The Legal 500 Country Comparative Guides

Jersey: Private Equity

This country-specific Q&A provides an overview of private equity laws and regulations applicable in Jersey.

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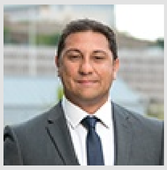

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1. **What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?**

   An increasing number of transactions including both those arising from the Jersey regulated financial services M&A market and also where Jersey vehicles are utilised for outbound investment involve financial sponsors as buyer or sellers. Transactional activity and trends in Jersey tend to follow market activity levels in the UK (London) and Europe. Financial sponsors acquiring have looked to put investor capital to hard work through both conventional downstream buyout strategies and more innovative transactions such as, for example, GP stakes deals. The mid-market landscape has been the most competitive and possibly overcrowded segment of the global private equity ("PE") market in recent years.

   Domestic market activity in Jersey is dominated by PE and other financial sponsor involvement in financial services sector M&A. This has primarily taken shape via a steady series of primary and secondary investments in fiduciary and corporate service providers, banks and wealth and asset management firms. Market consolidation has occurred in this sector as a result of bolt-on acquisition activity undertaken as part of directed M&A strategies, some trade sale transactions and also IPO activity. Global banking businesses with a Jersey footprint also provide non-core business carve out opportunities for PE and other financial sponsors in the local fiduciary and corporate services market.

   Separately, a sustained use of Jersey vehicles by leading PE sponsors investing in larger scale primary cross-border deals across 2019 and 2020 has seen the most significant sector growth in infrastructure and, in particular, in the following asset sub-classes:

   - Biotech
   - Broadband internet service provision
   - Refuse and recycling
   - Midstream O&G
   - Transport and motorway services

   Very few Jersey GP stakes deals have been slated. We expect that these types of transactions, where larger financial sponsors acquire economic interests in smaller or mid-market PE sponsors in return for access to ready sources of permanent capital, will become more popular in Europe and the United Kingdom, as they are in the United States, in the next 12 to 18 months.

2. **What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?**

   Exit method and consideration structure are the main differences in M&A transaction terms in which trade sellers and financial sponsors participate. Private equity sellers require clean exit and divestment flexibility whether that involves secondary or tertiary activity, IPO or a trade sale route. Locked box consideration structures provide pricing certainty at signing by ensuring cash, debt and working capital are known (fixed) amounts at the locked box date thereby preventing leakage by various forms of value extraction from the target business after the locked box date which benefits the seller.

Jersey financial services sector businesses required to maintain prescribed regulatory capital are increasingly structured using locked box consideration mechanics. This is to avoid leakage arising as a result of fluctuation in the amount of regulatory capital required to be held in a particular business. Regulatory capital requirements can vary significantly depending on a range of applicable factors.

The less frequent usage of locked box structures in trade sale transactions can be attributable to most trade sales involving asset separation or carve-out elements which mean a locked box mechanism will not work.

Conventional seller warranty cover packages are increasingly replaced by buyer Warranty & Indemnity (W&I) insurance in both PE and trade sale transactions. Management are frequently looked to in PE deals to ‘stand behind’ businesses by giving substantial business warranties. A trade seller will normally give both fundamental and business warranties, particularly where management are unlikely to derive significant value from the transaction.

3. **On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?**

On an acquisition, the legal process for effecting the transfer of shares involves shares in certificated form being transferred by an instrument of transfer, most commonly a stock transfer form. A resolution of the board of directors of the Jersey private company will also need to have been passed to record the approval of the transfer by the directors. It is key in Jersey that the register of members, which is conclusive as to ownership, is updated by the Jersey company secretary who will maintain the register of members. Share certificates are both cancelled and issued to members.

No stamp duty is payable on the transfer of shares in a Jersey private company, and there is no corporation or capital gains tax in Jersey. As no stamp duty is payable on the transfer of shares, shares should not be subject to tax / stamp duty on future disposal.

4. **How do financial sponsors provide comfort to sellers where the purchasing entity is a special purpose vehicle?**

In larger cross-border transactions involving Jersey acquisition holding entities, delivery of equity commitment letters at signing is used to provide contractual certainty of funds and give sellers comfort that the sponsor funds will fund the equity financing portion of the purchase price. Performance guarantees built into the sale and purchase agreement are not common in transactions involving financial sponsors but are insisted upon fairly frequently in trade sale transactions.

5. **How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?**

As mentioned in Question 1 above, the use of locked-box consideration structures in Jersey PE transactions is not predominant but is increasing. The specific and unique features of each separate transaction generally drives whether completion accounts or a locked-box consideration mechanic is employed. Levying interest charges on any value leakage that is not permitted leakage is not common or market standard in Jersey.

6. **What are the typical methods and constructs of how risk is allocated between a buyer and seller?**

Financial sponsor sellers seek to reduce the allocation of risk to them in a transaction through limiting liability, warranty protection as well as certain other protections in the acquisition documentation.

The process of limiting liability is a way of allocating risk. The main ways a PE seller will look to limit liability include negotiating:

- Caps on financial exposure;
- Time periods by which claims can be made (e.g. 12 to 24 months);
- De minimis claim levels (individual and aggregate);
- Regulation of the conduct of a dispute regarding a breach of warranty or any third party claims; and
- Obligations on buyers to mitigate loss suffered.

Warranty Protection

Warranty coverage in PE transactions in Jersey is generally limited to title of target shares or assets, capacity and authorisation to enter into the transaction, solvency and accuracy and completeness of information provided to the buyer. Warranties are usually limited in duration to a 12 to 24 month claim period. Please note Question 2 above regarding W&I.

Protections in Acquisition Documentation

Earn-outs, lock-ins and price adjustment provisions are often negotiated as part of the management specific terms of an acquisition agreement. A tax covenant and deed of indemnity is also a relatively common feature and further allows the allocation of risk as between buyer and seller.

A general observation is that in Jersey, market practice is a more powerful driver in respect of the allocation of risk between parties to a PE acquisition transaction than the type or nature of the parties involved. For example, numerous fiduciary and corporate services businesses in Jersey have been the subject of primary PE investment as well as secondary and tertiary management buy-outs ("MBO") and management buy-ins ("MBI"). In the majority of these deals, it is common that risk is shared between the parties, although on balance, PE sellers prioritise minimising their exposure to liability in the sale of a portfolio company. The impact is that the extent to which PE sellers assume ongoing liability in a divestment is very limited. On buyer-insured transactions where W&I is put in place, nominally capping seller liability will result in only theoretical risk for PE sellers.

7. **How prevalent is the use of W&I insurance in your transactions?**

Please see Question 2 above: buyer W&I insured deals are increasingly common following the trend in the UK and elsewhere. W&I coverage increases the relatively low level of protection which management teams are able to provide and which PE sellers are not prepared to consider. The additional diligence and input from a seller on an insured deal is often accepted as necessary from a buyer's perspective. The cost of insuring known risks is generally prohibitive, and so, is less common.

8. **How active have financial sponsors been in acquiring publicly listed companies and/or buying infrastructure assets?**

Public-to-private transactions (also known as take-privates) are not common in Jersey from a domestic utility or infrastructure asset point of view. There are very few domestic businesses in Jersey which are publicly listed. However, as many internationally focused Jersey companies are listed on stock exchanges throughout the world, including the main board of the London Stock Exchange and increasingly North American stock markets, such as NYSE, NASDAQ and TSX, a number of those listed companies have become targets in take-private transactions in which PE sponsors are active.

9. **Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?**

Apart from obtaining mandatory Jersey government and / or regulatory authority consents in financial services, healthcare and energy transactions, no other controls apply to financial sponsors.

10. **How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?**

Obtaining domestic competition (anti-trust / merger) clearance in Jersey is usually addressed in favour of the seller in the sale and purchase agreement. Conditionality is standard in PE and other financial sponsor acquisition transactions where matters like merger clearance are not within the bidder’s control or dependent solely on the bidder’s subjective judgement.

It is not common in Jersey transactions that are subject to merger clearance to have a PE-backed buyer agree to ‘hell or high water’ provisions. Agreements to absolute obligations of this kind, which may result in divestitures or require certain outcomes in the context of pending litigation, are more common in a public merger and acquisition context and possibly where Jersey investment acquisition vehicles / platforms are present but not regarding domestic businesses.

11. **Have you seen an increase in the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside?**

Most PE deals undertaken by financial sponsors in Jersey involve complete or significant majority / controlling PE sponsor ownership. However, on larger cross-border deals involving Jersey PE acquisition vehicles, co-investment structures are an increasingly popular way to syndicate the equity contributions to be made. PE fund investors investing alongside the sponsor as a passive co-investor (on a no carry, no fee basis) is increasing in frequency. Larger infrastructure consortium transactions commonly involve a series of investors none of whom will retain a controlling interest.

12. **How are management incentive schemes typically structured?**

Unsurprisingly, incentivisation of management teams is a key feature of PE transactions in Jersey and those that involve Jersey registered vehicles. Different drivers and expectations from both PE sponsors and management team come into focus where the market is moving to a more ‘patient capital’ model, compared to shorter hold periods typically associated with PE, i.e. in the seller friendly landscape of the last five or six years. Up to 10% of equity participation by management is common but certain and more entrepreneurial management teams have been able to command a higher proportionate equity ownership share.

There are a number of different ways of structuring management participation in PE transactions in Jersey. It is common that managers subscribe for sweet equity on primary investments and for part of the institutional strip on secondary buyouts where managers roll over on the same terms (and equity to debt ratio) as the PE sponsor. Preference shares (disenfranchised as to voting / any blocking trigger) are also used as the following arrangements where incentivisation is planned for a larger number of managers / executives:

- Long-term incentive plans
- Share options plans
- Management incentive plans
- Deferred share plans
- Joint ownership equity plans

13. **Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?**

No. Generally speaking, management incentive structures ("MEPs") established in Jersey, providing it has no Jersey or Guernsey resident beneficiaries, can accrue income and capital value, free from domestic tax. However, the tax treatment of MEPs including contributions to and benefits received from MEPs is usually very relevant to the financial sponsor and management / executives. For this reason, onshore rules (and in particular, those in the United Kingdom and the United States) on employment related securities should always be considered when structuring equity incentives for UK / US management.

14. **Are senior managers subject to non-competes and if so what is the general duration?**

Non-compete clauses are one kind of customary restrictive covenant agreed to by management in PE transactions in Jersey. However, such covenants are unenforceable unless they are reasonable as between the parties and in respect of the public interest. Duration is dependent on context.

15. **How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?**

Where PE sponsors hold a majority ownership position in a portfolio company asset, they normally enjoy significant veto rights over major corporate, commercial and financial matters pertaining to the portfolio company business, although thresholds are commonly set to ensure that day-to-day decisions can be taken by management. In other words, management will have operational control of the business whereas PE sponsors will have oversight and ultimate influence over management by being able to control the board of the holding company of the portfolio business.

Management business operation and PE sponsor control rights are regulated in a shareholders' agreement that governs their relations as shareholders in the portfolio company. This will likely include, among other provisions:

- Covenants from management with regard to the conduct of the business of the portfolio company;
- Extensive veto rights for the PE sponsor;
- Restrictions on the transfer of securities in the portfolio company; and
- Provisions regarding further issuances of shareholder equity / debt.

In addition, the constitutional documents may include governance arrangements, particularly with regard to the transfer of shares. The extensive veto rights in favor of PE sponsors will typically be split between director veto rights and shareholder veto rights. Such veto rights (or reserved matters) would include amendments to the capital structure, constitutional documents, entering into, amending or terminating material contracts, changing the nature of the business or entering into new business lines, and commencing or settling litigation.

In a minority PE investment, given the PE sponsor is unlikely to have board control, it is usually much more focused on veto controls to the extent that, in certain cases, a minority investment may result in more veto control than might be the case in a majority investment.

16. **Is it common to use management pooling vehicles where there are a large number of employee shareholders?**

Pooling of management shares or interests in a separate vehicle is not common where there are a large number of employee shareholders. What is more common is requiring management shareholders to hold their shares via a nominee vehicle such as a professional trustee acting as trustee of an employee benefit trust or similar. Nominee holding in this way gives rise to an efficient invocation of drag-along provisions thereby preserving a clean exit path or route for the PE sponsor.

17. **What are the most commonly used debt finance capital structures across small, medium and large financings?**

Senior secured bank debt supported by a revolving credit facility for working capital purposes and additional mezzanine or layered (second lien) debt to extend leverage across the spectrum of small, medium and large capital financings are usual where Jersey vehicles feature as part of the acquisition structuring. Where a domestic concern is involved, a scalable model of this combination is usually employed.

For more significant private equity financings the external bank debt referred to above will usually be structured as a ‘bridge to bond’ facility where the buyer requires the certainty of a fully committed financing package, but which is intended to be replaced in the future with a mid-to-long-term financing in the form of high yield bonds. Availability and pricing of high yield leverage is wholly dependent on global capital markets investor appetite.

Small to mid-cap leveraged transactions are primarily financed with secured external bank debt which, in recent times, has been challenged by the offer of a wide range of tailored unitranche loan products from alternate credit providers, including the credit arms of PE sponsors themselves. The hybrid nature of unitranche facilities (bilateral debt obligations structured in bond-like fashion) has proved increasingly popular amongst mid-market PE sponsors.

18. **Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?**

No. There is no prohibition in Jersey against a company giving financial assistance for the acquisition of its own shares, although if such assistance amounts to a distribution of assets by the company it may need to be sanctioned as such. However, it is highly unlikely in either event that there would be any impact on debt financing arrangements.

19. **For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?**

Top sponsor transactions usually involve sponsor counsel preparing and issuing bespoke sponsor-approved credit and collateral documentation as a starting point. This is becoming more frequent just as the Loan Market Association ("LMA") form precedent documentation, while providing a useful reference point for boilerplate, can no longer be said to be represent the industry standard in leveraged financial sponsor transactions.

Where the financial sponsor and credit counterparties have an existing relationship, more material negotiation is likely to arise with regard to deal specific nuances or anomalies which have not previously been encountered and this is the only basis upon which most top sponsors will entertain negotiation of their 'standard' precedent documentation.

20. **What have been the key areas of negotiation between borrowers and lenders in the last two years?**

The breadth and scope of both collateral-specific and non-collateral specific representations, warranties, covenants and undertakings are pertinent areas of negotiations between borrowers and lenders in the last two years. Similarly, bespoke excluded assets concepts, the definition of EBITDA(C19) and the ability to incur incremental debt on a senior secured, junior secured or unsecured basis, have all been hot topics. A noticeable increase in, and the presence of, more covenant-lite credit arrangements has become a market feature in the last two years.

21. **Have you seen an increase or use of private equity credit funds as sources of debt capital?**

While an alternate strategy for PE to their 'main' buyout business activity, PE credit funds have successfully disrupted the established UK and European market for leveraged debt capital products. It is no longer fair to assume that a PE credit fund's focus is lower mid-market financing mandates and transactions. Where bank lenders hold the keys to know how in respect of structuring their businesses to provide short-term limited partner investor settlement disparity (bridge) funding, PE credit funds have been permitted to participate in bank fund financing syndicates to provide capital solutions and also 'learn the ropes' of the leveraged credit business originate and distribute model.