

Change in Control Considerations for Investments in Licensed Financial Services Companies

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As the pandemic continues to change the economic landscape, financial services companies and investors may be looking to make strategic acquisitions. Among the numerous business and legal considerations that go into those investments, one must also be aware of "change in control" concerns when the target company holds a state license.

Financial services companies are often very familiar with the numerous obligations that arise from licensing. Obtaining the license can involve long, detailed applications; background checks and fingerprinting; net worth requirements; surety bonds; and the preparation of GAAP-approved financial statements, to name some of the common requirements. Maintaining the license can require periodic renewals; record keeping requirements; reporting to the regulator; and the need to comply with other substantive requirements, depending on the products offered. In times like these, those burdens increase. As employees work from home and licensed locations temporarily close due to COVID 19 concerns, licensees face additional obligations. Along with ensuring the safety of employees and customers, licensees may need to inform regulators of changes to operations, ensure policy and procedures are updated, and navigate data security concerns.

One licensing obligation that can surprise people is the need for change in control filings. A change in control filing, also called a change in ownership filing, is when a state licensing authority imposes affirmative requirements on a licensee when the control persons or owners of the licensee will change. A control person typically includes the officers and directors of the licensed company, as well as entities and natural persons who own some percentage of the company. An ownership interest of 10% or more is a common benchmark. In many states the ownership interest can include both direct and indirect ownership. This means if a person owns a certain percentage of a licensee, the parent company of the licensee, or a company higher in the ownership chain, and that ownership interest equates to what is considered "ownership" or "control" under the state law, the licensee (or owner) may be subject to legal requirements when that ownership interest will change.

The requirements for a change in control vary by state. In some cases, the licensee merely needs to notify the state regulator of the change after it occurs. In more difficult states, the licensee must provide the regulator with notice some amount of time before the change occurs. The states that are most concerning are those that need to be notified of and approve the change before it can occur. The notification period could be as much as 90 days or more before closing.

The notification filings and approval process can include the need to submit detailed information about the transaction, including such items as the transaction documents for the deal. The proposed new

owners also will be subject to disclosure requirements. Owners who are natural persons may need to submit fingerprints, credit reports, background checks, employment histories, and residential histories, along with information about any criminal, civil, regulatory, financial, or litigation issues in the person's past. In the most difficult states, an individual also may need to submit personal financial information and information about the individual's relatives, including spouses, children, and parents.

As indicated above, the more detailed information often must be submitted for individuals who have a direct or indirect ownership interest of 10% or more. However, it is not always so limited. Some states have a smaller ownership threshold, such as 5%. Also, some states require information not only from natural person owners, but also entity owners. So, companies that will acquire a certain percentage of the licensee may need to submit financial statements or information about any significant issues or problems in the company's past. At its most onerous, states also can require information on the officers and directors of new entity owners.

A number of issues can arise from these broad concepts of a change in control. For example, one common question is what "ownership" interests trigger the process. The ownership of voting stock is often clearly within the requirements. However, state requirements also may pick up non-voting equity interests, as well as certain economic ownership interests. Transactions structured as debt financing would not trigger these obligations, because there is no "ownership." But even that is not absolute.

In addition to bright-line triggers, such as an equity stake of 10% or more, states may have a catch-all provision within the definition of "ownership" or "control" that picks up anyone who has the power to direct the management or policies of the licensee. That can have implications for transactions that do not involve any ownership. In particular, most debt financing transactions include certain negative covenants that place limits on the activities or actions of the licensee or the licensee's owners. A common covenant would prohibit the recipient of the financing from liquidating the company's assets. Those covenants are meant to protect the financier's investment, and it is commonly understood those types of limits would not be considered "control" of the licensed company. However, it is not hard to imagine a transaction with covenants and obligations that are so restrictive or broad they rise to the level of "control."

Further, even debt financing transactions with reasonable and typical provisions may not always be excluded from change in control requirements. At least one state has adopted a license that obligates the licensee to provide information on any person that lends, provides, or infuses, directly or indirectly, in any way, funds to or into a licensee.

Change in control issues are complex. It can be difficult to determine whether a transaction triggers the process, and if it does, there is also the need to figure out exactly what will be required. Complicating the process, the deals and transactions involved often develop very quickly. As much as possible, companies contemplating a change in control should consult counsel for help identifying and addressing these compliance issues early in the process. Knowledgeable counsel also may be able to advise on ways to structure the deal to mitigate the change in control requirements.

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