What is an EB-5 Investment "At Risk" – A Discussion of the Degree of Risk Required

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Proof of an investment being "at risk" is an important element of the EB-5 Immigrant Investor Program. A certain element of risk is what demonstrates the immigrant's commitment to the investment and job creation that are central to the EB-5 program. How to present an EB-5 project as one in which an investment is *"at risk"* and yet is not a *"risky"* project is a challenge that EB-5 practitioners have been grappling with for years. Unfortunately, although the regulations address the "at risk" element, neither the statute nor the existing body of EB-5 case precedents specifies precisely what the degree of risk must be. Rather, existing case law This article analyzes the elusive *at risk* element by utilizing two separate scenarios: the use of municipal bonds in EB-5 projects and EB-5 investments secured by property ownership.

Statutory Provisions, Regulatory Requirements, and Agency Interpretations

The regulations state that an EB-5 visa applicant must have invested or be in the process of investing the requisite amount of lawfully obtained capital at the time of filing their I-526 petition.[1] Notably, the regulations do not state that the capital has to be fully invested at the time of the filing of the I-526 petition, but that the investor can be "*in the process of*" investing.[2] There are various strategies used in the industry to demonstrate that the investor is in the process of investing, including promissory notes.

It is not enough, however, just to demonstrate that the investment is fully committed; additionally, the I-526 investor petition must be accompanied by evidence establishing that the capital has been placed *at risk*.[3] This regulatory requirement has been in place since the

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[1] *See generally* 8 U.S.C. 1153(b)(5)(A).

[2] 8 CFR 204.6(j)(2) provides that "To show that the petitioner has invested or *is actively in the process of investing*." (emphasis added).

[3] 8 CFR 204.6(j)(2) states that, "To show that the petitioner has invested or is actively in the process of investing . . . the petition must be accompanied by evidence that the petitioner has placed the required

inception of the EB-5 program, however, nowhere in the regulations does it state the exact definition of *at risk*, or what degree of risk is required.

There is no precise definition of "at risk" in the statute and, in fact, the "at risk" concept is not even mentioned. The term "at risk" is mentioned but not defined in the regulations. The leading case cited with regard to what is meant by an "at risk" investment, ***Matter of Izummi***, discusses what it is not, rather than what it is. In the absence of any express, affirmative definition of the term, there is no authoritative guidance as to what the degree of risk must be to satisfy the "at risk:" requirement. The general understanding of what is meant by requiring an investment to be "at risk" is that the funds must be actually committed, with no guarantee of a return or redemption. When the evidence demonstrates that the investor faces both a risk of loss and a chance of gain, the investment is considered to be “at risk”.

The *Matter of Izummi* is the source of the general definition of the “at risk” element. According to *Matter of Izummi*, if the immigrant investor is guaranteed the return of the capital investment or a portion of the capital investment, or is guaranteed a rate of return on a portion of his or her investment, then that portion of the capital is not at risk. In *Izummi*, a partnership agreement permitted the investor to demand a return of capital or redeem some portion of the investment. Here, the EB-5 capital was not considered to be at risk because the investment was governed by a redemption agreement that protected against the risk of loss, and therefore, constituted an impermissible debt arrangement under 8 C.F.R. § 204.6(e). In the case of a promissory note, in order for the capital investment to be considered *at risk*, it must be secured by assets enforceable in a U.S. court and for which the investor is personally and primarily liable. The assets shall be enforceable and access to the full amount of capital is necessary to cover a demand or court judgment.[4]

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amount of capital at risk for the purpose of generating a return on the capital placed at risk.” (emphasis added).

[4] 8 CFR § 204.6(e).

Municipal Bonds and EB-5 Investment "At Risk"

All investors are in search of secure and safe projects. How much security is too much to comply with the investment "at risk" requirement? Some adventurous practitioners are not afraid to test the legal boundaries of the "at risk" requirement. The authors chose the Municipal Bonds structure in the Seattle Bridge project because it is a case that was approved by USCIS (approved exemplar) with difficulties and controversy and is a good example to illustrate the degree of the risk required under EB-5 rules.

Although it may appear that the use of municipal bonds violates the "at risk" rule because bonds are often associated with issuers' general obligation or guaranteed security interests, the conclusion may not be so clear. For example, the Seattle Bridge 520 EB5 Project (Washington Regional Center) raised $47.5 million from 95 EB-5 investors in Washington State municipal bonds to replace the aging State Route 520, a floating bridge across Lake Washington. This is the first occasion in which EB-5 investor funds were used as part of the capital stack to fund a public infrastructure project.

The significance of the Seattle Bridge project funding lies in the distinction between the two basic types of municipal bonds: (1) general obligation bonds ("GOB"), which are secured by the full faith and credit of the issuer; and (2) revenue bonds secured by revenues derived from the tolls, and charges from the facility built.

Inasmuch as general obligation bonds amount to the issuer's personal guarantee of the return of all or part of the capital invested and the EB-5 regulations prohibit such a guaranteed, thus GOB *per se* with usual 20 year maturity date violate the requirements of the EB-5 program

The Seattle Bridge project met the requirements of the funds invested in revenue bonds are "at risk" within the meaning of the EB-5 regulations because by their nature, revenue bonds contain variables such as liquidity risks that are unpredictable. EB-5 investors purchase the GOB and revenue bonds and bear the liquidity risks of the bonds. In the Seattle Bridge 520 project, however, the capital stack combined both GOB and revenue bonds as sources of funding for the project, which precludes any guarantee of return. For example, the maturity period for the bonds is 20 years. Yet the EB-5 investors' funds are scheduled to be returned in five (5) years. This means that the EB-5 investors bear the risks of liquidating the bonds and seeking returns prior to the maturity date.

In addition, the municipal bonds were purchased by the Limited Partnership from the primary bonds market. In five (5) years, the Limited Partnership will sell the bonds on the secondary market based on current market value. The EB-5 investors may not be able to recover the $500,000 investment amount because the bond price is subject to market rate fluctuation. Thus, the investors face both a chance to gain and a risk of loss relation to the return of capital. Furthermore, if a project is not completed for any number of reasons there remains a risk of loss for the investors.

Taken further, the argument that investment in bonds does not violate the "at risk" requirement is that no state or municipal bond is without substantial risks. Indeed, the general obligation bonds in the EB-5 context would be liquidated within 5 years prior to the 20-year maturity period. The investors thus bear liquidity risks (find a buyer on the secondary market) related to the return of EB-5 capital, including interest rate risks, default risks and other financial risks.

The municipal bond offering is an investment vehicle subject to stricter scrutiny by the U.S. Securities and Exchange Commission (SEC) in comparison with other EB-5 private offerings based on the loan or equity model.

In addition, the timing of the EB-5 offering needs to be coordinated with the bond offering. The EB-5 investors' funds should be placed in the escrow account before the municipal bonds are issued. It is confirmed that non-recourse municipal bond structure has received I-526 approvals.

The authors spoke with the Washington Regional Center and learned the exemplar petition of the municipal bonds structure was approved by USCIS in August 2013. At the time of writing this article, I-526 submissions were still pending.

Investment Guaranteed by Property Ownership

Another situation where the "at risk" requirement remains murky arises when an investment is guaranteed by property ownership. It is not uncommon for developers to guarantee the investment by offering the eventual property ownership. Some potential EB-5 investment project offerings include a "reservation agreement," so that in the event that the project fails, the investor will still be compensated with a unit of the existing real estate. The sort of practice violates the investment "at risk" requirement.

The authors have examined several project scenarios employing the arrangement where a portion of the investors' funds would be utilized to purchase vacation suites requiring renovation (having already been constructed). The remainder of the EB-5 funds would be used for the construction and renovation of the common areas. The AAO has deemed a similar case as not in compliance with EB-5: "The AAO finds that the applicant's proposal is a marketing strategy to attract buyers for vacation suites rather than investors of capital in a new commercial enterprise."[5]

The AAO denied the structure because eventually the investor will own a property unit through investment - *a form of guaranteed return* which does not meet the investment "at risk" requirement. Again, according to *Matter of Izummi*, for the capital to be "at risk", there must be a risk of loss and a chance for gain. The promise to guarantee the investment by property ownership negates the risk of loss element.

[5] Administrative Appeals Office Decision W09 000 980 (April 26, 2011).

When trying to determine whether such an investment is actually at risk, the following should be taken into account:

(i) What is the evidence under 204.6(j)(2) that the investor has placed the required amount of capital at risk for the purpose of generating a return on the capital placed at risk?

(ii) Is there or will there be evidence of funds transferred or committed to be transferred to the new commercial enterprise in exchange for (unredeemable) shares of stock?

(iii) Is there or will there be evidence of any loan or mortgage agreement, promissory note, security agreement, or other evidence of borrowing which is secured by assets of the investor, other than those of the new commercial enterprise, and for which the investor is personally and primarily liable?

The project proposal should be crafted in such a way that the component parts are viewed as a whole enterprise in which the investors are making their investment and for which jobs are going to be created. For example, a plan for "a pooled equity investment of capital into a new commercial enterprise," and the investor needs to establish that the risk at which his/her investment is placed is tied to the successful development of the whole project. The proposal must avoid the appearance that the investors will be making individual investments in separable aspects of the development of the property (e.g., purchasing private property).

The funds to be invested should not be able to be viewed as supporting future development or later phases of the project, but must be directly and integrally tied to a project created by the pooled funds held by the enterprise. Likewise, the evidence of job creation needs to be tied to the number of jobs associated with the specific commercial development of the project.

In reality, the structure and description of a large-scale hospitality development project that involves the use of pooled investment funds should be expected to generate the evidence necessary for an investor to document the type of at-risk investment in a new commercial enterprise that is required for EB-5 approval.

Conclusion:

There is a direct comparison to Immigrant Investor Programs from other countries, where in most cases, the return of the investment is guaranteed. The very elements of investment “at risk” that have caused investors to be cautious of EB-5 have actually proved to be an advantage. The EB-5 Program in the US has avoided all of the vices that caused the termination of the Canadian Program. The EB-5 Program compels the investors to invest cash or “new money” into mostly privately owned new commercial enterprises. The investment is placed “at risk” and the return of the funds or a portion of the funds cannot be guaranteed in any form. The funds are invested into job creating and economic development initiatives. It mitigates the government’s risks in underwriting the projects and conducting due diligence. It leaves the project assessment and due diligence to the private sector. Investment “at risk” and the actual capital commitment are legal safeguards to attract new foreign investment to the United States. The EB-5 Program has provided alternative financing to high-risk and low-return privately owned projects that otherwise wouldn’t be funded.