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## EB-5 Defaults: Unique Challenges to Consider as EB-5 Loans Go Bad

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For the past decade, real estate developers have increasingly used EB-5 loans to finance their projects. For the reasons discussed below, these investments are defaulting at a high rate, a trend that may increase if the luxury residential and hotel markets continue to soften.

EB-5 defaults give rise to a unique set of issues, which complicate the restructuring process. This practice note briefly describes the EB-5 program, outlines some of those unique issues, and provides some tips for insolvency professionals new to this type of restructuring, including a discussion of:

- What Is the EB-5 Program?
- Successes and Failures of EB-5 Projects
- Unique Considerations for EB-5 Projects in Distress

### What Is the EB-5 Program?

The EB-5 program was enacted by Congress in 1990 as part of the Immigration Act of 1990 to induce foreign investment and create jobs for Americans. Program participants—foreigners seeking green cards—must put money at risk, with no assurance of a full return, and that investment must lead to the creation of American jobs. See IMMIGRATION ACT OF 1990, 1990 Enacted S. 358, 101 Enacted S. 358, 104 Stat. 4978.

The program offers two pathways for foreign investors to attain permanent residence in the United States. Most common is an investment through a government-approved “regional center,” which pools the investors’ capital and invests that capital in the project. Less frequently, investors make direct investments in a project without a regional center. EB-5 investments can be structured as either debt or equity investments in the project, with the former arrangement being more common. A common structure is that foreign investors will purchase interests in a limited partnership or limited liability company, with the regional center or its designee as general partner or manager. That entity will then lend the cash infused by the foreign investors to a developer-owned SPV that owns the subject project.

Regardless of the mechanism used for investing, the commercial enterprise funded by the investors must create (typically within two years) at least 10 permanent full-time American jobs per EB-5 investor. Investments through a regional center have the advantage that the requisite jobs may be created indirectly, as a downstream result of the project.

The baseline minimum EB-5 investment is \$1 million. However, if the project is located in a Targeted Employment Area (TEA) (defined as an area that is rural or that has experienced unemployment of at least 150% of the national average) the minimum is just \$500,000. In practice, most investments are located in designated TEAs. This is often a result of “creative” mapping practices that could uncharitably be described as gerrymandering. Recent proposals would serve to increase these thresholds to \$1.35 million for projects within TEAs and \$1.8 million for those not in a TEA. A foreign national seeking permanent residence under the EB-5 program could also be required to invest in a business managed by the investor, eliminating the benefits of the regional center program.

## Successes and Failures of EB-5 Projects

Although established nearly 30 years ago, the EB-5 program initially attracted only limited use until traditional financing began to dry up in 2007. Since then, real estate developers and others have looked to EB-5 investments as an alternative financing vehicle for both large and small projects. According to data from the consulting firm Brandlin & Associates, EB-5 investment increased over 840% in the 10-year period ending December 2016. See <http://www.brandlin.com/LexTalk.pdf>.

The EB-5 program has funded many successful projects, attracting billions of dollars of foreign investments, and spurring the creation of tens of thousands of jobs. However, along with the dramatic increase of EB-5 financing has come a slew of failed projects. Indeed, according to additional data from Brandlin & Associates, approximately 13% of EB-5 loans in the period from 2013–2016 were nonperforming—approximately two-and-a-half times the broader CMBS default rate for the same period. Id.

The most publicized failures are those caused by alleged fraud. For example, the most notorious failed project was the Jay Peak development in Vermont, where the SEC accused the developers of misusing hundreds of millions of dollars of EB-5 funds. A map illustrating many EB-5-related frauds through mid-2016 can be found here: <https://cis.org/Map-Sites-EB5-Visa-Fraud-and-Folly-United-States>. Other failures, however, can be the result of mismanagement, poor underwriting or market forces.

EB-5 projects are at increased risk of default for several reasons. The investors are foreign and often do not conduct appropriate diligence on the project and investment, do not arrange for adequate monitoring of the project's progress, and lack investment sophistication necessary to detect a fraud. Unlike many traditional investors, investors in EB-5 loans are not regulated entities, so fewer safeguards exist to prevent poor investment decisions. In addition, many EB-5 investors focus primarily on obtaining a green card, rather than the return on their investment. Thus, a critical analysis of the economics can get short shrift. Also, EB-5 money often comes in near the bottom of the capital structure, such as in the form of mezzanine financing, making it inherently more risky than other loans. Market forces play a role, too. Many EB-5 loans have been used to fund luxury residential buildings and hotels, and the markets for those projects are softening.

## Unique Considerations for EB-5 Projects in Distress

The bankruptcies and restructurings of entities funded by EB-5 investments present unique complexities that can make them more challenging.

### *Noneconomic Motivations*

The ultimate goal in any restructuring is typically to maximize recovery. While that goal is important to EB-5 investors, it is often secondary to obtaining (or not losing) the investors' permanent resident visas. For that reason, special care needs to be taken in connection with any restructuring to ensure that the EB-5 investors' funds remain "at risk," that the project is not subject to changes that the U.S. Citizenship and Immigration Services (USCIS) (the federal immigration authorities) would deem material, and that nothing occurs that would deprive investors of the ability to claim credit for the creation of jobs. Practically speaking, restructuring professionals would be wise not to "go it alone." Restructuring professionals should obtain the service of a competent immigration lawyer with expertise in EB-5 to advise on any restructuring path being considered.

Investors' concerns that their immigration benefits be preserved also create other complications. In a default context, aggrieved lenders often assert various claims against developers and others, including claims sounding in fraud. However, pressing too hard on claims that the project was predicated on fraud or that money was misused may raise red flags with the USCIS and could result in denial or revocation of the investors' visa. This issue is particularly important in light of a reported recent uptick by the USCIS in its independent efforts to verify the representations in visa petitions through site visits and other means.

To further complicate matters, non-EB-5 participants in the deal are likely to be motivated by economic factors alone. Even members of an EB-5 investor group may not be of a like mind, because some may have already received permanent visas while others have not. The different focuses among a project's key stakeholders can result in challenging negotiation dynamics. There is no one-size-fits-all solution to this challenge.

Finally, receivers are sometimes appointed in connection with defaulted EB-5 projects. The receiver's duty typically is to maximize value for stakeholders. However, in the EB-5 context, the stakeholders may have a greater interest in preserving immigration status. Depending on the timing of the receiver's appointment and the circumstances of the case, those goals may be inconsistent.

### ***Practical/Documentation Issues***

In most cases, investors in an EB-5 transaction live outside of the United States, speak a different language, and have little or no understanding of the U.S. legal system and concepts. As a result, communication with investors can be difficult. To the extent where investor consents are required (or desired) in connection with any restructuring alternative, they can be difficult to obtain. Attorneys representing foreign investors accordingly need to establish clear protocols for communicating with their clients.

Moreover, investors in these deals often have less control than would, for example, a holder of a public debt instrument or a lender under a syndicated bank facility. Oftentimes, the regional center or a designee is appointed irrevocably as manager or general partner of the lending entity. Unlike an indenture trustee or administrative agent in a typical financing arrangement, the regional center usually cannot be voted out by a majority of the holders. This asymmetrical power dynamic adds a layer of additional risk for EB-5 investors and can complicate restructuring discussions when the investors and the regional center have a difference of opinion on how best to proceed.

Even aside from the governance issues discussed above, the loan and other transaction documents in EB-5 deals—which are generally negotiated by parties without any economic “skin in the game”—may be more investor-friendly than in a typical transaction. Where the EB-5 money is junior in the capital structure, the applicable intercreditor agreements are often unfavorable to EB-5 investors, leaving junior EB-5 lenders with an uphill battle even to participate meaningfully in the restructuring process. In the event of multiple tranches of EB-5 loans, careful attention also needs to be paid in the intercreditor and other agreements to the treatment and allocation of the credit for job creation among the various groups of EB-5 investors. The documents will sometimes give economic priority to one group of investors while giving job creation priority to another, thus further complicating any potential restructuring.

### ***Financing Issues***

Most restructuring transactions will require the infusion of additional “rescue” capital to complete the project. Raising new capital in defaulted EB-5 transactions can be challenging. In many transactions, the parties look first to the existing investors for new money. In EB-5 deals, that money is not likely to be available from the individual investors. Moreover, bringing in new money from third parties can pose immigration risks (on top of the more typical disputes attendant to the infusion of new money such as priming and valuation fights), particularly if it is conditioned on a material modification to the project. Consultation with immigration counsel on these issues is critical.

### **Conclusion**

EB-5 defaults bring with them unique challenges that require insolvency professionals to work outside the usual “playbook.” As these types of defaults become more common, insolvency professionals should be aware of the challenges to best serve their clients.

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