Emily Fuller, Deborah Low, Ellen McGinnis, Emma Russell in PrivateEquityWire: Shariah in the Spotlight IV: Fund Finance

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If an investor in a private equity fund is subject to Shariah, or committed to making ESG investments, then such investor might seek to be excused from participating in certain investments that are non-compliant with its investment guidelines. In the context of fund finance, such restrictions can pose problems for lenders, as in capital call facilities the lender is providing short term liquidity for the fund to acquire investments that is backed by the unfunded capital commitments of the fund's investors, and, frequently, loans are advanced when the investment is first made without a simultaneous capital call and opportunity for investors to review and, potentially, raise excuse rights with respect to, the investment.

If an investor later rejects the investment, unless the investor has made further agreements for the protection of the lenders (for example, that the investor will not exercise its excuse right for a capital call made the purpose of repaying debt), the lenders may not have recourse to the unfunded commitment of that investor for repayment. In order for the lender to get comfortable lending against the capital contributions of a fund's investors, the lender will seek assurances (which are often contained in the fund's partnership agreement) that the investor is obligated to fund its capital contribution without defence.

Therefore, if the lender advances loans for the purposes of acquiring an investment and an investor has a defence to its obligation to fund its pro rata share of such investment, then the lender may be left with a shortfall in the available capital contributions needed to repay loans made to acquire such investment.

In order to mitigate these risks, if a fund is looking to include unfunded capital of either a Shariah-compliant investor or an investor with a strict ESG investment policy in the calculation of its borrowing base, the lender will need to perform additional diligence to understand the investor's investment limitations, get comfortable that the fund will not invest in prohibited investments, and build out provisions of the loan documents that enable the lender to exclude all or part of the investor's capital commitment from the calculation of the borrowing base with respect to any prohibited investment, or, to include it with the proper structure and assurances.

Excerpted from *PrivateEquityWire*. To read the full article, click here.

This article is the fourth part of a series.