment to avoid underpayment penalties. For partners with significant partnership income, the estimated payment may be substantial. Confirm the specific amount required for each partner with the CPA.* **Responsible:** Each founding partner individually **Penalty if late:** Underpayment penalty (generally the federal short-term rate plus 3%)	○
Jan 31	■ **W-2 delivery to all employees** *The company must deliver Form W-2 to all employees who received compensation during the prior calendar year. W-2s must accurately reflect actual wages, withholding, and benefits. Late or inaccurate W-2s create employee relations problems and IRS penalties.* **Responsible:** CPA or payroll provider **Penalty if late:** $60 to $340 per W-2 depending on how late the correction is	○
Jan 31	■ **Form 1099-NEC delivery to independent contractors** *Form 1099-NEC must be delivered to every independent contractor paid $2,000 or more during the prior calendar year (the threshold increased from $600 for tax year 2026). This includes attorneys, CPAs, consultants, and other service providers paid from any company entity. A separate 1099 is required for each entity that made qualifying payments.* **Responsible:** CPA or bookkeeper **Penalty if late:** $60 to $340 per 1099; separate penalties for failure to file with the IRS	○
Jan 31	■ **Form 1099-NEC filing with the IRS** *Forms 1099-NEC must also be filed with the IRS by January 31. The deadline for recipient delivery and IRS filing is the same for NEC forms. Note that 1099-MISC forms (for royalties, rents, and other payments) have a different IRS filing deadline (February 28 for paper, March 31 for electronic).* **Responsible:** CPA or bookkeeper **Penalty if late:** $60 to $340 per form; $680 per form for intentional disregard	○
Jan 31	■ **FUTA annual filing (Form 940) if applicable** *If the company deposited all FUTA taxes when due, Form 940 (Employer's Annual Federal Unemployment Tax Return) is due January 31. If any FUTA taxes remain unpaid, they must be deposited by this date. For most small development companies, the FUTA obligation is modest.* **Responsible:** CPA or payroll provider **Penalty if late:** Failure-to-file penalty: 5% per month up to 25% of unpaid tax	○

Jan to Feb	■ **Begin the K-1 preparation process** *K-1 preparation for each partnership entity requires complete, final, tax-basis financial information. Begin collecting all year-end information from lenders (final loan statements), contractors (final invoices), and property managers in January. The earlier the data collection begins, the more time the CPA has to prepare accurate K-1s before the extension deadline.* **Responsible:** CPA and Managing Partner **Penalty if late:** No direct penalty for the preparation start date; late preparation leads to late K-1 delivery	○
Jan 1 to 31	■ **Begin the annual business plan implementation** *While the business plan should have been approved by December 31 of the prior year, January is the implementation launch: communicating the plan to all team members, setting individual performance objectives tied to the plan's targets, and establishing the Q1 milestones that will be measured at the Q1 governance review.* **Responsible:** Managing Partner and all partners	○

FEBRUARY

5 action items

Feb 15	■ **Review prior-year securities law compliance for each active offering** *Before the annual Form D amendments are prepared (due at the one-year mark for open offerings), conduct a comprehensive review of each active offering's compliance status: investor qualification documents current; bad actor certifications current; state blue sky filings complete for all investor states; PPM current and accurate; and no material changes in the management team or offering terms since the last investor communication.* **Responsible:** Securities Counsel and Managing Partner	○
Feb 28 / Mar 31	■ **Form 1099-MISC IRS filing deadline** *The paper-filing deadline for Form 1099-MISC (rents, royalties, and other payments not covered by 1099-NEC) is February 28. The electronic filing deadline is March 31. Any company paying rent on its office space to a non-corporate landlord must file Form 1099-MISC for those payments.* **Responsible:** CPA **Penalty if late:** $60 to $340 per form	○
Feb 28	■ **Investment Company Act exclusion review for 3(c)(5)(C) entities** *For each deal-level entity relying on the Section 3(c)(5)(C) exclusion, conduct a year-end asset composition review confirming that qualifying assets constitute at least 55% of total assets and that qualifying plus real estate-related assets constitute at least 80% of total assets. If any entity fails the test, engage securities counsel immediately.* **Responsible:** Securities Counsel and CPA **Penalty if late:** Failure to qualify without registering: an Investment Company Act violation	○
Feb 15 to 28	■ **Workers' compensation policy audit preparation** *Workers' compensation insurers conduct annual audits of payroll to reconcile the classification and payroll amounts used to calculate the prior year's premium with actual figures. Prepare the payroll records, employee classification codes, and job description documentation the auditor will need. Inaccurate classification can produce retroactive premium adjustments.* **Responsible:** CPA or HR and the insurance broker	○
By Feb 14	■ **Q4 (prior year) investor reports** *Investor quarterly reports for Q4 of the prior year are due within 45 days of December 31. For a calendar-year company, the Q4 report is due by February 14. These reports should reflect the project's Q4 financial performance, construction progress, budget variance analysis, and updated return projections.* **Responsible:** Managing Partner or CFO	○

MARCH

7 action items

Mar 15	■ **Partnership tax returns (Form 1065): filing deadline or extension** *Form 1065 (U.S. Return of Partnership Income) is due for all LLC entities taxed as partnerships, including the management company, the GP entity, and all deal-level SPEs. If an extension is needed (and it almost always is for companies with multiple entities and investors), file Form 7004 by this date. The extension grants an additional six months, to September 15.* **Responsible:** CPA **Penalty if late:** $255 per partner per month (up to 12 months) for late filing without an extension	○
Mar 15	■ **Schedule K-1 delivery to partners (if no extension is filed)** *If the partnership return is not extended, K-1s must be delivered to each partner and investor by March 15. For a company with multiple entities and investors across several deals, the March 15 non-extended deadline is rarely achievable. File the extension to preserve the September 15 deadline and notify all investors by March 15 that an extension has been filed.* **Responsible:** CPA and Managing Partner or IR **Penalty if late:** No direct penalty for K-1 delivery beyond the partnership return late-filing penalty	○

Mar 15	■ **Form 7004 extension request for all partnership entities** *File Form 7004 for each LLC entity to extend the partnership return filing deadline from March 15 to September 15. The extension is automatic upon timely filing; no reason is required. File a separate Form 7004 for each entity. Confirm with the CPA that extensions have been filed for every partnership entity in the company's structure.* **Responsible:** CPA **Penalty if late:** A late extension request loses the extension benefit; returns are then due March 15	○
Mar 31	■ **Annual ERA Form ADV update (90 days after a December 31 fiscal year end)** *For development companies registered as Exempt Reporting Advisers with a December 31 fiscal year end, the annual updating amendment to Form ADV Part 1A is due by March 31 (90 days after December 31). The amendment must reflect current RAUM, the number of private funds managed, ownership and control information, and disciplinary history for all supervised persons.* **Responsible:** Securities Counsel **Penalty if late:** Failure to timely update Form ADV: an Advisers Act violation; potential SEC examination finding	○
Mar 31	■ **Annual conflicts disclosure process for all founding partners** *Each founding partner completes the annual conflicts disclosure form identifying all business entities in which they hold a 5% or greater interest; all advisory relationships with real estate developers, investors, or lenders; all personal real estate investments made since the prior year's disclosure; and any new contractual restrictions affecting their company obligations. The disclosures are reviewed and approved by the management committee.* **Responsible:** Managing Partner and all partners	○
Mar 31	■ **Investor notification: K-1 extension status and expected delivery date** *By March 31, notify all investors that the partnership return has been extended and provide the expected K-1 delivery date (typically June through August for a well-organized company). Include the tax-year information each investor needs to file for an individual extension if they choose to do so while awaiting the K-1.* **Responsible:** Managing Partner or IR	○
March	■ **Q1 management committee governance meeting** *The Q1 committee meeting reviews Q4 and full-year prior financial performance against the business plan; the status of each active deal; the capital raise pipeline; the compliance calendar for Q2 through Q4; and any items requiring committee approval that have arisen since the last meeting. All minutes are documented and retained.* **Responsible:** All partners and the management committee	○

APRIL — *5 action items*

Apr 15	■ **Individual income tax returns for founding partners** *Founding partners' personal income tax returns (Form 1040) are due. If awaiting K-1s from partnership entities, file for an individual extension (Form 4868) by April 15 to extend the personal return to October 15. The extension is automatic. However, any taxes owed are due by April 15 regardless of whether an extension is filed. Underpayment of taxes due on April 15 accrues interest and penalties from that date.* **Responsible:** Each founding partner and personal tax advisor **Penalty if late:** 5% per month on unpaid taxes for late filing; 0.5% per month for late payment	○
Apr 15	■ **Q1 estimated tax payment for the current year** *The first quarterly estimated tax payment for the current tax year is due April 15. Founding partners receiving guaranteed payments and distributive share income must make quarterly estimated payments to avoid the underpayment penalty. The CPA should prepare each partner's estimated payment schedule at the beginning of the year.* **Responsible:** Each founding partner individually **Penalty if late:** Underpayment penalty (federal short-term rate plus 3%)	○
By Apr 30	■ **Annual financial statement delivery to investors (prior year)** *Reviewed or audited financial statements for each deal-level entity for the prior fiscal year should be delivered to investors within 120 days of the fiscal year end (April 30 for calendar-year entities). Begin distribution in April to ensure timely delivery. For RIAs subject to the Custody Rule, audited statements must be delivered within 120 days of the fund's fiscal year end.* **Responsible:** CPA and Managing Partner **Penalty if late:** RIA Custody Rule violation; breach of investor reporting obligations; investor claims	○
Apr 15 to 30	■ **Annual insurance program review** *Conduct the annual review of all insurance coverages: D&O and management liability; E&O; EPLI; CGL; cyber liability; workers' compensation; key-person life insurance; and Builder's Risk for active projects. Assess coverage limits against current AUM, deal volume, headcount, and any new contractual requirements from institutional investors or lenders. Engage the insurance broker to prepare renewal recommendations.* **Responsible:** Insurance broker and Managing Partner	○
Apr (prep)	■ **Q1 investor reports: begin preparation**	○

	Quarterly investor reports covering Q1 of the current year are due by May 15. Begin preparation in mid-April. The report should cover financial performance for Q1 against plan; construction or lease-up progress; any material developments during Q1; and the updated full-year outlook. **Responsible:** Managing Partner or CFO	

MAY

4 action items

By May 15	■ **Q1 investor reports: final delivery deadline** *Q1 investor reports must be in investors' hands by May 15 (45 days after March 31). Confirm delivery of all reports to all investors in each active offering, and maintain delivery records.* **Responsible:** Managing Partner or IR	○
May	■ **Annual Form D amendments for offerings open one year** *For any Regulation D offering that remains open one year after the initial Form D filing date, an annual amendment must be filed with the SEC. Review the filing history of each active offering and calendar the annual amendment deadline for each. The annual amendment is due on the anniversary of the original filing date.* **Responsible:** Securities Counsel **Penalty if late:** Technical violation of Rule 503; state regulators monitor Form D amendment status	○
May	■ **Key-person life insurance coverage review and update** *Review the face amount of each key-person life insurance policy against the current fair market value of each founding partner's equity interest. If the company's valuation has increased since the policies were issued, the coverage may be inadequate to fund the buy-sell agreement's buyout obligations. Engage the insurance broker to assess whether coverage increases are needed.* **Responsible:** Insurance broker and Managing Partner	○
May to Jun	■ **Begin K-1 finalization (target Q2 delivery)** *For a well-organized company with complete year-end records, K-1 preparation should be substantially complete by late May or early June. Target delivering K-1s to all partners and investors by June 30 to minimize investor relations friction. Confirm with the CPA what additional information is needed to complete the K-1 preparation.* **Responsible:** CPA and Managing Partner **Penalty if late:** No additional penalty beyond the partnership return penalty if an extension was filed; significant investor relations impact from late delivery	○

JUNE

5 action items

Jun 15	■ **Q2 estimated tax payment for the current year** *The second quarterly estimated tax payment for the current year is due June 15. Partners should confirm with their personal tax advisors that the estimated payment is adequate based on year-to-date income. If guaranteed payments have been consistent with the beginning-of-year estimate, the Q2 payment should match the Q1 payment. If income has been materially higher or lower, adjust.* **Responsible:** Each founding partner individually **Penalty if late:** Underpayment penalty	○
By Jun 30	■ **K-1 delivery target: all partners and investors** *The target K-1 delivery date for a well-organized company is June 30. This allows investors more than three months before the October 15 individual return deadline to incorporate their K-1 information. For companies unable to meet the June 30 target, communicate the expected delivery date to all investors no later than June 30.* **Responsible:** CPA and Managing Partner or IR **Penalty if late:** No additional penalty if an extension was filed; investor relations impact escalates with each month of delay past June 30	○
Jun 30	■ **Q2 management committee governance meeting** *The mid-year committee meeting reviews first-half financial performance against the annual business plan; assesses whether the plan's deal volume, capital raise, and revenue targets are on track; identifies any material deviations that require plan amendment; and approves any committee items that have arisen since Q1.* **Responsible:** All partners and the management committee	○
Jun 30	■ **Annual financial statement delivery: final deadline** *April 30 is the target delivery date for annual financial statements; June 30 is the absolute deadline for any company that has experienced delays in the CPA firm's preparation timeline. Any investor who has not received prior-year financial statements by June 30 should receive them by this date, or receive a specific written explanation of the delay and a revised delivery date.* **Responsible:** CPA and Managing Partner **Penalty if late:** Breach of investor reporting obligations; potential investor claims for late delivery	○

Jun 30	■ **Review SEC cybersecurity compliance position** *For ERAs and RIAs with SEC cybersecurity obligations: review the written cybersecurity policies and procedures; confirm that an incident response plan is documented and current; assess whether the cybersecurity insurance coverage is adequate for current AUM and data holdings; review employee cybersecurity training status; and confirm that investor data access controls are current.* **Responsible:** Managing Partner and IT or cybersecurity consultant	○

JULY — *4 action items*

Jul (prep)	■ **Q2 investor reports: begin preparation** *Q2 investor reports covering April through June are due by August 14. Begin preparation in mid-July. Reports should cover financial performance against plan; any material construction, leasing, or market developments in Q2; updated full-year and hold-period projections; and any items of specific concern to investors.* **Responsible:** Managing Partner or CFO	○
July	■ **Mid-year annual business plan assessment** *At the midpoint of the year, conduct an informal assessment of the annual business plan's progress: are the deal origination, capital raise, and revenue targets on track for the full year? Are any adjustments to the plan needed that require committee approval? Begin informal thinking about the following year's plan priorities.* **Responsible:** Managing Partner and all partners	○
Jul to Aug	■ **RAUM assessment: mid-year update** *Calculate the company's current total RAUM across all managed investment vehicles as of June 30. Compare it to the Private Fund Adviser Exemption ceiling ($150 million, above which the ERA exemption is lost and SEC registration is required) and to the state and SEC registration thresholds ($100 million and $110 million respectively). If RAUM is approaching any threshold, engage securities counsel to plan the registration process.* **Responsible:** CPA and Securities Counsel	○
July	■ **Builder's Risk policy reviews for active projects** *For any development project currently in active construction, review the Builder's Risk policy's coverage limits against current construction progress. As the project's completed value increases, confirm the policy limit is adequate. If the project's scope has expanded (additional units, square footage, or amenities) since the policy was originally issued, notify the insurance broker to assess whether the coverage limit needs adjustment.* **Responsible:** Insurance broker and Managing Partner	○

AUGUST — *3 action items*

By Aug 14	■ **Q2 investor reports: final delivery deadline** *Deliver all Q2 investor reports no later than August 14 (45 days after June 30). Confirm delivery to all investors in all active offerings. Maintain delivery records and address any investor questions about Q2 performance promptly.* **Responsible:** Managing Partner or IR	○
Aug 15	■ **Begin annual business plan preparation for the following year** *The most important governance process of the year begins in August. Assemble Q2 and year-to-date financial results; review the prior year's plan against actuals; and develop the preliminary framework for the following year's plan, including deal targets, capital raise goals, headcount plan, and fee revenue projections. Circulate the preliminary framework to all partners for input before the formal drafting process begins in September.* **Responsible:** Managing Partner and all partners	○
August	■ **Anti-harassment and anti-discrimination training (annual requirement)** *Several states (including California, New York, Connecticut, Delaware, and Illinois) require employers to provide annual or biennial anti-harassment training to all employees and supervisors. Confirm the training requirements for each state in which the company has employees, arrange training, and document completion. Even in states without mandatory training, annual training is a best practice that reduces liability exposure.* **Responsible:** HR or Managing Partner **Penalty if late:** State-specific penalties for failure to train; increased liability in harassment claims	○

SEPTEMBER — *5 action items*

Sep 15	■ **Extended partnership tax returns (Form 1065): final filing deadline**	○

	The extended deadline for Form 1065 and all K-1 delivery for entities that filed extensions in March. This is the absolute deadline; no further extension is available for partnerships. Every partnership entity in the company's structure must have its return filed by this date. **Responsible:** CPA **Penalty if late:** $255 per partner per month for late filing; applies even after the extension period expires	
Sep 15	■ **K-1 final delivery deadline: all partners and investors** *K-1s must be delivered to all partners and investors in all entities by September 15. Any K-1 delivered after this date has been delivered beyond the extended deadline. Partners who receive K-1s after September 15 may need to file amended personal returns or may incur underpayment penalties on their own returns.* **Responsible:** CPA and Managing Partner or IR	○
Sep 15	■ **Q3 estimated tax payment for the current year** *The third quarterly estimated tax payment for the current year is due September 15. By this point, partners should have a reasonably clear picture of their full-year income and should ensure that total estimated payments made through Q3 are adequate to avoid the underpayment penalty.* **Responsible:** Each founding partner individually **Penalty if late:** Underpayment penalty	○
Sep 30	■ **Q3 management committee governance meeting** *The Q3 committee meeting is the most strategically important of the year: nine months of performance data is available to assess the year's plan; the following year's plan is in active development; and there is still enough time in the current year to make meaningful operational adjustments. Review Q3 financials, the deal pipeline, capital raise status, and the compliance calendar.* **Responsible:** All partners and the management committee	○
Sep 30	■ **Annual business plan drafting: first complete draft** *The first complete draft of the following year's annual business plan should be circulated by September 30. The draft should address all six required components from Chapter 9: deal pipeline and transaction volume targets; capital structure and capital raise plan; revenue and expense budget; headcount plan; strategic priorities and milestones; and the governance and compliance calendar.* **Responsible:** Managing Partner	○

OCTOBER

4 action items

Oct 15	■ **Individual income tax returns: final extended deadline for founding partners** *Form 1040 individual returns for founding partners who filed extensions in April are due October 15. By this point, all K-1s should have been received and partners can finalize their personal returns. Confirm with personal tax advisors that all partnership income, gains, losses, and credits have been properly incorporated.* **Responsible:** Each founding partner and personal tax advisor **Penalty if late:** 5% per month on unpaid taxes for late filing after October 15	○
Oct (prep)	■ **Q3 investor reports: begin preparation** *Q3 investor reports are due by November 14 (45 days after September 30). Begin preparation in mid-October. Q3 reports are particularly important because they provide investors with a performance update through three quarters and often establish expectations for year-end performance and distributions.* **Responsible:** Managing Partner or CFO	○
October	■ **Annual PPM review for all active offerings** *Review the PPM for each active offering for accuracy: are the management team biographies and track record current? Does the fee schedule reflect current arrangements? Have any material conflicts of interest changed? Is the investment strategy still accurately described? If any material change has occurred, prepare a PPM amendment or supplement for delivery to future investors.* **Responsible:** Securities Counsel and Managing Partner	○
Oct to Nov	■ **Annual review of operating agreement consistency** *Compare the current operating agreement terms against how the company actually operates. Has the management committee composition changed? Have the approval thresholds been consistently applied? Has the compensation framework evolved beyond what the operating agreement addresses? Any material inconsistency should be addressed through a formal amendment before year-end.* **Responsible:** Securities Counsel and all partners	○

NOVEMBER

4 action items

By Nov 14	■ **Q3 investor reports: final delivery deadline** *Q3 investor reports must be delivered to all investors by November 14. Year-to-date financial performance and construction or lease-up status should provide a clear picture of whether the investment's year-end position will be consistent with original projections.* **Responsible:** Managing Partner or IR	○
Nov 30	■ **Annual business plan: final review before December approval** *The final version of the following year's annual business plan must be ready for management committee review by November 30, allowing the full month of December for committee discussion, negotiation of any disputed provisions, and formal adoption by December 31. Attach the following year's compliance calendar to the plan.* **Responsible:** Managing Partner	○
November	■ **Year-end tax planning review** *The November review with the CPA firm should assess estimated full-year taxable income for each entity and each partner; strategies to accelerate or defer income or deductions before December 31; cost segregation study eligibility for any project placed in service during the year; Section 1031 exchange opportunities for any project being marketed for sale; and opportunity zone investment opportunities if applicable.* **Responsible:** CPA and Managing Partner	○
Nov to Dec	■ **Annual employee compensation review** *Review guaranteed payment levels and employee compensation against the approved business plan's budget. Identify any compensation adjustments for the following year that require management committee approval (supermajority for partner compensation adjustments; majority for employee compensation above the threshold). Prepare adjustments for committee approval at the December meeting.* **Responsible:** Managing Partner and all partners	○

DECEMBER

7 action items

Dec 15	■ **Investor communication: Q3 follow-up and year-end preview** *For any active offering where Q3 results were materially different from projections, consider sending an additional investor communication in December previewing the year-end performance and distribution timeline. This proactive communication reduces investor anxiety and reinforces the company's commitment to transparent reporting.* **Responsible:** Managing Partner or IR	○
Dec 31	■ **Annual business plan for the following year: management committee approval** *The final annual business plan for the following year must be formally approved by the management committee by December 31. The approval should be documented in the committee meeting minutes, with each partner's vote recorded. The plan becomes effective January 1 and authorizes the Managing Partner to take all actions within the plan's parameters without additional committee approval.* **Responsible:** Management committee	○
Dec 31	■ **Update and document the RAUM calculation as of December 31** *Calculate total RAUM across all managed investment vehicles as of December 31. Document the calculation methodology and the specific assets included or excluded. This calculation is used in the ERA Form ADV annual amendment due by March 31. If RAUM has crossed or approaches the $100 million or $110 million registration thresholds, or the $150 million Private Fund Adviser Exemption ceiling, notify securities counsel immediately.* **Responsible:** CPA and Securities Counsel	○
Dec 31	■ **Q4 management committee governance meeting: year-end review** *The Q4 meeting reviews full-year performance against the annual business plan; the year-end financial position; distribution planning; and a preview of the upcoming year's key milestones. Approve any year-end decisions (distributions, compensation adjustments, new engagements) that require committee authorization before December 31.* **Responsible:** All partners and the management committee	○
Dec 31	■ **Confirm all annual compliance obligations completed: year-end certification** *Review the compliance calendar against the completion record at the end of this appendix. Identify any item that was not completed during the year and document the reason and remediation plan. Year-end is the last opportunity to complete any outstanding obligations before the next year's obligations begin accumulating.* **Responsible:** Managing Partner and all partners	○
Dec 31	■ **Issue Q4 estimated tax distribution to partners** *For each entity that has generated taxable income during Q4, calculate and distribute the mandatory tax distribution (the pro-rata share of estimated taxes owed on Q4 income allocations, at the agreed tax distribution rate) before December 31 to protect partners from year-end phantom income without a corresponding cash distribution.*	○

	Responsible: CPA and Managing Partner	
Dec 31	■ **Renew insurance policies coming up for annual renewal** *Most commercial insurance policies renew annually. Review the renewal dates for all company policies and ensure that renewals are completed before the expiration date. A gap in coverage, even a one-day lapse, in a D&O or EPLI policy creates a claims-made coverage hole that is extremely difficult to fill retroactively.* **Responsible:** Insurance broker	○

Part II: Event-Triggered Obligations

The calendar above covers recurring annual obligations. The following event-triggered obligations occur whenever a specific event takes place, regardless of the calendar month. These must be calendared individually each time the triggering event occurs.

Triggering event	Obligation and deadline	Responsible party
First sale of securities in a new Regulation D offering	File Form D with the SEC via EDGAR within 15 days of the first sale; also trigger state blue sky notice filings for each investor's state of residence within the applicable state deadline (typically 15 days).	Securities Counsel
First investor located in a new state	File the state blue sky notice within 15 days of the first sale to an investor in that state; pay the state filing fee; check state-specific form requirements.	Securities Counsel
First reliance on the Private Fund Adviser Exemption	File ERA Form ADV Part 1A within 60 days of first reliance. If already filed for a prior fund, update at the next annual amendment to include the new fund.	Securities Counsel
A new offering is a Rule 506(c) offering	Implement and document the accredited investor verification process before any subscription is accepted; retain verification records for at least three years.	Securities Counsel and Managing Partner
Material change in the offering (management team, fee structure, project)	Amend the PPM before the change is communicated to investors; deliver the amendment to all investors who have subscribed or are in active subscription discussions.	Securities Counsel and Managing Partner
RAUM crosses the $100 million threshold	Assess whether state investment adviser registration is required; engage securities counsel to evaluate registration obligations; do not cross the threshold without a compliance plan in place.	Securities Counsel and CPA
RAUM crosses the $110 million threshold	Begin the SEC registration process (Form ADV, compliance program, CCO designation). Register before RAUM exceeds $110 million and maintain registration as a full RIA.	Securities Counsel
New employee hired	Complete Form I-9 within 3 business days of the start date; add to payroll; enroll in benefits; deliver the employee handbook and obtain a signed acknowledgment; add to workers' compensation coverage.	HR or Managing Partner
Employee terminated	Final paycheck timing per state law; COBRA notice within 14 days; I-9 retention (3 years from hire or 1 year from termination, whichever is later); update benefits terminations.	HR or Managing Partner
New construction project commences	Bind the Builder's Risk policy before construction begins; confirm the GC's insurance certificates name the project entity and lender as additional insureds; establish project-level bank accounts; begin 3(c)(5)(C) asset composition monitoring.	Insurance broker, Managing Partner, and CPA
Construction project placed in service (certificate of occupancy)	Commission a cost segregation study immediately; assess 100% bonus depreciation eligibility for qualifying components; file any required state or local tax filings related to the project's completion.	CPA
New profits interest or equity grant to an employee or partner	Prepare and deliver the Section 83(b) election notice; ensure the recipient files the election within 30 days of the grant date; retain the signed acknowledgment and a copy of the filed election.	Tax advisor and counsel
A 3(c)(1) entity reaches 100 investors	Stop admitting additional investors immediately; analyze whether 3(c)(5)(C) is available as an alternative; if not, assess registration as an investment company or restructuring the offering.	Securities Counsel
Material cyber incident or data breach	Notify counsel and the compliance team immediately; activate the incident response plan; prepare investor notification if investor data is involved; assess SEC disclosure obligations for ERAs and RIAs.	Managing Partner and cybersecurity counsel

Part III: Annual Compliance Completion Record

Complete the following record at year-end to confirm that all required compliance obligations were satisfied during the year. Retain this record as part of the company's permanent compliance documentation. This record is also the starting point for the following year's compliance planning: any item left incomplete requires a remediation plan before the end of the year.

Month	Obligation	Completed (date)	Notes / deferral reason
Jan	W-2 and 1099 delivery to employees and contractors		

Month	Obligation	Completed (date)	Notes / deferral reason
Jan	W-2 and 1099 filing with the IRS or SSA		
Jan	Q4 estimated tax payment (prior year)		
Feb	Investment Company Act exclusion review (3(c)(5)(C) entities)		
Feb	Workers' compensation audit preparation		
Mar	Form 7004 extension filed for all partnership entities		
Mar	ERA Form ADV annual amendment filed		
Mar	Annual conflicts disclosure for all founding partners		
Mar	K-1 extension notification to all investors		
Apr	Personal income tax returns or extensions filed		
Apr	Q1 estimated tax payment		
Apr	Annual financial statements delivered to investors		
Apr	Annual insurance program review completed		
May to Jun	K-1 delivery to all partners and investors (target June 30)		
Jun	SEC cybersecurity compliance position reviewed		
Jun 15	Q2 estimated tax payment		
Aug	Anti-harassment training completed for all employees		
Sep 15	All partnership returns filed (extended deadline)		
Sep 15	All K-1s delivered (absolute extended deadline)		
Sep 15	Q3 estimated tax payment		
Oct 15	Founding partners' individual returns filed		
Oct to Nov	Annual PPM review and update for active offerings		
Oct to Nov	Operating agreement consistency review		
Dec 31	Annual business plan approved by management committee		
Dec 31	RAUM calculation documented as of December 31		
Dec 31	Q4 tax distributions issued to partners		
Dec 31	All insurance policies renewed (no coverage gaps)		
Dec 31	Year-end compliance certification completed		

End of Appendix G

APP. H

APPENDIX H

Formation Documents Checklist

Every Document Required from Phase 1 Through the First Investor Closing

A complete, phase-by-phase checklist of every document a real estate development company must prepare, negotiate, and execute during the formation process, organized by phase, with the responsible party and the specific triggering condition that determines when each document must be complete.

> *The formation of a real estate development company requires substantially more documentation than most founding teams anticipate. The operating agreement and the entity formation filings are only the most visible pieces. Beneath them sits a full document set that spans five phases of the formation process, running from the partner alignment documents of Phase 1 through the offering documents and regulatory filings of Phase 5.*
>
> *Any component left out of the formation document set leaves a gap that has to be filled later, usually under the pressure of an actual event such as a partner departure, an investor dispute, or a regulatory inquiry. A document drafted reactively in that moment is almost always weaker than one drafted deliberately beforehand. This checklist exists so that the founding team can confirm nothing has been left behind.*

How to Use This Checklist

Each item below gives the document name, the context that explains why the document matters and what happens in its absence, the timing trigger that fixes when it must be complete, and the party primarily responsible for it. Work through the items in order within each phase. Do not begin the legal drafting of Phase 3 until the alignment documents of Phase 1 are complete.

Items marked CRITICAL carry an absolute or near absolute consequence if the deadline passes. The consequence may be a statutory filing deadline, a tax election window that cannot be reopened, or a legal exposure that attaches the moment the document is missing. Items marked REQUIRED are necessary for a complete and properly documented formation, but missing a particular date does not carry the same immediate consequence.

Phase Color	Phase	What the Phase Covers
■ **Phase 1 (Navy)**	**Partner Alignment**	Non-binding alignment documents produced through the partner conversations: Term Sheet, Contribution Matrix, preliminary budget, investment criteria
■ **Phase 2 (Green)**	**Advisory Team & Pre-Formation Analysis**	Engagement letters, and legal analysis memos that confirm the regulatory framework before entity formation
■ **Phase 3 (Amber)**	**Entity Formation & Legal Docs**	All binding formation documents: Articles of Organization, operating agreements, equity grants, 83(b) elections, exhibits
■ **Phase 4 (Blue)**	**Regulatory & Operational Infrastructure**	Tax registrations, adviser filings, insurance policies, banking, accounting system

Phase Color	Phase	What the Phase Covers
■ **Phase 5 (Purple)**	**First Offering Documents**	Deal-level entity, PPM, subscription documents, regulatory filings for the first investor offering

PHASE 1 · PARTNER ALIGNMENT DOCUMENTS

Phase 1 documents come out of the partner alignment conversations covered in Chapters 1 and 22. None of them is legally binding, yet they form the foundation for every binding document that follows, and their quality sets the ceiling on the quality of the Phase 3 legal documents. No attorney should be retained to start drafting until Phase 1 is substantially complete.

☐	**Partners' Term Sheet: Completed and Signed by All Founding Partners.** *The non-binding written record of the founding partners' agreed terms on every material issue: entity structure, equity allocation and basis, vesting schedule and cliff, good leaver and bad leaver framework, compensation levels and payment triggers, governance structure, promoted interest allocation methodology, restrictive covenant scope, valuation methodology for buyouts, and dispute resolution mechanism. See Appendix A for the complete template and the completion guide. This is the primary instruction document for legal counsel in Phase 3, and counsel should not begin drafting the operating agreement without it.* **When:** Before any legal counsel is retained for entity drafting, at the completion of Phase 1 • **Owner:** All Founding Partners	**PHASE 1**	**CRITICAL**
☐	**Contribution Matrix: Completed, Scored, and Documented with Rationale.** *The completed nine-category contribution assessment from Appendix C, including each partner's scores across all categories, the agreed category weights that reflect the company's priorities at this stage, the synthesis worksheet showing implied equity percentages, and the final agreed allocation with documented rationale for any adjustment away from the implied percentages. Signed by all founding partners as the documented basis for the equity grant agreements in Phase 3.* **When:** Before the Partners' Term Sheet is finalized, and before equity percentages are agreed • **Owner:** All Founding Partners	**PHASE 1**	**CRITICAL**
☐	**24-Month Operating Budget: Base Case and Downside Scenario.** *A preliminary two-year operating budget covering the management company's expected revenues and expenses: guaranteed payment obligations to founding partners, professional service retainers (legal, CPA, insurance), office and infrastructure costs, anticipated deal origination expenses, and pre-deal-closing overhead. Prepare both a base case (on-target deal volume) and a downside scenario (no deals in Year 1). The downside scenario sets the minimum capitalization the company needs to survive an adverse first year.*	**PHASE 1**	**CRITICAL**

	When: Before initial capital contribution amounts are agreed in the Term Sheet, and before Phase 2 advisory team engagement • **Owner:** Managing Partner and CPA		
☐	**Investment Criteria Statement: Written and Agreed by All Partners.** *A written statement of the company's target asset class, geographic market, deal size range, and development strategy, specific enough to serve as the corporate opportunity definition in the operating agreement. A statement that is too broad, such as 'all real estate in Texas,' restricts the partners more than they intend; one that is too narrow, such as 'ground-up multifamily in the Dallas central business district,' may fail to capture the company's actual pipeline. This statement also appears in the offering documents as the investment strategy description.* **When:** Before Phase 2 advisory team engagement, and before the corporate opportunity doctrine is drafted into the operating agreement • **Owner:** All Founding Partners	**PHASE 1**	**REQUIRED**

PHASE 2 · ADVISORY TEAM ENGAGEMENT AND PRE-FORMATION ANALYSIS

Phase 2 formalizes the company's relationships with its primary professional advisors and produces the analytical groundwork that shapes the legal architecture of Phase 3. The Phase 2 analysis, and in particular the Investment Company Act exclusion analysis and the investment adviser registration analysis, must be documented in writing before the company accepts its first investor capital or takes its first investor relations action.

☐	**Legal Counsel Engagement Letter: Signed.** *A signed engagement letter with securities and corporate counsel establishing the scope of the representation, the fee arrangement, the billing and payment terms, and the specific deliverables for the formation engagement. Counsel should be experienced specifically in real estate development company formation, not a general business attorney and not a real estate transactional attorney whose practice focuses on closings rather than on entity governance and securities compliance.* **When:** Before any operating agreement drafting begins • **Owner:** Managing Partner	**PHASE 2**	**REQUIRED**
☐	**CPA Firm Engagement Letter: Signed.** *A signed engagement letter with the real estate CPA firm covering the scope of accounting and tax services (entity setup and chart of accounts, ongoing bookkeeping, K-1 preparation, cost segregation coordination, tax planning advisory), the fee arrangement, and the first-year service timeline. Engage the CPA before the operating agreement is finalized so they can review and coordinate on the tax and capital account provisions.* **When:** Before the operating agreement is finalized in Phase 3 • **Owner:** Managing Partner	**PHASE 2**	**REQUIRED**

☐	**Insurance Broker Engagement: Insurance Program Design Initiated.** *A written engagement with a commercial insurance broker to design the management company's initial insurance program covering all required lines: D&O and management liability, EPLI, CGL, cyber liability, workers' compensation, key-person life insurance, and project-level builder's risk for future projects. The broker should begin the design process in Phase 2 so that policies are ready to bind in Phase 4 without delaying entity formation or operations.* **When:** During Phase 2, with design complete and quotes received before Phase 4 activation • **Owner:** Managing Partner	PHASE 2	REQUIRED
☐	**Investment Company Act Exclusion Analysis: Written Memo from Securities Counsel.** *A written analysis from securities counsel determining the applicable Investment Company Act exclusion for the deal-level entities: Section 3(c)(5)(C) for entities primarily engaged in acquiring qualifying real estate assets, which is the correct exclusion for most real estate sponsors; Section 3(c)(1) for entities with 100 or fewer beneficial owners; or Section 3(c)(7) for entities whose investors are all qualified purchasers. The memo should document the applicable exclusion, the structural requirements for maintaining it, and the ongoing asset composition monitoring obligations. See Chapter 20 and Appendix B.* **When:** Before the deal-level entity structure is finalized in Phase 3, and before any investor capital is accepted • **Owner:** Securities Counsel	PHASE 2	CRITICAL
☐	**Investment Adviser Registration Analysis: Written Memo from Securities Counsel.** *A written analysis from securities counsel applying the six-step decision framework from Chapter 20 to determine whether the GP entity meets the definition of an investment adviser, which registration status or exemption applies (Exempt Reporting Adviser, state registration, or no registration required), and what ongoing compliance obligations attach to the applicable status. Document this analysis before the first investor capital is accepted and before any investor relations activity that could constitute 'advising' under the Advisers Act.* **When:** Before any investor capital is accepted, and before investor relations activity begins • **Owner:** Securities Counsel	PHASE 2	CRITICAL
☐	**State Blue Sky Requirements Research: Summary Prepared by Counsel.** *A state-by-state summary of blue sky notice filing requirements for the target investor states, including the specific triggering event (first offer versus first sale), the required filing form (federal Form D or a state-specific form), the deadline measured from the triggering event, and the filing fee. Used to build the post-closing compliance calendar for the first offering so that no investor state's deadline is missed.*	PHASE 2	REQUIRED

	When: Before the first offering's investor outreach begins, ideally completed in Phase 2 so the calendar is ready for Phase 5 • **Owner:** Securities Counsel		

PHASE 3 · ENTITY FORMATION AND LEGAL DOCUMENTATION

Phase 3 produces the legally binding documents that establish the company and govern the relationship of the founding partners with each other and with the entities they create. Every document in this section is required, and several carry critical timing consequences. The 30-day deadline for the Section 83(b) election is the timing failure that founding teams miss most often, and it is permanent once the window closes.

☐	**Operating Company, Articles of Organization: Filed.** *Filed with the secretary of state in the state of formation. This creates the legal entity and must include the company name, registered agent, and any state-required provisions. The filing date establishes the entity's formation date, which is the reference point for the equity grant date and the 30-day Section 83(b) election window.* **When:** Before any business is conducted in the company's name, and before any capital is contributed • **Owner:** Counsel	PHASE 3	CRITICAL
☐	**Operating Company, Registered Agent Appointment.** *Appointment of a registered agent in the state of formation and in any state where the company will be foreign-qualified. The registered agent receives service of process on the company's behalf. A gap in registered agent coverage can cause the company to miss notice of legal proceedings, which creates default judgment risk.* **When:** Concurrent with the Articles of Organization filing • **Owner:** Counsel	PHASE 3	REQUIRED
☐	**Operating Company, Federal Employer Identification Number (EIN): Obtained.** *Obtained from the IRS through Form SS-4 (online or by fax). Required for banking, payroll, tax filings, and investor K-1 preparation. Obtain it within 24 hours of entity formation, since no filing can be made and no bank account can be opened without the EIN.* **When:** Immediately after entity formation, and before any bank account is opened • **Owner:** Counsel or CPA	PHASE 3	CRITICAL
☐	**Operating Company, Operating Agreement: Fully Negotiated and Executed by All Partners.** *The primary governing document of the founding partners' relationship. It must address all eleven provisions identified in Chapter 4: (1) defined terms; (2) capital contributions and capital accounts; (3) profit, loss, and distribution allocations, including the mandatory tax distribution provision; (4) management structure and authority; (5) transfer restrictions and ROFR; (6) member departure mechanics for all scenarios; (7) vesting schedules with cliff and acceleration; (8) fiduciary duties, corporate opportunity, and*	PHASE 3	CRITICAL

	related-party transaction policy; (9) information rights and reporting; (10) dispute resolution and deadlock; and (11) dissolution procedures. The Decision Authority Matrix (Appendix D) must be completed and attached as Exhibit C. The Partner Exit Scenarios Table (Appendix E) must be adopted as a reference exhibit. No founding partner should sign without having read the document in full. **When:** Before any company operations begin, and before any capital is contributed by any partner • **Owner:** Counsel and All Partners		
☐	**GP Entity, Articles of Organization: Filed.** *Filed with the secretary of state for the separate GP and carry entity that will hold the promoted interest in each deal. This entity must be formed before it can serve as the managing member of any deal-level LLC or execute any development management agreement.* **When:** Concurrent with or immediately after operating company formation, and before the GP entity acts as managing member of any deal entity • **Owner:** Counsel	**PHASE 3**	**CRITICAL**
☐	**GP Entity, Federal Employer Identification Number (EIN): Obtained.** *A separate EIN for the GP entity. Required for the GP entity's annual partnership tax return (Form 1065), K-1 preparation to the founding partners on their carry distributions, and any banking the entity conducts.* **When:** Immediately after GP entity formation • **Owner:** Counsel or CPA	**PHASE 3**	**REQUIRED**
☐	**GP Entity, Operating Agreement: Executed.** *Governs the GP entity's internal affairs and, most importantly, the allocation of promoted and carried interest among the founding partners. It must specify (1) the carry allocation percentage for each partner, expressed as a percentage of total carry received; (2) whether the allocation is uniform across all deals or role-based, so that the deal-sourcing partner receives a higher share on deals they originated; (3) the consequences of partner departure for carry participation across deals closed before, in negotiation at, and after departure; and (4) the allocation of any clawback obligation among the founding partners. This is the most commonly omitted document in development company formations. By the time the first carried interest distribution arrives, it is too late to agree on what was discussed only verbally at formation.* **When:** Before the GP entity enters its first deal management or managing member role, and before the first investor closes into any deal entity • **Owner:** Counsel and All Partners	**PHASE 3**	**CRITICAL**
☐	**Equity Grant Agreements: Executed with Each Founding Partner.** *Individual written agreements confirming each founding partner's specific membership interest in the operating company, the vesting schedule applicable to that interest, the consideration for the grant*	**PHASE 3**	**CRITICAL**

	(services to be rendered), the good leaver and bad leaver treatment upon departure, and the acknowledgment that the partner has been advised of the Section 83(b) election process and the 30-day filing deadline. One agreement per founding partner. **When:** Simultaneously with or immediately following operating agreement execution; the equity grant date starts the 83(b) election clock • **Owner:** Counsel		
☐	**Section 83(b) Elections: Filed with the IRS by Each Partner, Absolute 30-Day Deadline.** *Each founding partner whose equity is subject to a vesting schedule must file a Section 83(b) election with the IRS within 30 days of the equity grant date. The election may be made on IRS Form 15620, the standardized form the IRS released in 2024, which can be filed electronically through the taxpayer's IRS online account or downloaded and mailed; a partner may also file a compliant written statement by mail. When the election is mailed, send it by certified mail and keep the certified mail receipt as proof of timely filing. A copy goes to the company, and the taxpayer keeps a copy. The 30-day deadline is absolute and cannot be extended for any reason. A partner who misses the window recognizes ordinary income at each vesting date equal to the fair market value of the interest on that date, which can be a substantial tax liability if the company has grown in value. No corrective filing is available once the 30-day window closes.* **When:** Within 30 calendar days of the equity grant date. No exceptions. No extensions. Calendar this deadline the moment the equity grant agreements are executed. • **Owner:** Each Founding Partner individually, with the Tax Advisor	**PHASE 3**	**CRITICAL**
☐	**Spousal Consent Agreements: Executed by Each Married Partner's Spouse.** *Executed by the spouse of each founding partner who resides in a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin). The consent acknowledges the operating agreement's transfer restrictions and confirms that any community property interest in the membership interest is subject to those restrictions. Without it, a spouse can argue that the operating agreement's buyout and transfer provisions do not bind their community property interest.* **When:** Simultaneously with operating agreement execution, before the operating agreement is treated as fully effective • **Owner:** Counsel	**PHASE 3**	**CRITICAL**
☐	**Decision Authority Matrix (Appendix D): Completed with All Thresholds and Executed as Operating Agreement Exhibit C.** *The complete DAM with all dollar thresholds filled in, all authority levels agreed, and all special conditions noted in the Notes column. Reviewed and approved at the same time as the operating agreement, signed by all founding partners, and attached as Exhibit C. A DAM without specific dollar thresholds provides the form of governance without the substance.*	**PHASE 3**	**CRITICAL**

	When: Before the operating agreement is signed, attached as an exhibit at execution • **Owner:** Counsel and All Partners		
☐	**Partner Exit Scenarios Table (Appendix E): Adopted as Operating Agreement Exhibit.** *The completed Partner Exit Scenarios Table, signed by all founding partners and attached as a reference exhibit to the operating agreement. It identifies the agreed economic treatment for every departure scenario, including voluntary resignation (pre-cliff and post-cliff), termination for cause and without cause, retirement, death, permanent disability, bankruptcy, divorce, and a non-compete breach after departure.* **When:** Before the operating agreement is signed, attached as an exhibit at execution • **Owner:** Counsel and All Partners	PHASE 3	REQUIRED
☐	**Foreign Qualification Filings: Each State Where the Company Will Operate.** *A company formed in Delaware or another state must foreign-qualify in each state where it maintains a principal place of business or conducts regular operations. This requires filing a Certificate of Authority (or its equivalent) with the secretary of state of the operating state and paying the applicable filing fee. Failure to foreign-qualify can prevent the entity from enforcing contracts in that state.* **When:** Before conducting business in any state other than the formation state • **Owner:** Counsel	PHASE 3	REQUIRED
☐	**Buy-Sell Agreement Funded by Key-Person Life Insurance: Executed and Funded.** *A standalone agreement, or an operating agreement provision, specifying that upon a founding partner's death the surviving partners have the right and the obligation to purchase the deceased partner's membership interest at the agreed valuation, funded by the proceeds of a key-person life insurance policy. The agreement and the insurance policy must be coordinated so that the policy proceeds are directed to fund the buyout mechanics.* **When:** Concurrent with key-person life insurance policy activation in Phase 4, in place before operations begin • **Owner:** Counsel and Insurance Broker	PHASE 3	CRITICAL

PHASE 4 · REGULATORY AND OPERATIONAL INFRASTRUCTURE

Phase 4 documents establish the company's operational infrastructure and satisfy its initial regulatory filing obligations. Several items in this phase carry specific statutory deadlines. The insurance policies must be bound before operations begin, because a single day's gap in D&O or EPLI coverage on a claims-made policy creates a coverage hole that is nearly impossible to fill after the fact.

☐	**State Income and Franchise Tax Registration: Each Operating State.** *Registration with the state tax authority in each state where the company has nexus for income or franchise tax purposes. In*	PHASE 4	REQUIRED

	Texas, this is the franchise tax registration; the Texas franchise tax is revenue-based, at 0.375% for entities primarily engaged in retail or wholesale trade and 0.75% for other entities. In California, it is the $800 minimum annual LLC franchise tax. Other states apply as relevant. Registration is required before the company files its first state tax return in that state. **When:** During Phase 4, before the first state tax return is due in each operating state • **Owner:** CPA		
☐	**Federal and State Payroll Tax Registration.** *Federal: register for EFTPS (the Electronic Federal Tax Payment System) for payroll tax deposits using the company's FEIN. State: register for state income tax withholding and state unemployment insurance in each state where the company has employees. Required before the first guaranteed payment or salary payment is made to any employee or partner.* **When:** Before the first payroll payment to any employee or founding partner receiving guaranteed payments • **Owner:** CPA or Payroll Provider	**PHASE 4**	**CRITICAL**
☐	**ERA Form ADV Part 1A: Initial Filing with the SEC (if applicable).** *If the GP entity qualifies as an Exempt Reporting Adviser under the Private Fund Adviser Exemption, meaning it advises only 3(c)(1) or 3(c)(7) private funds and has total regulatory assets under management in the United States below $150 million, file Form ADV Part 1A with the SEC through the IARD system. The filing is due within 60 days of first relying on the exemption. If the deal vehicles rely exclusively on Section 3(c)(5)(C), confirm with securities counsel whether the ERA exemption is available, since a 3(c)(5)(C) vehicle is not a private fund for this purpose, or whether a different position is required.* **When:** Within 60 days of first reliance on the Private Fund Adviser Exemption; before that date the ERA status is not formally established • **Owner:** Securities Counsel	**PHASE 4**	**CRITICAL**
☐	**State Investment Adviser Registration: If Required.** *If the investment adviser analysis from Phase 2 concludes that state registration is required, which is typical for investment advisers with regulatory assets under management below $100 million, file through the IARD system with the applicable state securities regulator or regulators. Registration must be complete before the company begins providing advisory services to investors in that state.* **When:** Before providing advisory services to any investor in a state that requires registration • **Owner:** Securities Counsel	**PHASE 4**	**CRITICAL**
☐	**D&O and Management Liability Insurance: Policy Bound.** *The D&O and management liability policy must be bound before the company accepts any investor capital or makes any investment*	**PHASE 4**	**CRITICAL**

	decision on behalf of investors. This is a claims-made policy, so the policy in force when a claim is made governs coverage. A gap between the policy inception date and the date investor capital is accepted creates an uncovered period. **When:** Before the first investor capital is accepted, and before any investment decision is made on an investor's behalf • **Owner:** Insurance Broker		
☐	**EPLI (Employment Practices Liability Insurance): Policy Bound.** *Must be bound before the first employee's start date. EPLI covers claims alleging wrongful termination, discrimination, harassment, and other employment-related wrongful acts. Because it is a claims-made policy, no retroactive coverage exists for the period before the policy is bound.* **When:** Before the first employee's start date, with no exceptions • **Owner:** Insurance Broker	**PHASE 4**	**CRITICAL**
☐	**General Commercial Liability, Cyber Liability, and Workers' Compensation: All Policies Bound.** *CGL before any physical office presence or site visits begin. Cyber liability before investor personal data is stored in any company system. Workers' compensation before the first employee's start date, since it is legally required in virtually all states. All three belong to the Phase 4 insurance program activation. Workers' compensation is a legal requirement, not a discretionary coverage.* **When:** CGL and cyber before office or investor data; workers' comp before the first employee • **Owner:** Insurance Broker	**PHASE 4**	**CRITICAL**
☐	**Key-Person Life Insurance Policies: Bound on Each Founding Partner's Life.** *Term life insurance policies on each founding partner, with face amounts equal to the current fair market value of each partner's equity interest. The policies fund the buy-sell agreement's buyout obligation upon a partner's death. The buy-sell agreement from Phase 3 and the insurance policies must be coordinated on policy ownership, beneficiary designations, and the mechanics of directing insurance proceeds to fund the operating agreement's buyout provision.* **When:** Before operations begin, concurrent with buy-sell agreement execution • **Owner:** Insurance Broker	**PHASE 4**	**CRITICAL**
☐	**Management Company Bank Account: Opened with Dual-Authorization Controls.** *An operating company bank account with two-person authorization requirements for wire transfers and ACH payments above the agreed threshold. All initial capital contributions are deposited here. No management company expenses may be paid from investor capital accounts, and no investor capital may be deposited into the management company operating account. Establish the corporate credit card program at the same time.*	**PHASE 4**	**CRITICAL**

	When: Before any company expenses are incurred, and before capital contributions are received • **Owner:** Managing Partner and CPA		
☐	**Accounting System Implementation: Chart of Accounts Established for All Entities.** *Accounting software selected and implemented for the management company on an accrual-basis GAAP footing. The chart of accounts is set up to support multi-entity accounting with complete segregation between the management company, the GP entity, and future deal-level entities. The CPA firm advises on setup so that the system supports K-1 preparation and investor reporting from its first use.* **When:** Before any company transactions are recorded, and before Phase 5 deal-level entities are formed • **Owner:** CPA and Managing Partner	**PHASE 4**	**REQUIRED**

PHASE 5 · FIRST OFFERING DOCUMENTS

Phase 5 documents are specific to the company's first investor offering, and the order in which they are completed matters as much as their completeness. The PPM and the subscription documents must be complete and reviewed by counsel before any investor sees offering information. Form D must be filed within 15 calendar days of the first sale. State blue sky notice filings must be made within each state's deadline, measured from the first sale to an investor who resides in that state. Each new offering requires its own Phase 5 document package.

☐	**Deal-Level Entity, Articles of Organization: Filed.** *Filed for each deal-level special purpose entity in the state where the project is located, or in Delaware with foreign qualification in the project state. This establishes the entity that will hold the real property, receive investor equity, and borrow construction debt. The Investment Company Act exclusion analysis from Phase 2 must confirm the applicable exclusion for this entity before it is formed and before investor capital is accepted.* **When:** Before investor subscriptions are accepted, and before the LOI or PSA is executed on the project • **Owner:** Counsel	**PHASE 5**	**CRITICAL**
☐	**Deal-Level Entity, Federal Employer Identification Number (EIN): Obtained.** *A separate EIN for each deal-level entity. Required for the entity's annual partnership tax return (Form 1065), investor K-1 preparation, construction lender requirements, and banking.* **When:** Immediately after deal entity formation • **Owner:** Counsel or CPA	**PHASE 5**	**REQUIRED**
☐	**Deal-Level Entity, Operating Agreement: Investor-Facing Version Executed.** *The operating agreement governing the relationship between the GP entity, as managing member, and the investor LPs, as non-managing members. It must address GP authority and investor governance rights (information rights, material decision approval*	**PHASE 5**	**CRITICAL**

	thresholds), economic terms (preferred return rate, promote waterfall with a worked numerical example, mandatory tax distributions), investor protections, capital call provisions and mechanics, exit mechanics, and the complete distribution waterfall. This document is what investors agree to when they sign the subscription agreement. **When:** Before any investor subscription is accepted for the offering • **Owner:** Counsel		
☐	**Bad Actor Background Checks: All Covered Persons, Documented.** *Background checks through a qualified provider on all covered persons: the issuing entity, each managing member and executive officer, each beneficial owner of 20% or more, and any person compensated for soliciting investors. Results are documented and retained. Any potential disqualifying event must be reviewed by securities counsel before the offering commences, because the offering cannot proceed with a disqualified person in a covered role.* **When:** Before the offering commences; documentation retained permanently as part of the offering's compliance file • **Owner:** Securities Counsel	**PHASE 5**	**CRITICAL**
☐	**Private Placement Memorandum (PPM): Completed and Reviewed by Securities Counsel.** *The primary disclosure document for the offering. All required components must be present: offering summary and cover page, executive summary, business description and investment strategy, management team biographies and a complete track record that includes underperforming deals, offering terms, use of proceeds, a complete and specific fee schedule (all fees, all rates, all conditions), specific risk factors for this offering and this project, complete conflict of interest disclosure, investment structure and waterfall, tax considerations, investor qualification requirements, and subscription procedures. No investor may receive offering information before the PPM is complete and reviewed by counsel.* **When:** Before the first investor receives offering information or is shown deal terms • **Owner:** Counsel and Managing Partner	**PHASE 5**	**CRITICAL**
☐	**Subscription Agreement and Investor Questionnaire: Finalized.** *The document by which each investor subscribes for their membership interest. It must include accredited investor representations and warranties, acknowledgment of PPM receipt and review opportunity, a representation that the investor has had the opportunity to obtain independent legal and tax advice, a no-general-solicitation representation for Rule 506(b) offerings, investment suitability representations, subscription funding mechanics, and the investor's joinder and agreement to be bound by the deal-level operating agreement. No subscription funds should be accepted before the signed subscription package is complete.* **When:** Before any investor subscription is accepted for the offering • **Owner:** Counsel	**PHASE 5**	**CRITICAL**

☐	**Accredited Investor Verification Materials: Rule 506(c) Offerings Only.** *For Rule 506(c) offerings, which permit general solicitation, document the verification method and the supporting materials for each investor's accredited investor status before accepting any subscription. Rule 506(c) requires reasonable steps to verify accreditation, not a simple self-certification. The commonly used methods are: (1) income verification through the prior two years' W-2s or tax returns; (2) net worth verification through financial account statements together with a recent credit report; (3) a written confirmation from the investor's licensed attorney, CPA, or registered investment adviser; and (4) for an offering with a high minimum investment, reliance on that minimum together with written representations from the investor, under the SEC staff guidance issued in March 2025. Under that guidance the minimum must be at least $200,000 for an individual investor or $1,000,000 for an entity, the investor must represent in writing that it is accredited and that the investment is not financed by a third party for the purpose of making this investment, and the issuer must have no actual knowledge to the contrary. A verbal representation of accredited status, on its own, does not satisfy Rule 506(c) and puts the exemption at risk for that investor.* **When:** Before accepting any subscription funds from any investor in a Rule 506(c) offering • **Owner:** Counsel and Managing Partner	PHASE 5	CRITICAL
☐	**Deal-Level Entity Bank Accounts: Opened Before First Investor Capital Is Received.** *Three separate bank accounts for the deal-level entity: (1) an investor capital account holding committed equity pending deployment; (2) a construction account from which project costs and draw disbursements are paid; and (3) a reserve account holding lender-required and project-required reserves. No deal entity funds may be commingled with management company operating funds, for any purpose, at any time.* **When:** Before any investor subscription funds are received • **Owner:** Managing Partner and CPA	PHASE 5	CRITICAL
☐	**Form D: Filed with the SEC via EDGAR Within 15 Days of First Sale.** *Form D, filed electronically through the SEC's EDGAR system. It is a public filing that identifies the issuing entity, the Regulation D exemption relied upon (Rule 506(b) or Rule 506(c)), the total offering amount, the amount raised in the first closing, the number of investors, and the managing member's contact information. The 15-day deadline runs from the date of the first sale, not from the date the offering launches or the date the PPM is distributed. A late filing is a technical violation that does not, by itself, invalidate the exemption, but state regulators monitor EDGAR filings and a missed deadline is visible.* **When:** Within 15 calendar days of the date of the first sale of securities in the offering • **Owner:** Securities Counsel	PHASE 5	CRITICAL
☐	**State Blue Sky Notice Filings: Each State Where an Investor Resides.** *State-level notice filings triggered by each investor's state of*	PHASE 5	CRITICAL

	residence. Most states require filing within 15 days of the first sale to a resident of that state; some require filing before any offer is made to residents of that state. Each state has its own form (many accept the federal Form D), its own filing fee, and its own deadline. Build the state-specific filing calendar before investor outreach begins. Missing a state's deadline does not invalidate the federal exemption, but it creates a securities law violation in that state, which may give the affected investors rescission rights. **When:** Within the applicable deadline from the first sale to an investor in each state (typically 15 days; confirm state by state) • **Owner:** Securities Counsel		

Formation Documents Completion Record

Use the following record to document the completion of each phase's documents. Complete it as each item is finished and retain it in the company's permanent formation files. This record is the primary evidence that the company's formation was properly documented, and it may be reviewed during due diligence for an institutional capital raise, an acquisition of the company, or a regulatory inquiry.

Phase	Document	Date Completed / Filed	Counsel or Advisor Responsible
1	Partners' Term Sheet, signed by all partners		
1	Contribution Matrix, completed and signed		
1	24-Month Operating Budget, base case and downside		
1	Investment Criteria Statement, written and agreed		
2	Legal counsel engagement letter, signed		
2	CPA firm engagement letter, signed		
2	Insurance broker engagement initiated		
2	ICA exclusion analysis, written memo from counsel		
2	Investment adviser registration analysis, written memo		
2	State blue sky requirements research, summary prepared		
3	Operating company, Articles of Organization filed		
3	Operating company, EIN obtained		
3	Operating company, operating agreement executed		
3	GP entity, Articles of Organization filed		
3	GP entity, EIN obtained		
3	GP entity, operating agreement executed (carry allocation)		
3	Equity grant agreements, executed with each partner		

Phase	Document	Date Completed / Filed	Counsel or Advisor Responsible
3 ⚠	**Section 83(b) elections, FILED WITHIN 30 DAYS OF GRANT**		
3	Spousal consent agreements, executed		
3	Decision Authority Matrix (App. D), completed and attached as Exhibit C		
3	Partner Exit Scenarios Table (App. E), adopted as exhibit		
3	Foreign qualification filings, operating states		
3	Buy-sell agreement, executed and coordinated with insurance		
4	State income and franchise tax registration, all operating states		
4	Federal and state payroll tax registration		
4	ERA Form ADV Part 1A, initial filing (if applicable)		
4	State investment adviser registration (if required)		
4	D&O and Management Liability policy, bound		
4	EPLI policy, bound (before first employee)		
4	CGL, cyber, and workers' comp policies, all bound		
4	Key-person life insurance, all policies bound		
4	Management company bank account, opened with controls		
4	Accounting system, implemented with chart of accounts		
5	Deal-level entity, Articles of Organization filed		
5	Deal-level entity, EIN obtained		
5	Deal-level operating agreement, investor-facing version executed		
5	Bad actor background checks, all covered persons documented		
5	PPM, completed and counsel-reviewed		
5	Subscription agreement and investor questionnaire, finalized		
5	Accredited investor verification materials, prepared (506(c) only)		
5	Deal-level entity bank accounts, all three accounts opened		
5 ⚠	**Form D, filed with SEC within 15 days of first sale**		
5	State blue sky notice filings, all investor states filed timely		

⚠ Absolute Deadline Items

Two items in the completion record are marked with the warning symbol to flag an absolute, non-extendable deadline, one where missing the date permanently forecloses the option or creates a material securities law violation.

Section 83(b) elections must be filed within 30 calendar days of the equity grant date. There is no extension, no corrective filing, and no cure once the window is missed. Calendar this deadline the moment the equity grant agreements are executed.

Form D must be filed within 15 calendar days of the date of the first sale of securities. The deadline is tied to the sale date, not to the offering launch date. Calendar it the day the first investor closes.

End of Appendix H

APP. I

APPENDIX I

Insurance Coverage Checklist

For Every Coverage a Real Estate Development Company Must Carry

A comprehensive reference covering every insurance policy a real estate development company requires: what each policy covers, what it does not cover, when it must be bound, what limits are appropriate at each stage, the critical policy terms to negotiate, the most common coverage mistakes, and an annual adequacy review checklist for each coverage type.

Insurance is the most consistently underbuilt part of a development company's risk management. Most founding teams purchase the minimum coverage their lenders and investors require and treat everything else as optional. That choice makes sense as a short-term cost decision, but it is a poor long-term risk decision. The losses that hurt most in development company operations, such as an employment discrimination claim filed by a former employee, a data breach that exposes investor information, a construction accident during a principal walkthrough, or a partner who raises a breach of fiduciary duty claim, are exactly the losses the optional coverages are built to absorb.

This appendix addresses every insurance coverage a real estate development company needs across the three layers of the company's structure: the management company (the operating platform), the deal-level projects, and the founding partners as individuals. For each coverage, it explains what the policy actually covers, what the most common exclusions remove, when the policy must be in place, what limits are appropriate at different stages of the company's growth, the policy terms worth negotiating, and the annual review questions that determine whether the existing coverage remains adequate.

How to Use This Checklist

This appendix is organized in four sections: management company coverages (the insurance the operating platform must maintain whether or not any deal is active); project-level coverages (the insurance required for each active development project); partner-level coverages (the insurance that protects the founding partners individually and funds the buy-sell agreement upon a partner's death or disability); and the annual insurance program review (the recurring process for assessing whether all coverages remain adequate as the company grows).

Each coverage is presented as a structured card with consistent fields: the policy name and type, what it covers, what it does not cover, when it must be bound, recommended limits, key policy terms to negotiate with the insurance broker, the most common mistake companies make with that coverage, and a checklist of annual adequacy review questions. The timing badge on each card indicates when the policy must be in place: before investor capital is accepted or operations begin; before the first employee starts; per project; or on the annual review cycle.

CLAIMS-MADE VS. OCCURRENCE POLICIES: THE SINGLE MOST IMPORTANT DISTINCTION

The most consequential distinction in development company insurance is between claims-made policies and occurrence policies. It determines whether a claim that arises from an event in one policy period but is filed in a later policy period will be covered.

Occurrence policy: covers claims arising from events that occurred during the policy period, regardless of when the claim is filed. A General Liability policy is typically an occurrence policy. An incident that happens in Year 2 of operations is covered by the Year 2 policy even if the claim is not filed until Year 5.

Claims-made policy: covers only claims that are both (i) made during the policy period and (ii) arising from events that occurred after the policy's retroactive date. D&O, EPLI, E&O, and Cyber are typically claims-made policies. A claim filed after the policy expires is not covered even if the underlying event occurred while the policy was in force, unless the company purchased Extended Reporting Period (tail) coverage.

The critical implication: never allow a claims-made policy to lapse without either renewing it or purchasing tail coverage. A one-day gap in a D&O or EPLI policy on a claims-made basis means that any claim filed after the lapse date, even one arising from an event that happened years before the lapse, is uninsured. This is the most expensive insurance mistake a development company can make.

Management Company Coverages

The following coverages apply to the management company (the operating platform) and must be maintained continuously, whether or not any development project is active. They protect the company's operations, its employees, and its founding partners from the liability exposures that arise from running a professional real estate investment and advisory business.

Directors & Officers / Management Liability Insurance

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Claims-Made Policy. Must Not Lapse Without Tail Coverage.

What It Covers: Claims by investors, partners, lenders, or regulatory authorities alleging that the company's managing partners or officers made wrongful decisions in the management of the company, including mismanagement of investor capital, breach of fiduciary duty, material misrepresentation in offering documents, failure to disclose material information, improper self-dealing, and violation of securities laws. Covers defense costs and settlements or judgments arising from covered claims, including regulatory investigations and SEC inquiries.

What It Does NOT Cover: Fraudulent or criminal acts (deliberate fraud is excluded, though defense costs may be covered until adjudication). Claims arising from events before the policy's retroactive date. Claims arising from the same facts as a previously reported claim under a prior policy. Claims between the company's own insured persons (entity versus officer claims may have limited coverage depending on the policy form). Bodily injury and property damage (covered under CGL, not D&O).

When to Bind: Before the company accepts any investor capital, makes any investment decision on behalf of investors, or takes any action in a management capacity that could give rise to a fiduciary duty claim. This is the first policy that must be bound in Phase 4 of the formation process.

Recommended Limits: Emerging company (AUM under $25M): $1M to $3M per claim and $2M to $5M aggregate. Growing company (AUM $25M to $100M): $3M to $10M per claim and $5M to $15M aggregate. Institutional company (AUM above $100M): $10M to $25M or more,

with excess layers as needed. Institutional investors frequently specify minimum D&O limits as a condition of investment.

Key Policy Terms to Negotiate: Retroactive date (set as far back as possible, ideally the company's formation date); full prior acts coverage for any predecessor entity; definition of insured persons (should include all managing partners, officers, and key employees); entity coverage for securities claims (confirm the policy covers the management company entity, not just individual officers); defense cost advancement (the insurer advances defense costs before a final adjudication); choice of defense counsel provision; severability of the application (one insured's material misrepresentation in the application should not void coverage for other innocent insureds).

Most Common Mistake: Allowing the policy to lapse, or not purchasing tail coverage when switching insurers. Even a brief gap in a claims-made D&O policy means that claims filed after the gap date are uninsured regardless of when the underlying act occurred. Always purchase Extended Reporting Period (tail) coverage if a policy is being replaced rather than renewed with the same insurer.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Current AUM and deal volume. Have limits kept pace with the company's growth and the potential size of investor claims?
- ☐ New institutional investor relationships. Do any new LP agreements specify minimum D&O limits that exceed current coverage?
- ☐ Changes in the management team. Are all new managing partners, officers, and key employees included as insured persons?
- ☐ Retroactive date. Is it still the company's formation date, or has it been moved forward during a policy change?
- ☐ Premium competitiveness. Has the broker obtained competitive quotes from at least two other D&O insurers?
- ☐ Claims history. Are there any open or potential claims that should be reported to the insurer before renewal?

Employment Practices Liability Insurance (EPLI)

BIND BEFORE FIRST EMPLOYEE

Claims-Made Policy. Must Be Bound Before the First Employee's Start Date.

What It Covers: Claims by current employees, former employees, and job applicants alleging wrongful employment practices: wrongful termination (including constructive dismissal); workplace harassment (sexual harassment and hostile work environment claims); discrimination based on protected characteristics (race, sex, age, disability, national origin, religion, pregnancy, sexual orientation, and other protected classes under applicable law); retaliation claims; failure to accommodate a disability or religious practice; wage and hour violations (in some policy forms); and third-party claims where an employee alleges harassment by a customer, vendor, or contractor. Covers defense costs and settlements or judgments.

What It Does NOT Cover: Criminal acts and intentional violations of law. Wage and hour violations (excluded from most standard EPLI forms; must be added by endorsement if desired). Claims by independent contractors who are not treated as employees. OSHA

citations and regulatory penalties. Workers' compensation claims (covered under a separate WC policy). Bodily injury and property damage.

When to Bind: Before the first employee's start date. A day-one employment discrimination claim has already occurred before the policy is bound if binding is delayed, and EPLI is typically not available retroactively for events that occurred before the policy inception date.

Recommended Limits: Company with 1 to 5 employees: $500,000 to $1M per claim and $1M to $2M aggregate. Company with 6 to 25 employees: $1M to $3M per claim and $2M to $5M aggregate. Company with 25 or more employees: $3M to $5M or more per claim, with aggregate appropriate to headcount. Texas and California companies should note that employment litigation in both states is among the most active in the country.

Key Policy Terms to Negotiate: Third-party coverage (covers claims by non-employee third parties alleging harassment by the company's employees); wage and hour endorsement (adds coverage for overtime and classification claims that are otherwise excluded from standard EPLI); prior acts coverage (retroactive date should be the company's formation date); definition of employment practices wrongful act (should be broad enough to cover the specific claims most common in the company's industry and geography); sublimit versus full policy limits for wage and hour claims.

Most Common Mistake: Purchasing EPLI only after the first employee is hired. Any claim arising from the hiring process itself, such as a rejected candidate alleging discrimination in the interview process, occurred before the policy's inception if the policy was purchased after that interview. Bind EPLI before the first employment action of any kind, including the job posting.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Current employee count. Have limits kept pace with headcount growth?
- ☐ New states of operation. Does the policy cover employees in all states where the company now has employees, including remote workers?
- ☐ Annual anti-harassment training. Most EPLI policies offer premium discounts for documented annual training; has it been completed?
- ☐ Employee handbook. Has it been reviewed and updated in the last 12 months?
- ☐ Open or threatened employee claims. Are there any that should be reported to the insurer before renewal?
- ☐ Independent contractor relationships. Are any contractors who should be classified as employees creating misclassification exposure?

Errors & Omissions Insurance (Professional Liability)

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Claims-Made Policy. Annual Review; Required Before Advisory Services Begin.

What It Covers: Claims by clients (investors, joint venture partners, or third parties) alleging that the company failed to perform its professional services with the competence, care, or accuracy that a reasonably competent professional would provide. For a real estate development company, covered claims may include errors in the underwriting or financial projections presented to investors; failure to complete a project within the disclosed timeline or budget; failure to disclose a material risk factor in the offering documents; errors in legal or regulatory advice provided to investors; and negligent management of investor capital. Covers defense costs and damages.

What It Does NOT Cover: Fraudulent or deliberately wrongful acts. Claims arising from bodily injury or property damage (covered under CGL and Builder's Risk). Criminal fines and penalties. Claims for which coverage is provided under another policy (some E&O policies are excess over D&O for overlapping claims). Pure business disputes that do not involve a professional error or omission.

When to Bind: Before the company begins providing advisory or management services to any investor or client. For a company that is also a registered investment adviser or exempt reporting adviser, E&O coverage is strongly recommended from the first offering.

Recommended Limits: Emerging company: $1M to $3M per claim and $2M to $5M aggregate. Institutional level: $5M or more per claim, with appropriate aggregate. Institutional investors and some lenders may require E&O certificates with specified minimum limits as a condition of engagement.

Key Policy Terms to Negotiate: Definition of professional services (must specifically include real estate development management, asset management, investor relations, and investment advisory services, not just 'consulting' or 'management services'); retroactive date (set to company formation); prior acts coverage; defense cost advancement; whether E&O and D&O are written on the same policy form (combined management liability policies may be more efficient but require careful limit allocation).

Most Common Mistake: Treating E&O coverage as duplicative of D&O and skipping it. The two policies address different theories of liability: D&O covers governance and fiduciary duty claims, while E&O covers professional service claims. Both are relevant to a development company that provides advisory services to investors. Companies that skip E&O and then face a professional liability claim discover that their D&O policy may not cover a claim framed as professional negligence rather than wrongful management.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Definition of professional services. Does it still accurately describe all services the company provides to investors and clients?
- ☐ New service lines. Has the company added any advisory relationships that may fall outside the existing coverage definition?
- ☐ Policy limits. Are they still appropriate relative to the size of the largest single investor commitment the company manages?
- ☐ Investor satisfaction. Has any investor expressed dissatisfaction with the company's performance that could become a professional liability claim?
- ☐ Coordination with D&O. Is E&O coordinated with D&O to avoid gaps or unintended duplications in coverage?

Commercial General Liability Insurance (CGL)

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Occurrence Policy. Bind Before Office Occupancy or Any Site Visits.

What It Covers: Third-party claims for bodily injury and property damage arising from the management company's operations. For a development company, this includes a visitor injured in the company's office; property damage caused by a company employee during an operational visit; personal injury claims (libel, slander, false imprisonment) arising from the company's business activities; and products and completed operations coverage (relevant once development projects are completed and sold). CGL is an occurrence policy, so the

policy in force when the injury or damage occurs governs coverage regardless of when the claim is filed.

What It Does NOT Cover: Professional errors and omissions (covered under E&O and D&O). Intentional acts. Employee injuries (covered under Workers' Compensation). Pollution liability (may require a separate pollution policy for projects near contaminated sites). Automobile liability for company vehicles (requires a separate commercial auto policy). Construction-phase property damage (covered under Builder's Risk at the project level). Employer liability (covered under the Workers' Compensation employer liability section).

When to Bind: Before the company establishes any physical office presence and before any employee or principal conducts site visits to potential or active development projects. Because CGL is an occurrence policy, a gap in coverage means that any bodily injury or property damage incident during the gap period is uninsured regardless of when the claim is filed.

Recommended Limits: Standard minimum: $1M per occurrence and $2M aggregate for a company with an office presence and active project site visits. Construction lenders on active projects frequently require the management company to carry CGL with the lender named as additional insured, and may specify minimum limits of $2M to $5M per occurrence as a loan covenant.

Key Policy Terms to Negotiate: Additional insured endorsements (lenders, joint venture partners, and institutional investors may require additional insured status on the management company's CGL); primary and non-contributory endorsement (the management company's CGL should be primary over any coverage the lender or JV partner carries); contractual liability coverage (covers the company's assumption of third-party liability through indemnification agreements in contracts); completed operations coverage tail (extends coverage for bodily injury or property damage claims arising from completed projects after the project is sold).

Most Common Mistake: Failing to add lenders and joint venture partners as additional insureds when the loan agreement or JV agreement requires it. Lenders frequently perform certificate of insurance audits and can declare a loan covenant default if the required additional insured status is absent.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Locations. Does the policy list all current office locations and operational addresses?
- ☐ Construction lenders. Have all active lenders been added as additional insureds as required by each loan agreement?
- ☐ JV partners. Have all JV partners who require additional insured status been added?
- ☐ Aggregate limit. Is it still adequate given the company's increased office footprint and number of active site visits?
- ☐ Company vehicles. Has the company added any vehicles that require a commercial auto policy?

Cyber Liability Insurance

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Claims-Made Policy. Bind Before Any Investor Data Is Stored.

What It Covers: First-party costs arising from a data breach or cyber incident affecting the management company's systems: forensic investigation costs to determine the breach's scope and source; notification costs (legally required in every state when personally identifiable information is compromised); credit monitoring services for affected investors and employees;

public relations costs for breach communication; business interruption losses from a system outage; and ransomware extortion payment costs (in policies that include this coverage). Also third-party liability for claims by investors or employees whose personal data was compromised, including regulatory defense costs for SEC and state attorney general investigations arising from a data breach.

What It Does NOT Cover: Property damage to physical systems from non-cyber events. Prior acts before the policy's retroactive date. Criminal fines and penalties (except as specifically covered). Intellectual property theft claims (may require a specific endorsement). Unencrypted data on lost or stolen devices (may be excluded depending on the policy form and whether basic security standards were met).

When to Bind: Before any investor personal information (name, address, Social Security number, accredited investor documentation, or financial account information) is stored in any company system, whether that system is a CRM, a shared drive, an email platform, or physical files on a device. For a development company that begins storing investor questionnaires and subscription documents in its first offering, Cyber coverage must be in place at or before the launch of that first offering.

Recommended Limits: Emerging company (fewer than 50 investors): $1M to $2M. Growing company (50 to 300 investors): $2M to $5M. Institutional company (300 or more investors, or any institutional LP relationships): $5M to $10M or more. Cyber premiums have increased substantially since 2020, so budget for annual premium increases of roughly 10% to 30% depending on the company's cybersecurity posture.

Key Policy Terms to Negotiate: Social engineering fraud coverage (covers losses from fraudulent wire transfer instructions, which are increasingly common in real estate transactions); ransomware coverage (covers extortion payments and recovery costs; confirm whether the policy covers payments to sanctioned actors, which carries its own legal complexity); regulatory defense coverage (covers defense costs in SEC and state cybersecurity investigations); a broad definition of personal information (should include financial account numbers, Social Security numbers, and accredited investor documentation, not just medical records or consumer data); business interruption waiting period (shorter is better; some policies impose an 8 to 12 hour waiting period before BI coverage begins).

Most Common Mistake: Purchasing a cyber policy without first implementing the basic cybersecurity hygiene measures the policy requires as conditions of coverage. Many cyber policies contain conditions requiring multi-factor authentication, regular data backups, and employee security training. A breach that occurs because these conditions were not met may be denied. Review the policy conditions before binding and implement all required controls.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Investor records. Has the number of investor records in company systems grown significantly since the last policy review?
- ☐ Required controls. Are all required cybersecurity controls (MFA, backups, security training) being maintained as required by the policy conditions?
- ☐ New systems. Have any new cloud systems, CRM platforms, or data storage tools been added that expand the company's cyber exposure?
- ☐ Near-miss incidents. Has the company experienced any near-miss cyber incidents (phishing attempts, suspicious login activity) that should be reported?
- ☐ Wire fraud coverage. Does the policy include social engineering and wire fraud coverage, given the frequency of these attacks in real estate transactions?
- ☐ Policy limit. Does it still reflect the current number of investor records and the potential notification cost of a full data breach?

Workers' Compensation & Employer's Liability Insurance

BIND BEFORE FIRST EMPLOYEE

Statutory / Occurrence Policy. Bind Before the First Employee.

What It Covers: Part A (Workers' Compensation): statutory benefits owed to employees injured in the course of their employment, including medical treatment, lost wages during disability, permanent disability benefits, and death benefits to dependents. Coverage is not limited by a policy dollar limit; the insurer pays all statutory benefits owed under applicable state workers' compensation law. Part B (Employer's Liability): liability to employees who cannot recover under workers' compensation, typically claims for occupational disease, dual-capacity suits, or third-party-over actions where a third party (a contractor, for example) sues the employer for contribution. Part B carries a dollar limit separate from Part A.

What It Does NOT Cover: Injuries to independent contractors (WC covers employees only; misclassifying employees as contractors creates uninsured exposure and significant penalties). Intentional acts by the employer causing injury. Punitive damages in most jurisdictions. Injuries sustained outside the course of employment.

When to Bind: Before the first employee's first day of work. Workers' compensation is mandatory in every state except Texas, which is the only state that lets most private employers opt out and operate as nonsubscribers. A Texas nonsubscriber avoids the cost of coverage but gives up the exclusive-remedy protection that bars employee injury suits, and it loses the common-law defenses of contributory negligence, assumption of the risk, and the fellow-servant rule, which exposes it to direct negligence lawsuits with damages that can far exceed statutory benefits. A Texas nonsubscriber must also post the required notice, give written notice of no coverage to new employees, and file the annual DWC Form-005 with the Texas Department of Insurance. A Texas company with employees in other states must still carry workers' compensation in those states even when it is a nonsubscriber in Texas. Outside Texas, operating without coverage exposes the company to statutory fines, regulatory sanctions, and direct liability for employee injury claims the policy would otherwise cover.

Recommended Limits: Part A limits are set by statute and are not selected by the employer; the insurer pays all required statutory benefits. Part B (Employer's Liability) standard limits are $100,000 per accident, $500,000 disease policy limit, and $100,000 disease per employee. Many professional employers increase Part B limits to $500,000 / $500,000 / $500,000 or $1M / $1M / $1M.

Key Policy Terms to Negotiate: Waiver of subrogation (many construction contracts require the company to waive the insurer's right of subrogation against contractors; confirm with the WC insurer before signing any construction contract with this requirement); state-specific coverage (WC is state-regulated; confirm that the policy provides coverage in all states where the company has employees, including any remote employees outside the company's home state); USL&H coverage if applicable (United States Longshore and Harbor Workers' Act coverage, required for employees working near navigable waterways).

Most Common Mistake: Failing to add remote employees in new states to the WC policy. A remote employee in a state not listed on the policy may not be covered if injured while working. Every time the company hires a remote employee in a new state, notify the WC insurer immediately.

ANNUAL ADEQUACY REVIEW. CONFIRM:

☐ States listed. Are all states where the company has employees listed on the policy, including states where remote employees are located?

☐ Payroll reporting. Have payroll amounts been accurately reported to the insurer for the premium audit?

☐ Classification codes. Are all employee classification codes correct? (Misclassification can produce significant audit adjustments.)

☐ Reclassified contractors. Have any independent contractors whose roles have shifted to more employee-like functions been reclassified?

☐ Part B limit. Is the Employer's Liability limit adequate given the size of the workforce and the nature of the work?

Project-Level Coverages

The following coverages are required for each active development project. They are maintained at the project-entity level and must be in place before construction activity begins and before the project entity executes any construction or development contracts. The construction lender on each project will specify minimum coverage requirements and additional insured requirements as loan covenant conditions.

Builder's Risk Insurance

BIND PER PROJECT

Occurrence Policy. Bind Before Any Construction Activity Begins.

What It Covers: Physical loss or damage to the project under construction during the construction period, from the inception of construction through substantial completion and project delivery. Covered causes of loss (on an 'all risk' or 'special causes of loss' form) include fire, lightning, wind, hail, vandalism, theft of materials, collapse, and accidental damage during construction. It also covers temporary structures and equipment used in the construction; materials stored on-site or in transit to the site; debris removal costs following a covered loss; and soft costs (architectural and engineering fees, permit costs, and project overhead) incurred because of a covered delay in completion.

What It Does NOT Cover: Earthquake and flood (typically excluded; these require separate endorsements or policies and are particularly important for projects in high-risk zones). Faulty workmanship (defective work by the contractor is not a covered loss; the resulting damage to non-defective work may be covered under a resulting damage endorsement, but the defective work itself is not). Mechanical breakdown. War and terrorism (terrorism coverage may be added by endorsement under TRIA). Professional errors and omissions (covered under design professional liability policies for architects and engineers). Loss or damage after substantial completion (once the project is substantially complete, Builder's Risk should be replaced by a permanent property policy).

When to Bind: Before any construction activity begins, including site clearing, demolition, excavation, or materials delivery to the site. The construction loan agreement will specify the minimum coverage requirements and the requirement that the lender be named as loss payee and additional insured. Do not wait until framing begins to bind Builder's Risk; site clearing and excavation already create significant exposure.

Recommended Limits: The Builder's Risk limit should equal the completed project value at substantial completion, not the construction cost or the land value. For a project with $15M in construction costs and a projected completed value of $20M, the limit should be $20M. Most policies are written at the total insurable value (TIV) of the project at completion. As the project

progresses and the completed value becomes clearer, confirm that the limit remains adequate and request an endorsement to increase it if needed.

Key Policy Terms to Negotiate: Soft costs coverage (additional architect, engineer, and permit fees incurred because of a covered loss and resulting delay); delay in completion coverage (covers lost rental income or project overhead during a delay caused by a covered loss); ordinance or law coverage (covers the increased cost of complying with current building codes if a loss requires reconstruction under new code requirements, which matters most for projects in jurisdictions with active code updates); transit coverage (covers materials in transit to the site); temporary structures; and the deductible (particularly for wind and hail events in coastal or high-wind areas, where the deductible is often a percentage of the insured value rather than a fixed dollar amount).

Most Common Mistake: Not increasing the Builder's Risk limit as the project's construction cost grows through change orders and additions. A project that starts at an approved budget of $15M and reaches a revised budget of $18M through change orders still carries the limit purchased at the original contract price unless the policy is endorsed to reflect the revised cost. Check the limit each time the construction budget increases materially.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Completed value. Has it been re-assessed, and has it increased beyond the current limit due to construction cost inflation?
- ☐ Change orders. Have approved change orders increased the total development cost above the original policy limit?
- ☐ Schedule. Is the project on track to reach substantial completion before the policy expires? (Builder's Risk policies are written for a defined construction period; if the project is delayed, the policy must be extended.)
- ☐ Lender status. Has the lender verified that it is properly listed as loss payee and additional insured on the current policy?
- ☐ New exposures. Are there any new exposures (adjacent excavation, unusual materials, expanded scope) that should be reported to the insurer?

General Contractor and Subcontractor Insurance Requirements

BIND PER PROJECT

Contract-Required Occurrence and Claims-Made Policies. Verify Before Any Work Begins.

What It Covers: This is not the company's own coverage. It is the coverage the company must contractually require the general contractor and all subcontractors to carry and maintain throughout the construction period. Required coverages include CGL (minimum $1M per occurrence and $2M aggregate, with the project entity and lender as additional insureds); Workers' Compensation (statutory limits); Employer's Liability; Commercial Auto (for all vehicles used in connection with the project); and Umbrella or Excess Liability. For design professionals, add Architects and Engineers Professional Liability (E&O). For contractors working with hazardous materials, add Pollution Liability.

What It Does NOT Cover: The company's own liability arising from its own acts and decisions (covered under the management company's CGL and E&O policies). The adequacy of a contractor's own insurance program for risks beyond what the construction contract requires.

When to Bind: Before any contractor begins any work on the project. Collect certificates of insurance from each contractor before authorizing work, and verify that the certificates show

the required coverage types, the required minimum limits, the required additional insured status, and the required primary and non-contributory endorsements. A certificate of insurance is not itself proof of coverage; it is an evidence document, so request endorsement copies for the most important coverage requirements.

Recommended Limits: GC CGL minimum: $2M to $5M per occurrence and $4M to $10M aggregate (higher for larger projects). GC Umbrella: $5M to $25M depending on project size and risk. Subcontractor minimums: $1M to $2M per occurrence and $2M to $4M aggregate, with umbrella requirements proportional to each subcontract size. Design professionals (architects, engineers): $1M to $5M per claim and $2M to $5M aggregate E&O.

Key Policy Terms to Negotiate: Additional insured status on the GC's CGL for the project entity, the management company, and the lender; primary and non-contributory language (the GC's policy must be primary over any coverage carried by the additional insureds); waiver of subrogation (the GC's insurer waives its right of subrogation against the project entity and lender); completed operations coverage for two years after substantial completion; thirty-day notice of cancellation to additional insureds; and umbrella following form over the underlying CGL, WC, and auto policies.

Most Common Mistake: Accepting a certificate of insurance without verifying that the underlying policy includes all required endorsements. Certificates can be issued showing coverage types and limits that are technically accurate but that do not include the required additional insured or primary and non-contributory endorsements. Always request copies of the additional insured endorsements from the broker, not just the certificate.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ Renewals. Have all active contractors renewed their policies, and are current certificates of insurance on file for each?
- ☐ Additional insureds. Do all current certificates show the project entity, the management company, and the lender as additional insureds?
- ☐ Mid-project lapses. Has any contractor's coverage lapsed mid-project? (Require thirty-day cancellation notice to the project entity.)
- ☐ New subcontractors. Have any new subcontractors started work without submitting insurance certificates?
- ☐ Completed operations tail. Is it still in force for any contractor whose work was completed in the last two years?

Pollution Liability Insurance (Contractor's Pollution / Site-Specific)

BIND PER PROJECT

Claims-Made Policy. Project-Level; Bind Before Work on Potentially Contaminated Sites.

What It Covers: Claims arising from the release or threatened release of pollutants in connection with the development project: cleanup costs for soil and groundwater contamination; third-party bodily injury and property damage claims arising from pollution; regulatory compliance costs and government-ordered remediation; and transportation and disposal of hazardous materials. Site-specific pollution policies cover the specific project site for conditions existing before construction or conditions created during construction. Contractor's pollution liability covers a contractor's pollution liability arising from its construction operations.

What It Does NOT Cover: Pollution conditions that were known before the policy inception and were not disclosed (known prior contamination requires specific disclosure and may require a separate remediation cost cap policy). Pollution resulting from intentional illegal discharge. Gradual pollution where the release began before the retroactive date. Nuclear contamination.

When to Bind: Before any soil disturbance or construction activity begins on a site with potential environmental conditions. Phase I and Phase II environmental assessments should be conducted before site acquisition; if a Phase II reveals any recognized environmental conditions, pollution liability coverage is essential before construction begins. Even sites with no identified prior contamination should be evaluated, because historical industrial uses, underground storage tanks, and fill material from other sites create pollution risks that only become apparent during excavation.

Recommended Limits: Site-specific pollution: $1M to $5M per occurrence and $2M to $10M aggregate depending on site history and proximity to sensitive receptors (waterways, schools, residential neighborhoods). Contractor's pollution (carried by the GC): $1M to $2M per claim and $2M to $4M aggregate. The lender's environmental consultant may specify minimum pollution liability requirements as a condition of financing.

Key Policy Terms to Negotiate: Definition of pollutants (should be broad enough to include construction materials such as lead, asbestos, silica, mold, and fuels in addition to traditional chemical contaminants); retroactive date (should predate the company's acquisition of the site); site-specific versus contractor's pollution liability (understand which policy covers which party's exposure, since both are needed); and discovery provisions (the time period within which newly discovered pollution conditions are covered).

Most Common Mistake: Assuming that the GC's insurance program adequately covers the development company's pollution exposure. The GC's contractor's pollution liability policy covers the GC's acts; it does not cover pollution conditions that pre-existed construction or that arise from the developer's own decisions about site use. The development company needs its own site-specific pollution policy for pre-existing conditions.

ANNUAL ADEQUACY REVIEW. CONFIRM:

☐ Assessments. Have Phase I and Phase II environmental assessments been completed for all active project sites?

☐ Limits. Are pollution liability limits adequate given any newly discovered environmental conditions on active sites?

☐ GC coverage. Does the GC's contractor's pollution liability policy cover all construction activities with pollution exposure (demolition, excavation, fuel handling)?

☐ Vicinity changes. Have any changes in the site's vicinity (newly discovered nearby contamination, regulatory designation changes) altered the pollution risk profile?

Partner-Level Coverages

Partner-level coverages protect the founding partners individually and fund the company's buy-sell obligations upon specific triggering events. These coverages sit at the intersection of the company's governance documents and its insurance program: the buy-sell agreement (drafted by legal counsel) and the key-person life insurance policy (arranged by the insurance broker) must be coordinated so that the insurance proceeds are properly directed to fund the operating agreement's buyout obligations.

Key-Person Life Insurance (Buy-Sell Funded Life Insurance)

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Term Life Policy. Bind Before Operations Begin; Review Annually for Adequacy.

What It Covers: Death benefit paid upon the death of the insured founding partner. When properly coordinated with the buy-sell agreement, the death benefit funds the surviving partners' obligation to purchase the deceased partner's membership interest at the agreed valuation. Without the insurance funding, the surviving partners must find the purchase price from personal resources, third-party financing, or company distributions at the worst possible time.

What It Does NOT Cover: Disability (covered under a separate disability buyout policy if desired). Death by suicide within the first two years of the policy (most life insurance policies exclude suicide during the initial contestability period). Misrepresentation in the policy application (material misrepresentation about health history can void the policy at claim).

When to Bind: Before the company begins operations and before the buy-sell agreement is executed. The buy-sell agreement and the life insurance policy must be coordinated by legal counsel and the insurance broker together, so that the policy ownership, beneficiary designations, and the mechanism by which proceeds fund the buyout are consistent with the operating agreement's departure mechanics.

Recommended Limits: The face amount of each policy should equal the fair market value of that partner's equity interest at the time the policy is purchased, calculated under the valuation methodology agreed in the operating agreement. Review and update the face amount annually as the company's FMV changes. A company whose FMV has grown from $1M at formation to $3M two years later has an insured partner whose policy is $2M short of the buyout obligation, which is why annual reviews are essential.

Key Policy Terms to Negotiate: Policy ownership structure (the company may own the policies on each partner's life, with the company as beneficiary, and use the proceeds to purchase the deceased partner's interest; or each surviving partner may own the policy on the other partner's life under a cross-purchase arrangement; the choice has tax implications that must be evaluated with the CPA); beneficiary designations (must be consistent with the buy-sell agreement's funding mechanism); contestability period (the first two years during which the insurer can contest the policy for misrepresentation); waiver of premium rider (premiums are waived if the insured becomes disabled, which matters if the policy is owned by the insured partner).

Most Common Mistake: Purchasing the policies without coordinating with legal counsel on the ownership and beneficiary structure. A key-person life insurance policy with the wrong owner or wrong beneficiary may send the proceeds to the wrong party, creating a complex and expensive post-death dispute about who has the obligation to fund the buyout and who received the money to do so.

ANNUAL ADEQUACY REVIEW. CONFIRM:

- ☐ FMV. Has the company's FMV been re-assessed using the operating agreement's valuation methodology, and does each policy's face amount still equal each partner's current equity FMV?
- ☐ Ownership and beneficiary. Are the policy ownership and beneficiary designations still consistent with the current buy-sell agreement?
- ☐ Amendments. Has the buy-sell agreement been amended since the policies were issued? If so, have the policies been updated to reflect the amendment?
- ☐ In force. Are all policies in force and premiums current? (A policy that has lapsed for non-payment provides no benefit at death.)

☐ Disability funding. Should the company consider adding a disability buyout policy to fund the buyout upon a partner's permanent disability?

Disability Buyout Insurance

BIND BEFORE INVESTOR CAPITAL / OPERATIONS

Own-Occupation Disability Policy. Annual Review; Recommended for All Founding Partners.

What It Covers: A lump-sum or installment benefit paid when a founding partner becomes totally disabled and unable to perform the material duties of their occupation for a defined period (typically 12 to 24 months). When coordinated with the operating agreement's permanent disability departure provisions, the disability buyout insurance funds the surviving partners' obligation to purchase the disabled partner's membership interest at the agreed valuation, without requiring the company to fund the buyout from operating cash flow.

What It Does NOT Cover: Partial disability or short-term disability. Pre-existing conditions that were not disclosed at application. Disability resulting from self-inflicted injury, war, or criminal activity. Mental health conditions (some policies exclude or sublimit these).

When to Bind: Before operations begin if the company wants full disability departure funding from day one. At a minimum, disability buyout coverage should be in place within the company's first year, as the company's value grows and the unfunded buyout obligation increases.

Recommended Limits: The benefit amount should equal the fair market value of the disabled partner's equity interest, consistent with the operating agreement's disability departure valuation methodology. Disability buyout insurance is typically issued as a lump-sum benefit (the full FMV) rather than installments, which simplifies the funding of the buyout. It is subject to underwriting limits, since the maximum benefit per policy varies by insurer and the insured's income.

Key Policy Terms to Negotiate: Definition of total disability ('own occupation' is the most favorable: the insured is disabled if they cannot perform the material duties of their specific occupation, not just any occupation); waiting period (the elimination period before benefits begin, which should match the operating agreement's disability definition period, typically 12 to 24 months); benefit payment structure (lump sum versus installments, where lump sum simplifies buyout funding); and coordination with Social Security disability benefits.

Most Common Mistake: Skipping disability buyout insurance because disability seems less likely than death. In fact, the probability of a working-age professional experiencing a long-term disabling event is meaningfully higher than the probability of death during the same period. A partner who cannot perform their duties for 12 to 24 months creates the same operational disruption as a death but may not have the life insurance funding to resolve it.

ANNUAL ADEQUACY REVIEW. CONFIRM:

☐ FMV. Has the company's FMV grown beyond the disability buyout policy's benefit amount?

☐ Waiting period. Is it still consistent with the operating agreement's disability definition period?

☐ Health changes. Have any partner health changes occurred that should be reported to the disability insurer?

☐ Self-funding. Does the company now have sufficient AUM and financial health to fund a disability buyout from operating cash flow without insurance, reducing or eliminating the need for these policies?

Annual Insurance Program Review

The annual insurance program review is the single most important recurring insurance obligation for a development company. Insurance purchased at formation reflects the company's size, AUM, headcount, and risk profile at that point in time. As the company grows, the original coverage program becomes inadequate in ways that are not always visible until a claim reveals the gap. The annual review, conducted with the insurance broker each April or May to align with the typical policy renewal cycle, identifies and closes those gaps before they produce an uninsured loss.

Coverage	Primary Review Trigger	Action if Inadequate	Owner
☐ **D&O / Management Liability**	AUM growth; new LP relationships requiring minimum limits	Request endorsement to increase per-claim and aggregate limits; obtain competitive quotes from alternative insurers	*Insurance Broker*
☐ **EPLI**	Headcount growth; new operating states; prior-year claims	Increase per-claim limit; add new states; add wage and hour endorsement if payroll has grown	*Insurance Broker + HR*
☐ **E&O / Professional Liability**	New service lines; new client relationships; AUM growth	Expand the definition of professional services; increase limits if the largest single investor commitment has grown	*Insurance Broker*
☐ **CGL**	New office locations; increased site visit frequency; new lender requirements	Add new locations; add new additional insureds per lender or JV requirements; increase aggregate limit	*Insurance Broker*
☐ **Cyber Liability**	Growth in investor database; new technology systems; prior-year incidents	Increase limits; verify all required cybersecurity controls are maintained; add social engineering coverage if not present	*Insurance Broker + IT*
☐ **Workers' Compensation**	New hires; new states; payroll changes	Notify insurer of new states with employees; confirm payroll audit accuracy; update classification codes	*CPA + Insurance Broker*
☐ **Builder's Risk (each project)**	Construction cost inflation; approved change orders; schedule delays	Endorse policy to increase limit if total project budget has grown; extend policy period if the project is delayed	*Project Manager + Insurance Broker*
☐ **Key-Person Life Insurance**	Company FMV growth; partner health changes; buy-sell agreement amendments	Increase face amount of each policy to match current partner equity FMV; confirm policy ownership and beneficiary consistency with the buy-sell agreement	*Insurance Broker + Counsel*
☐ **Disability Buyout**	Company FMV growth; partner health changes	Increase benefit amount if FMV has grown; confirm waiting period matches the operating agreement's disability definition	*Insurance Broker*
☐ **Contractor / Subcontractor Requirements**	New contractors on active projects; contract renewals; change	Collect updated certificates of insurance from all active contractors; verify additional	*Managing Partner / Project Manager*

Coverage	Primary Review Trigger	Action if Inadequate	Owner
	orders adding new scope	insured and primary/non-contributory endorsements	
☐ **Pollution Liability (project-level)**	New Phase I/II findings; expanded project scope near contaminated areas	Endorse existing policy or bind new coverage for newly identified conditions; confirm the GC's contractor pollution liability is current	*Insurance Broker*

SELECTING THE RIGHT INSURANCE BROKER

The insurance broker relationship is as consequential to the company's insurance program as the CPA relationship is to its accounting. A generalist broker who covers a broad range of commercial insurance clients may not have the specific real estate development company expertise needed to design a program that addresses all the company's exposures, negotiate the most favorable policy terms, or identify the gaps that produce uninsured losses.

The founding team should look for a broker with specific experience placing D&O and EPLI for private real estate development and investment companies; relationships with insurers that write Builder's Risk and project-level pollution liability for ground-up development; familiarity with the insurance requirements that institutional LP investors and construction lenders typically impose; and a demonstrated practice of conducting structured annual program reviews rather than simply renewing existing policies without assessment.

The broker's compensation (typically a commission from the insurer, not a fee from the company) is built into the premium, so engaging a qualified specialist broker does not cost more than engaging a generalist. The cost difference between adequate and inadequate coverage only becomes apparent at the time of a claim.

End of Appendix I