Erosion of the Loan Model

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Since the EB-5 program's inception in 1990, the financing structures for EB-5 projects have evolved in sophistication and complexity. The shift to the EB-5 loan model (Loan Model) and the advent of "mega deals" largely contributed to the trend towards more complex structures.

The impetus for the transition to the Loan Model was likely based on at least two perceived benefits of a loan structure. First, because the usual green card process took about five years[1], structuring a loan between the new commercial enterprise (NCE) and the project's job creating entity (JCE) with a term of five years served to "marry" the financial expectations of the project developers and the investors' expected immigration timeline. As such, EB-5 investors could count on an "exit" from the investment (for which they typically receive little profit) shortly after green card approval. Second, EB-5 investors must have been attracted to the "safety" of a loan structure because now there would exist a contractual obligation to repay the EB-5 loan at maturity in priority over distributions on account of equity ownership. Also, the loan was often secured by the assets of the JCE and/or a pledge of the ownership interests in the JCE or its owner(s). Having a collateral package to further secure the loan, would of course add to the attractiveness of the Loan Model.

As the EB-5 industry matured, EB-5 investors became attracted to larger deals. Larger EB-5 projects introduced into the deal mix more sophisticated developers, migration agents and legal counsel, as well as more complex deal structures. This article explores how increased deal sophistication and complexity, including intercreditor agreements and structural subordination, have eroded the effectiveness and perceived benefits of the Loan Model.

EB-5 INVESTMENT STRUCTURES

Under the EB-5 program, each investor must invest either $500,000 in a project located within a targeted employment area (TEA) or $1 million in one outside a TEA. Regardless of TEA status, however, each investor's investment in the NCE must be in the form of equity, because debt arrangements are prohibited in the EB-5 program.[2]

Depending on the EB-5 project's structure, investors typically opt to invest directly into an NCE that aggregates investor funds for the purpose of making an investment in a JCE, often in the form of a secured or unsecured loan (EB-5 Loan). Alternatively, the NCE will sometimes use investor funds to make an equity investment (Equity Investment) directly into the JCE, which likely would include a preferred return equity element (Equity Model). In the Equity Model structure, the NCE becomes an equity owner in the JCE or, as discussed below, in a Mezz Company.[3]

DEBT VERSUS EQUITY MODELS

In the Loan Model, the EB-5 Loan from the NCE to the JCE can take the form of any debt arrangement, including a junior or senior loan. An increasingly common debt arrangement in the EB-5 context involves the NCE making a loan to the JCE's parent company or an intervening controlling entity (Mezz Company). This structure is sometimes referred to as a mezzanine structure and is common in both Loan Model and Equity Model deals (Mezz Structure).

In the Loan Model, the Mezz Structure plays an important role that should not be overlooked. Oftentimes, senior lenders to an EB-5 project will not permit the JCE to incur additional indebtedness, such as an EB-5 Loan. However, if the EB-5 Loan is made to a Mezz Company (Mezz Loan) and the Mezz Company uses the EB-5 Loan proceeds to make a capital contribution to the JCE, senior lenders will typically express less concern, although as will be discussed below, they will likely require an intercreditor agreement.

As noted, a project utilizing the Equity Model may also implement a Mezz Structure. For example, rather than the NCE making an Equity Investment in the JCE, the NCE may make the investment in a Mezz Company. Here, the Mezz Company would likewise ultimately contribute the Equity Investment proceeds to the JCE.

1 Generally, due to the longer waiting period of 8 years or more that mainland Chinese investors face because of visa backlog, many EB-5 deals allow for the usual 5-year EB-5 loan term to be extended for several additional years to accommodate the longer waiting period.

2 A debt arrangement on the part of the investor is specifically excluded from the definition of what would constitute a compliant contribution for the purposes of the EB-5 program. See 8 C.F.R. § 204.6(e).

3 Importantly, in the Equity Model individual investors have no personal investment in (and therefore no direct ownership or control over) the JCE. Deals can be structured where individual investors own an equity interest in a project in which the NCE also functions as the JCE. However, since the advent of the Loan Model and Equity Model, such deals appear less common, although there may be a resurgence of such deals given the legislative uncertainties haunting the Regional Center program

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While each structure can be tailored to achieve the project's desired objectives, investors often do not fully understand the nuances, similarities and differences, and weakness of each structure or the impact on the investors themselves. For example, under the Loan Model (as with most loans), the borrower is required to repay the loan to the NCE at a specified maturity date. The loan is often secured by a first or second mortgage on the property or by some other form of security interest, such as a pledge of ownership interests of the JCE or the Mezz Company. The Equity Model, on the other hand, will generally include a redemption date feature providing for the redemption (i.e., repayment) of the Equity Investment at a specified date. The redemption feature operates like the maturity date provision of a loan. Similarly, the terms of the Equity Investment would likely require that the JCE or Mezz Company (as applicable) make preferred return distributions on the Equity Investment to the NCE. Those preferred equity distributions are akin to the interest payable under the Loan Model.

While the Loan Model and Equity Model may be structured to achieve similar economic objectives, the Equity Model's greatest drawback is its subordination to all loan indebtedness and all other secured and unsecured creditor claims. As such, in a bankruptcy or other liquidation scenario, available or free cash must first be used to satisfy creditor claims before any distributions can be made to equity holders. And since the Equity Model is premised upon the NCE having an equity ownership in the JCE, the NCE will generally be subordinated to the JCE's bona fide creditors (as well as those of any Mezz Company). The Equity Model would thus appear to be less desirable than the Loan Model and for seemingly very good reasons. However, despite the Loan Model having the advantages of being typically collateralized and enjoying payment priority over equity investments, the effectiveness of the Loan Model may be significantly eroded by the senior lender's requirement that the parties enter into an intercreditor agreement and by the structural subordination that results from the Mezz Structure.

INTERCREDITOR AGREEMENTS

In projects where the NCE is granted a security interest, senior lenders may require the NCE to enter into an "intercreditor" agreement to avoid impairing or exposing those senior lenders' own collateral to claims or to litigation. These agreements restrict the NCE's rights as a secured party in a several significant ways. First, they typically require the NCE to affirm that the EB-5 Loan obligations and any collateral securing such loan are subordinated to the senior loan and its collateral.

Second, intercreditor agreements often include standstill provisions that restrict the NCE's ability to foreclose on its collateral or otherwise exercise remedies available under the EB-5 loan documents. In an EB-5 Loan where the collateral is a pledge of the ownership interests in the JCE, in some cases intercreditor agreements require that any person or entity that forecloses on the pledge (and that would succeed to the ownership interest in the JCE) maintain substantial minimum asset thresholds and/or possess significant experience in managing or developing projects similar projects. Such a restriction could pose a significant barrier to an NCE ability's to effectively seize its collateral if it is unable to meet either of such criteria, especially if, as is common, the NCE is a relatively new entity with few assets or other resources and little or no experience in real estate development (or whatever is the JCE's business). Despite its draconian nature, from the senior lender's perspective such a provision makes sense. After all, the senior lender would be interested in knowing that any substitute party has the experience necessary to complete or run the project and is not so financially weak as to potentially also imperil the project because it lacks the resources to fund shortfalls.

Additionally, intercreditor agreements may also restrict the NCE's right to receive payments of principal or interest under the EB-5 Loan. In such event, intercreditor agreements require the NCE to either hold loan repayment proceeds (and sometimes interest) in trust for the benefit of the senior lender. Such restrictions can remain in effect until the senior loan is repaid in full, during which time the NCE does not actually receive proceeds from the repayment of its own loan, which obviously introduces additional repayment risk, difficulty funding NCE payment of expenses (in particular to foreign brokers and migration agents), and may cause significant delays for investors' exit strategies.

STRUCTURAL SUBORDINATION

Structural subordination also serves to erode the effectiveness of the Loan Model using a Mezz Structure. In the Mezz Structure, the NCE never becomes a direct creditor of the JCE because the EB-5 Loan is made to a Mezz Company and no direct collateral of the JCE is typically pledged as security for the EB-5 Loan. In a bankruptcy or liquidation scenario, the creditors of the JCE come first, and their claims must be satisfied before any cash flow can be made available for distribution to equity owners. Thus, a properly structured Mezz Structure deal permits excess or free cash flow to be upstreamed to the Mezz Company to allow it to make the required interest payments to the NCE under the EB-5 Loan, but in a bankruptcy or liquidation scenario, the NCE will not receive repayment under its loan until all of the JCE's creditors have been paid and remaining assets, if any, are available for distribution to the Mezz Company. Even though the NCE likely received a pledge of the JCE's ownership interests, the Mezz Structure itself causes the NCE's loan to be structurally subordinated to the JCE's debt, meaning any collateral securing the Mezz Loan is essentially relegated to the same low priority as an equity investment in the JCE (and thus wholly dependent on the project's cash flow).

Structural subordination also impacts Equity Model projects, even where distribution mechanics appear to prioritize distributions to the NCE. This is because it is uncommon to see the NCE receive distributions prior to the JCE satisfying obligations to creditors and those other equity owners that are senior in priority. Consequently, structural subordination can have the effect of limiting cash available for distribution to the NCE.

Even though the Loan Model ostensibly provides investors greater protection by means of a security interest granted to the NCE, if the NCE's loan is structurally subordinated in a Mezz Structure or subject to an intercreditor agreement, the JCE's loans will remain senior in priority, and distributions from the JCE to the Mezz Company or NCE will likely be severely restricted. In such event, the Loan Model may not be much better than the Equity Model in a liquidation scenario. Thus, any investor considering funding into a Mezz Structure deal should recognize that the Loan Model may not by itself provide the perceived comfort sought in the debt arrangement promised by the Loan Model.