Is the Investment Truly at Risk?

How Call Options Could Result in I-526 Petition Denials

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In an ever-changing EB-5 investor program wrought with complexities and USCIS surprises, there has always been an unwavering tenet: the investment must remain at-risk. Unfortunately, USCIS continued its practice of unilaterally changing the landscape of EB-5 by recently denying I-526 petitions involving call options based on its own interpretation of the at-risk requirement.

Most recently, an EB-5 investor named Jingru Zhao filed suit in a United States Federal District Court after the Administrative Appeals Office (AAO) upheld the denial of her I-526 petition based, in part, upon a call option provision contained in the new commercial enterprise's (NCE) limited partnership agreement. Call options like those described in Zhao's suit allow the NCE or developer to purchase or redeem an investor's interest in the NCE. Unfortunately, both USCIS and the AAO held that the call option in Zhao violated the EB-5 Program's at-risk requirement. Zhao's lawsuit remains pending as of the date of this writing.[1]

1 Jingru Zhao v. U.S. Dep't of Homeland Sec., No. 18-1476 (D.D.C. filed June 22, 2018).

The AAO's decision in Zhao is emblematic of the at-risk conundrum facing investors and industry operators today. Previously, Matter of *Izummi* was heralded as the seminal case on "at-risk" investments because it provided guidance on how to navigate the at-risk requirement.

For example, *Izummi* clearly prohibits debt arrangements because there is no real risk of loss with respect to the investor's capital investment. Similarly, *Izummi* also prohibits put options – where an investor may opt to sell his or her interest in the NCE – because they allow an investor to dictate the return of his or her investment. USCIS believes put options negate the risk of loss because they are the functional equivalent of a prohibited debt arrangement. This is understandable.

Yet there remains a marked difference between the put options prohibited by *Izummi* and the call options used to justify recent I-526 denials such as Zhao. From a corporate law standpoint, call and put options function quite differently. Nevertheless, it seems USCIS and the AAO have mistakenly characterized call and put options as indistinguishable, which has led to USCIS' inconsistent adjudication of I-526 petitions.

However, at least two federal district court judges disagree with USCIS' narrow interpretation of call options. First, in Doe v. USCIS, investors contributed funds to finance several gold mining projects in Idaho.[2] The NCE's limited partnership agreement contained a call option that allowed the general partner "to repurchase the interest of a Limited Partner for a purchase price of either (i) $550,000 in cash, or (ii) 400 ounces of gold." Though I-526 petitions were initially denied by USCIS, the court ruled in favor of the investors and affirmed what many industry operators already knew: call options are notably different from put options because they do not guarantee an investor the return of his or her investment. Instead, it is the NCE – and not the individual investor – that has the right to end the investor's role in the NCE.

2 Doe v. U.S. Citizenship & Immigration Services, 239 F. Supp. 3d 297 (D.D.C. 2017).

A second federal judge, this time in *Chang v. USCIS*, reached a similar conclusion.[3] In *Chang*, the NCE's limited partnership agreement contained a common call option provision that allowed the general partner to purchase a limited partner's interest "by paying such Limited Partner its (i) unpaid Preferred Return through the date of withdrawal and (ii) Unrecovered Capital Contribution" at any time after an investor's I-829 has been adjudicated." USCIS subsequently began denying petitions for failure to comply with the at-risk requirement based on what USCIS viewed as a tacit understanding that capital would be returned to investors at a certain point in time.

The court rejected this argument and instead limited USCIS's interpretation of *Izummi* by ruling that USCIS cannot simply infer that all call options indicate "a preconceived intent to unburden oneself of the investment in full as soon as possible." While *Izummi* does allow USCIS to conduct a holistic examination of project documents, *Chang* clearly reigns in

3 Chiayu Chang v. U.S. Citizenship & Immigration Services, 289 F. Supp. 3d 177 (D.D.C. 2018).

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USCIS' authority to assume a call option's non-compliance absent concrete evidence of an arrangement that actually guarantees a return of capital

Despite the conflicting guidance from USCIS, compliant call options should in theory pass muster under *Izummi*. However, there are two critical components to consider when structuring call options in a manner that will survive at-risk scrutiny: (1) the option should **not** be exercised by the EB-5 investors themselves, which is to say that investors should have no control over the return of their own investments; and (2) the call option should be exercised for the fair market value of the interest in the NCE (and **not** a straight-forward promise to return the investor's capital contribution).

Both points are specifically tailored for compliance with *Izummi* because they preserve the investor's risk of loss and chance for gain. Importantly, it is the NCE that controls the exercise of the option and, depending upon when the option is exercised, the value of the interest could be worth significantly more or less than the amount of the investor's contribution.

In theory, this complies with USCIS' interpretation of *Izummi* and other relevant case law because the value will fluctuate depending on the market conditions of the business at the time of the exercise. Additionally, investors have no control over their return of capital or their exit from the project and cannot be assured that the NCE will ever exercise its call option.

Despite the call option's apparent compliance with *Izummi*, some EB-5 securities attorneys have started to incorporate automatic redemption mechanisms as an alternative to the call option. These provisions provide for an investor's interest to be automatically cancelled or withdrawn once the NCE has sufficient cash flow (generally as a result of a repayment under the NCE's loan to the job creating entity) to make a distribution to the investor in an amount equal to the fair market value of his or her interest, which cannot occur until that investor's I-829 petition has been adjudicated (after the exhaustion of all appeal rights in the case of a denial).

Following the investor's receipt of the fair market value of his or interest, the investor's interest will be automatically cancelled, and the investor will no longer be deemed a limited partner (or member, as applicable) of the NCE. Importantly, utilizing the automatic redemption mechanism as an exit strategy would seemingly comply with *Izummi* since it also preserves the critical call option components described above.

Ultimately, opposing views amongst USCIS and the federal courts have left EB-5 projects balancing inconsistent "at-risk" guidance with investors' expectations for a clean exit strategy. Regardless, it is critically important for EB-5 projects to incorporate compliant exit strategies since the failure to do so could make investors susceptible to a denial of their desired immigration benefit. Despite USCIS having created this conundrum, it is possible to navigate the common pitfalls associated with call options and eliminate some of the risks that have led to I-526 denials. As a result, it is now more important than ever to engage competent counsel to advise on the complexities regarding the EB-5 program's "at-risk" requirement and review the exit strategy contained in the project's offering documents.

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