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Guernsey: Private Equity

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The aim of this guide is to provide its readers with a pragmatic overview of the private equity law across a variety of jurisdictions.

This chapter of the guide provides information about the current issues affecting private equity practice in Guernsey and addresses topics such as mergers and acquisitions, management incentive schemes and debt financing, as well as insight and opinions and any upcoming legal changes planned.

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

M&A transactions in Guernsey tend to fall into two broad categories: (1) large cross-border or international transactions, commonly involving the United Kingdom, the United States or other international financial centres, in which either the acquirer or the target group have a Guernsey element within a wider corporate structure, and (2) local M&A deals in which a Guernsey-based and operating business is acquired by an acquirer with an existing Guernsey business or by a new entrant from outside the jurisdiction.

Precise data on M&A transactions in Guernsey is not easily available, but in our experience a very significant majority of international transactions with a Guernsey element involve financial sponsors, either as buyers or sellers. In respect of the local M&A market, a significant number of financial sponsors have acquired or invested into Guernsey-based service providers in the past 10-15 years, particularly in the financial services sector which is a leading industry for the island.

While there has been significant consolidation in the local financial services sector in recent years, and a corresponding reduction in the number of attractive target companies, there are still cases of financial sponsors acquiring or investing into independent/manager-owned service providers. The more notable recent transactions in this sector have included Genstar Capital-backed Apex Group acquiring Sanne Group PLC (a Jersey company with significant Guernsey operating companies), Palatine Private Equity-backed Suntera acquiring Carey Commercial, Warburg Pincus becoming a strategic partner and minority shareholder of Aztec Group, and Cinven acquiring a majority stake in Alter Domus.

Financial sponsors acquiring or investing in a business will commonly have all or part of their acquisition "stack" of companies incorporated in an international financial centre. Guernsey will commonly be used for these purposes where the underlying business or structure has a connection with Guernsey, but may also be used whether there is no such connection, such as with the sale by Mayfair Equity Partners of the holding structure for the brands Yo! Sushi, Snowfox, Bento and Taiko. This is driven mainly by the appeal of Guernsey company law, which adopts a familiar English company law-based system but with additional flexibility, especially in relation to distributions and returns of capital, plus the absence of transfer taxes. Guernsey companies can also offer tax neutrality (though most private equity acquisition stacks are tax resident onshore).

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?

Differences in transaction terms tend to track those seen in other jurisdictions, especially in England and Wales. Such differences are largely the result of financial sponsor sellers needing to achieve a "clean exit" from the asset following a disposal, in order to return capital to their LPs. As in other jurisdictions, the warranties given by trade sellers and financial sponsor sellers differ, with sponsors commonly giving only title and capacity warranties (with management giving business warranties and bearing the risk of any claim under such warranties, normally backed by W&I insurance), whilst trade sellers will usually give more comprehensive warranties. Financial sponsor sellers also tend to insist on locked-box pricing mechanisms, with completion accounts mechanisms being seen only where the seller is a trade seller, and even then fairly infrequently where there is a sponsor buyer.

It is worth noting however that in the local Guernsey M&A market there is a less of a delta in transaction terms as between those involving a trade seller and those involving a financial sponsor. Risk allocation as a whole tends to be more seller friendly in Guernsey, which can be attributed to the more limited number of suitable target companies in the jurisdiction.

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

A transfer of shares is typically effected via a stock transfer form, signed by the transferor (and if the shares are not fully paid, also by the transferee). Shares are transferred to the transferee at the point at which the transferee is entered into the register of members of the relevant company. Completion board minutes of the transferor will typically approve the transfer and execution of the stock transfer form, while completion board minutes of the target will approve the registration of the transfer. Whilst not obligatory, a share certificate may be issued to the transferee following the transfer, with the transferor's share certificate being cancelled.

No stamp duty is payable on a transfer of shares of a Guernsey company. The sale of an entity with rights over Guernsey real estate can give rise to a property document charge aimed at capturing the transfer of enveloped properties. Various exemptions apply, including if the target company operates its business from the relevant premises.

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

Comfort is commonly provided via equity commitment letters, debt commitment letters and other funding undertakings that create binding obligations on the relevant parties to fund the

special purpose vehicle for the acquisition. Equity commitment letters and other such instruments are generally only seen on transactions where a financial sponsor buyer or seller is using a Guernsey acquisition stack, with local M&A deals generally not being of the size to warrant their use.

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

As mentioned above, locked box mechanisms are used in almost all transactions involving financial sponsor sellers or buyers, with the terms of the mechanism mirroring those seen in the jurisdiction where the relevant financial sponsors involved in the transaction are based, commonly the United Kingdom or the United States. As in other jurisdictions, the price certainty and clean break afforded by using such mechanisms is the primary reason for their use.

Local Guernsey M&A transactions more commonly feature completion accounts mechanisms, with accurate valuation and determination of consideration being favoured over price certainty in this context.

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

Terms concerning pricing and payment of consideration are the primary methods of risk allocation. The price agreed in relation to an asset will reflect the risks that are being acquired with it. As referred to above, locked box mechanisms – where a price for an asset is agreed at signing based on a specified set of financial accounts, with no further adjustment to that price permitted unless any "leakage" (against which the buyer is indemnified) occurs – are the most common.

Mechanisms concerning how and when the purchase price is paid are also used to allocate risk. Most deals involving a financial sponsor buyer or investor include some element of deferred consideration or earn-out. Deferred consideration mechanisms often include a right to set-off any warranty claims against any outstanding deferred consideration or earn-out payments due, and claw-backs are on occasion seen.

Many sponsor-backed acquisitions and investors also include some degree of manager and, less frequently, seller participation in the acquisition structure (either by way of roll-over or buy-in). This not only acts as a performance incentive but also shifts some of the risk to the management team and/or seller.

Warranties and indemnities also play a critical role in risk allocation. However, we are seeing a move away from buyers insisting on specific indemnities in relation to material identified issues or risks in favour of price- and consideration-based risk allocation of the types mentioned above, or remediation being included as a condition precedent to completion.

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

International transactions with a Guernsey element will commonly feature the use of W&I insurance, as is the norm elsewhere. W&I insurance is not standard market practice for local Guernsey M&A transactions, with the size and risk profile of those transactions often not warranting the use of such policies, but is increasingly becoming accepted for the more significant local M&A transactions.

How active have financial sponsors been in acquiring publicly listed companies?

Guernsey is the second most common domicile for entities listed on the London Stock Exchange (second only to the UK) and so the jurisdiction has experienced a surge in the acquisition of publicly listed Guernsey companies in recent years, in line with the trend in the London markets generally. Such entities have been seen as comparatively undervalued on the public markets and as being especially attractive to US acquirers given the strength of the dollar against the pound. A number of the recent public M&A transactions in Guernsey have involved sponsors or sponsor-backed companies. Examples include the Apollo-backed acquisition of Round Hill Music Royalty Fund and Blackstone's acquisitions of Industrials REIT Limited and Hipgnosis Songs Fund Limited. All of these transactions were effected by way of a Guernsey-law scheme of arrangement.

It is worth noting that the UK City Code on Takeovers and Mergers applies to offers for Guernsey-registered companies where any of that company's securities are admitted to trading on a UK regulated market, UK multilateral trading facility or any stock exchange in the Channel Islands or Isle of Man, and in other specific circumstances.

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?

Guernsey does not have any foreign direct investment controls or other governmental consent requirements outside of anti-trust and heavily regulated sectors. For local operating business, to the extent local regulatory consents are required, those requirements apply equally to all types of acquirers and investors.

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

Merger clearance in Guernsey is regulated by the Guernsey Competition & Regulatory Authority (GCRA). A turnover threshold test is used to determine whether consent is required for a transaction, based on turnover arising in Guernsey and the Channel Islands. If the acquirer and the target (together with their respective connected undertakings) each meet the relevant turnover threshold tests, prior approval from the GCRA must be obtained before the transaction can be completed.

Completing a transaction without any required approval is an offence and the transfer of any Guernsey situs assets (including shares in Guernsey companies) is void (i.e. Guernsey's anti-trust regime is mandatory, and cannot be "closed over").

The seller and the financial sponsor will usually agree on whether clearance from the GCRA is likely to be required, with clearance being included as a condition precedent to completion in the transaction documents. A mutual obligation on each of the parties to cooperate towards obtaining the clearance will also be included, with parties typically applying for clearance jointly.

Have you seen an increase in (A) 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; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

Consistent with global trends, Guernsey has seen an increase in both minority investment and continuation fund transactions. Minority investments have tended to be structured as equity investments, with a number of high-profile minority investments being made in recent years, including Warburg Pincus's investment in Aztec Group.

Continuation fund transactions have also seen a marked increase, reflecting a growing need for portfolio companies to provide liquidity to LPs. Guernsey is a key fund domicile for such continuation funds and is often used irrespective of whether the portfolio company has any connection with Guernsey. Intra-portfolio transactions have also featured, where one portfolio company held by a financial sponsor is transferred to another portfolio company of that sponsor.

How are management incentive schemes typically structured?

As in the UK and other jurisdictions, management incentive schemes are typically structured with sweet equity being allocated to management and vesting on a set schedule over the life of the investment, though often not vesting fully until exit is achieved. The sweet equity attracts a preferential return once the hurdle created by any loan notes or preference shares which rank above them in the structure is cleared. Growth shares are also sometimes seen in MIP structures, particularly so in recent years, and ratchet provisions which increase the equity allocated to management upon meeting certain performance targets are common. Cash bonus programs are seen very rarely in Guernsey. Any incentive scheme will be subject to the good and bad leaver provisions included in the articles of incorporation of, or the investment/ shareholders agreement relating to, the relevant entity.

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

Management incentive schemes often feature an EBT or other pooling vehicle that is established in Guernsey given the tax neutrality of the jurisdiction, but such structures tend to be influenced by the tax laws of the jurisdiction in which the relevant managers are resident. Guernsey itself has no specific tax rules that impact the structuring of management incentive schemes (beyond local tax considerations for Guernsey resident members of the management team).

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

As in other jurisdictions, managers are typically subject to non-competes of around one to three years in length. Employment contracts for managers tend to feature non-competes around 12 months in length, whereas non-competes imposed on selling manager shareholders under an SPA, or incoming manager shareholders under a shareholders or investment agreement, might be closer to three years. Non-competes tend to cover businesses that are both of a similar nature or supplying the same market and operating in the same geography, which in the context of local Guernsey M&A deals is often the Channel Islands as whole.

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?

Control over decision making at the portfolio company level is typically ensured by a range of protections built into the articles of incorporation of the portfolio company (or relevant holding company) and into a shareholders or investment agreement that governs the relationship between the various investors in the portfolio company.

Typically the articles of incorporation of the Topco which sits above the portfolio company (and through which the sponsor and other investors hold their interest) will specify the voting rights that attach to each class of share in the holding company. The control afforded by the voting rights in effect flows down the acquisition stack to the portfolio company level. In investments other than minority investments, the sponsor will have shares that represent more than the 75% majority (which can be increased) needed to pass a special resolution, giving them effective control. The articles may specify certain matters that require further shareholder votes or consents outside of those matters which require it as a function of statute.

A shareholders or investment agreement at the Topco level will provide an additional layer of control. Elements such as a reserved matters / investor consent regime (stipulating matters that must be decided on / consented to by the shareholders

rather than the directors), information rights (commonly to periodic reporting and business updated from the management team) and director appointment and removal rights (so that control may be exercised at board level) are all common features of such agreements. Certain rights in the shareholders agreement will commonly be "baked into" the articles of incorporation, with others being cross-referenced; Guernsey law affords significant discretion to investors as to how much material must be included in the articles (which are public) rather than the shareholders/ investment agreement (which is not).

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

Pooling vehicles such as employee benefit trusts, mandatory nominee structures or other such arrangements are very common where employee or management shareholders feature in a structure. Employees / managers do in some instances hold their interests in a structure directly, but given the administrative, tax and other incentives for using a pooling vehicle this is less commonly seen.

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

Debt financing transactions tend to track those seen in other jurisdictions, especially in England and Wales.

Small financings will typically see a single bi-lateral secured term loan that is made to the "Bidco", which then uses the funds to acquire the target company. Sponsors may also fund a smaller acquisition entirely out of equity, before arranging financing after completion of the transaction.

Medium scale financings will typically involve a senior and a secondary tranche of financing, which facilities are often provided by a syndicate of lenders.

Large scale financings will often see a large lender group financing through a number of tranches or facilities, including a senior tranche through to revolving, mezzanine and payment-in-kind tranches.

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

Statutory provisions relating to financial assistance will be applicable where a Guernsey company is providing financial assistance for the acquisition of its own shares, or those of its parent. Financial assistance is permitted as long as the company providing the assistance will be solvent after it has done so. Solvency is confirmed by a board resolution of the relevant company, and does not require independent certification (such as by an auditor).

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?

Where there is a United Kingdom nexus, credit agreements tend to be based on existing leveraged finance precedents or on the Loan Market Association documents. Where a Guernsey company is used as a financing vehicle in United States sponsor transactions, the usual forms of United States debt documents will be used.

Agreements taking security over Guernsey situs assets have specific requirements, formalities and drafting relating to the taking of such security, so are bespoke for the jurisdiction (as tailored to reflect the commercial terms).

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

Practice in Guernsey tracks the key areas of negotiation in other jurisdictions. In particular, the most heavily negotiated points are typically loan pricing, financial definitions, applicable financial and maintenance covenants (and how the metrics those covenants concern are calculated) and restrictions around incurring any further debt and general covenants concerning the operation of the underlying businesses.

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

Consistent with the trend in the industry as a whole, we have seen increasing numbers of transactions supported by private credit lenders, which have emerged as contenders to the traditional syndicated lenders.

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