

Drafting Preferred Return and Other Waterfall Provisions in Real Estate Operating Agreements: Best Practices for Lawyers and Investors

In the Dirt: A Real Estate Legal Update

By Joseph Tierney IV on February 10, 2026

Preferred return and waterfall provisions are the backbone of economic alignment in the operating agreements that govern real estate joint ventures. Whether structured around Internal Rate of Return (“IRR”) hurdles or equity multiple thresholds, these clauses dictate how distributions are made between investor members (who are often called “limited partners” or “LPs” in a nod to their tax treatment as partners), and sponsors or managers (usually members, but sometimes just managers, but for the purpose of this article “sponsors”). Poor drafting can lead to confusion, misaligned incentives, disputes, and costly litigation, so understanding effective drafting techniques is crucial.

Approaches to Drafting

As a threshold issue, it is important to understand some distinctions in drafting approaches. Operating agreements tend to focus on a mix of benchmarks and agreements between the LPs and the sponsors that are used to create a process, often called a waterfall, for addressing distributions.

A key decision in benchmark drafting is whether to use an IRR or equity multiple approach. IRR measures the time-weighted return on invested capital. It is typically tiered (e.g., 8%, 12%, 16%) with escalating “promote” splits which determine how the LPs and sponsors share the distributions. IRR is most often used in short- to medium-term deals where timing of cash flows is critical. Equity multiple-based waterfalls look at total cash returned divided by total cash invested. This approach is usually tiered based on multiples of the equity contributed (e.g., 1.5x, 2.0x, 2.5x). Equity multiples are most often used for long-term deals where total return matters more than timing. Many deals use both IRR and equity multiple hurdles to balance short- and long-term performance.

As part of these waterfalls, LPs will often be granted some form of “preferred return” on their initial investment. These returns may be shaped in a variety of manners, but most often are described as follows:

- **Cumulative Preferred Return.** Any unpaid returns roll over to future years until paid. This ensures LPs eventually receive their full entitled preferred return ahead of other parties, including the sponsors.
- **Non-Cumulative Preferred Return.** The unpaid returns do not carry forward. If the project underperforms in a given year, that year’s return is forfeited.
- **Compounded Preferred Return.** Unpaid returns are added to the principal and future returns accrue on this higher base. For example, if \$8,000 is unpaid in Year 1 on a \$100,000 investment, Year 2 return is calculated on \$108,000.
- **Non-Compounded Preferred Return.** Unpaid returns accrue but do not increase the principal. For example, Year 2 return is still based on the original \$100,000, even if Year 1 was unpaid. Since a cumulative preferred return functions the in the same manner as a non-compounded preferred return, the latter term is typically only used when other types of preferred returns are present in the operating agreement. Preferred returns are usually set by the sponsor when developing the investment opportunity.

Preferred returns can also be modified to declining or sunseting. In this case, the preferred return decreases over time to potentially zero and/or has sunsets when certain events or benchmarks are hit. Each payment of the preferred return reduces the amount on which the preferred return is granted. In our example, the payment in Year 1 of \$8,000 would mean that the Year 2 return is only \$7,360 as the 8% would only be paid on the remaining \$92,000.

Best Practice for Drafting Waterfall Provisions

CLEARLY DEFINE KEY TERMS

In any drafting situation, it is crucial to clearly define the key terms. Avoiding ambiguity in terms that could lead to conflicting interpretations, especially in placement memorandums or other documents provided to investors, will prevent confusion and litigation in the future. Key areas that often require explicit definitions include:

- **Preferred Returns:** Define your accrual mechanics, indicate whether the preferred return is cumulative and/or compounded, and identify the timing of accrual (e.g., monthly, quarterly, annually).
- **Capital Return Priority:** State whether LPs receive full return of capital before any promote is paid. A common miss is the failure to include provisions for partial capital return in refinancing scenarios.

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- **Sponsor/Investor Catch-Ups:** If the a party is entitled to a catch-up after preferred return, define the percentage and mechanics clearly.

BE SPECIFIC

Waterfall provisions benefit from specificity to ensure everyone understands how and when distributions will be made.

Drafters should use tiered structures with clear thresholds. When using IRR approach, define each hurdle and corresponding profit split. When using an equity multiples approach, specify the multiple thresholds and splits.

It is also important to match the project's financial model. Working with the client and/or it's accounting team ensures the waterfall aligns with the pro forma and cash flow projections and using formulas, tables, and examples to clarify the language reduces the risk of misunderstandings.

Consider also what types of cash flow you are discussing—capital events, refinancing, cash flow, liquidation. Many projects protect LPs by including clawback language, which require the return of excess promote if final returns fall short. Consider whether this is appropriate for the project and, if used, work to model the clawbacks as well.

Finally, provisions should also be reviewed for any ambiguity about when distributions are made (e.g., quarterly, annually, at exit) . It may also be appropriate to include provisions for interim distributions and holdbacks in certain scenarios, such as substantial capital improvements, parties who have not met capital contribution obligations, or expansions.

Confirm Practical Details

Beyond mechanics, drafters should always confirm practical details as well. Examples include:

- Define when capital is deemed contributed (e.g., wire date vs. agreement date) and align the contribution with preferred return accrual start date. If there is a delay in the start of accrual, call that period out.
- Review the "standard" tax provisions and make sure capital account maintenance reflects the chosen waterfall economics or otherwise coordinate tax allocations and section 704(b) compliance.
- Confirm that profit/loss allocations are aligned with economic distributions to avoid mismatches that could trigger unintended tax consequences.

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PLAN FOR POTENTIAL CHANGES

Change in the parties to an operating agreement also present challenges to drafting the economic and waterfall provisions. Drafters should consider how transfers affect waterfall entitlements and promote eligibility, if at all. If a sponsor is removed or replaced, what are the consequences for the waterfall, preferred returns, or promote? Should the benchmarks (IRR hurdle, equity multiple, split) change? Finally, drafters and the client should model and define how final distributions are calculated and reconciled, including audit rights and reconciliation procedures.

MODEL FIRST, DRAFT SECOND

Effective drafting is a collaborative process between lawyers, sponsors, LPs, and other professional advisors to ensure the document reflects their shared understanding and intent. As a best practice, parties should “model first, draft second.” Building a financial model before drafting the waterfall usually leads to better results, especially if a summary of the model is provided to the drafter. Parties should model early exit, delayed return, and refinancing scenarios to test waterfall behavior.

Conclusion

Preferred return and waterfall provisions are more than just economic terms—they’re the foundation of trust and alignment in partnerships. Whether using an IRR or equity multiple approach, precision in drafting and coordination across the operating agreement are essential. By following these best practices, lawyers and investors can avoid costly disputes and ensure fair, transparent profit sharing that will bring investors back.

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