Adding Preferred Equity After the Senior Loan Closes

Sometimes, the closing timeline for a transaction dictates that the senior loan must close prior to the preferred equity close. There can be several reasons for this, including sponsors making the decision to add preferred equity later in the deal, leaving not enough time for due diligence; moving the estimated close date for the senior loan up; and delays in diligence. Once the preferred equity provider notifies the sponsor that they will be unable to close simultaneously with the senior loan, the loan documents and preferred equity documents will need to be modified to allow for later entry of preferred equity.

Potential Causes

The most common reasons for post-close addition of preferred equity include delays in the due diligence process. This can range from third-party reports taking longer than expected to be completed to a shortened timeline because a sponsor makes the decision to add preferred equity late in the game. Preferred equity providers will make every effort to meet the senior lender's targeted closing date regardless of delays, but sometimes there just isn't enough time. In those cases, there must be a conversation among the lender, sponsorship and preferred equity provider around the possibility of a post-close entry.

If all parties agree to the late entry, legal documents must be modified to lay out a path towards closing.

Changes to Senior Loan Documents

Once the senior lender has approved the addition of preferred equity post-close rather than simultaneous with its closing, the loan documents will need to be modified accordingly. This can involve language in the senior loan agreement's approved transfers section allowing the addition of the specific preferred equity provider within a certain amount of time post-close.

Another modification that lenders may require is around changes to the organization chart. When the senior loan closes, the organization chart will not show the preferred equity structure. The senior lender likely will require a new organization chart which shows the addition of the preferred equity and be approved before giving consent to the addition of preferred equity post-close.

Changes to Preferred Equity Documents

Much like the senior lender will need to modify its documents to account for the post-close entry of preferred equity, the preferred equity provider will modify the language in its own documents. The operating agreement between the sponsor and the preferred equity provider likely will include language meant to cover its investment in case the proposed addition does not happen by a certain date or is not approved by the senior lender. Depending on how much later the preferred equity closing will be than the senior lender's closing, the preferred equity provider may also have to adjust its underwriting and the language containing the deal terms in the governing documents.

Changes to Common Equity

Because the closing will not involve funds from the preferred equity provider, the sponsorship must be able to fund the necessary common equity when the senior loan closes. If the sponsor can cover the equity until the preferred equity is able to close, they likely will use some or all the preferred equity, once it is added, to pay the common investors down. This means that the sponsor's legal documents will have to provide both for the initial closing with the senior lender as well as any adjustments within their own waterfalls.

What It All Means

If a sponsor finds itself in the position of needing to close a senior loan and bring in preferred equity post-close, it will take negotiation with all parties involved to accomplish this change. All the negotiations and document modifications need to be made prior to the senior loan's closing, so they will have to take place quickly and simultaneously. If each party can modify its documents to allow for the post-close addition of preferred equity, it can prevent a deal from falling apart. Sponsors should keep in mind that lenders and preferred equity providers may not always be willing or able to accommodate this structure but that it is an option worth considering before having to pull out of a transaction.