Subscription Escrow Accounts in EB-5 – A Story of Evolution

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The use of a subscription escrow account to accept capital contributions from EB-5 investors seeking permanent residency in the United States through the EB-5 Immigrant Investor Program has been widely accepted by industry participants. While not required by any securities or immigration law or regulation, a properly structured escrow arrangement is an integral part of an EB-5 project's overall success. If implemented properly, the terms of the escrow agreement can offer the EB-5 investors assurance (i) that their funds can only be released to the appropriate party(ies), and (ii) that a refund could be facilitated in the event of an I-526 Immigrant Petition by Alien Entrepreneur (I-526 Petition) denial. The EB-5 regulations were not designed to impede private enterprise, thus there are minimum government mandates related to the structure or operation of the subscription escrow accounts. Issuers who can offer their investors protections through their escrow structures have a competitive advantage in a market saturated with projects seeking EB-5 investment as part of their capital stacks. That said, EB-5 escrows have been forced to evolve and adapt to market challenges over the years. Here is a look at where we've been and what we are to expect in the future.

Post Financial Crisis Era of Conservative Escrow Accounts

EB-5 as a mainstream source of financing skyrocketed in popularity following the financial crisis in 2008 and 2009. At that time, one could expect an I-526 Petition to be adjudicated by United States Citizenship and Immigration Services (USCIS) in four to six months. Issuers could raise the capital they sought from EB-5 investors, primarily in Mainland China where the demand was great and the familiarity with the program widespread, have their EB-5 investors file I-526 Petitions with USCIS, obtain adjudications on those Petitions and deploy the capital into the job creating enterprise (JCE) in a very short period of time. The EB-5 investors took comfort in the fact that their funds would be held safely in an escrow account under the control of an independent escrow agent until they knew that their immigration petitions had been approved. In the event there was something wrong with their petitions, or the projects for that matter, they could quickly and easily get their money back. They would be free to reinvest in a different project or return to the status quo and consider another path to permanent residency. Unfortunately, the good ole days had to come to an end.

2013 to 2018 - The Age of Creativity

As the popularity of the EB-5 Program continued to grow, so too did the number of petitions filed with USCIS and the length of time it was taking to adjudicate them. Gone were the days of a four to six-month processing time, and the industry found itself facing petitions left pending for over a year, and then more than two years. Despite commitments made by USCIS to increase staffing and implement efficiency measures, the waits continued to grow and the ripple effect wreaked havoc. Projects could no longer wait years to have access to the EB-5 funds. Developers, contractors, vendors, and networks of parties involved in designing, constructing and operating these EB-5 projects needed to get paid or else a series of defaults, bankruptcies, and foreclosures would be soon to follow. So, the industry pivoted.

The EB-5 investors still sought security and promises of refunds should their I-526 Petitions be denied, but they had to broaden their focus and consider seeking arrangements that also provided the ability for the projects to get funded timely. A failure to fund timely would increase the risk that the EB-5 investors could lose their investments altogether when the projects were forced to file for bankruptcy or lose

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the property in a foreclosure. This led to the introduction of the more aggressive escrow structures commonly known as "early release" escrows.

Through the careful collaboration of industry experts specializing in immigration law, securities law, and banking, a number of early release structures were developed to help meet the developers' funding needs while still providing protections for the EB-5 investors. These structures were meant to address two main risks: project failure risk and individual EB-5 investor denial risk. The early release escrows would incorporate release triggers and refund mechanisms designed to maximize the likelihood that sufficient funds would be available to refund any EB-5 investor whose I-526 Petition were to be denied by USCIS while also allowing the developers to access the funds when necessary. Often times, a project would not begin to release funds until either (i) an exemplar petition or at least one EB-5 investor's I-526 Petition were approved such that deference would be established, or(ii) the full capital stack was in place such that development could proceed with or without the EB-5 funds. Following project approval, a portion of the EB-5 investors' funds would be released to the New Commercial Enterprise at the time of I-526 Petition filing and a portion would be held in escrow until I-526 Petition adjudication to help facilitate refunds should any individual EB-5 investor's I-526 Petitions be denied. But even this methodology couldn't stand the test of time.

2018 to Present – The Modification Period

According to the USCIS website, processing times for I-526 Petitions are currently ranging between 29 and 45.4 months. Translation – we are approaching four years from the time an EB-5 investor's I-526 Petition is filed and the time when USCIS adjudicates it. This creates significant issues for EB-5 stakeholders including investors, regional centers, financial services providers and developers. If we look at the massive influx of I-526 Petitions that were filed shortly before the September 30, 2015 Regional Center Program Sunset Date and the steady flow of I-526 Petitions filed since then, we will see that the majority of those projects were structured with early release escrow accounts where a portion of the EB-5 investors' funds was expected to remain in the escrow account until such time as the EB-5 investors' I-526 Petitions were finally adjudicated. The protracted I-526 Petition processing times are causing that portion of the funds to be locked in the escrow account at a time when the developers either need capital to complete the development or where the project is completed and the developers are seeking to refinance or even sell the property. As part of the EB-5 immigration process, it is essential to be able to show not only that the EB-5 Funds have been fully invested into a new commercial Enterprise (NCE), but that there is a nexus between the capital contribution and the requisite job creation. When any portion of the EB-5 investors' funds remains in escrow pending adjudication of the I-526 Petitions (Holdback Structure) a disconnect is created between the capital contribution and the job creating activity. This disconnect, in turn, means that the USCIS may deny the EB-5 investors' I-526 Petitions preventing them from achieving conditional residency status, or deny their I-829 Petitions by Entrepreneur to Remove Conditions on Permanent Resident Status, preventing them from achieving permanent residency status and possibly causing them to be deported. So, the industry pivots again. But this time, the pivot is far more complex.

Contrary to what is thought by many, the solution to this problem is not nearly as simple as having the NCE and/or Regional Center contact the bank and amend the escrow agreement to remove the holdback provisions. The provisions controlling the mechanism for release, including conditions relating to the time and manner of such release, are typically described in the Private Placement Memorandum (PPM), LP Agreement or Operating Agreement of the NCE, as applicable (LPA), Subscription Agreement and Escrow Agreement (collectively, Offering Documents). Any change to those terms will impact each of those documents. And to make matters more complicated, amending some of those documents may require consent from some, if not all, of the EB-5 investors before such changes can be implemented. And because the EB-5 investors subscribed with the promise of certain security, like the availability of funds to facilitate refunds following I-526 Petition denial, they may not eagerly offer the requisite consent. Even worse, the EB-5 investors may get spooked and seek to withdraw from the offering altogether. So how can an issuer navigate this dilemma successfully?

Unfortunately, there is no one-size-fits-all approach in this context. As such, it is important to analyze how Holdback Structures are incorporated into the various Offering Documents in order to determine what consent, if any, is needed from EB-5 investors to eliminate an existing Holdback Structure (since the provisions of such documents likely dictate mechanics for amendments, including the requisite percentage required to effect such amendment and who has the necessary authority to enter into such amendments). For example, the provisions of the LPA may require that a majority of EB-5 investors consent to an amendment to the LPA. If the LPA is silent on mechanics for amendments, the statutory provisions of the NCE's state of organization would govern (which often requires a majority). By contrast, the NCE might, though it would seem unusual, have the authority to amend its Escrow Agreement without the express consent of EB-5 investors (though the NCE would still need the escrow bank, agent and/or administrator to enter into such amendment as well). Nevertheless, prudence would still dictate that an NCE seek consent from all of its current EB-5 investors before amending the Escrow Agreement for the purposes of eliminating a Holdback Structure.

The best (and most conservative) practice of effecting these changes is to prepare an amendment and/or supplement to the PPM and other Offering Documents (Supplement). The purpose of the Supplement is to notify EB-5 investors of the NCE's intent to access funds prior to adjudication of the I-526 Petition and to disclose the risks presented by removing such provisions. A properly drafted Supplement would modify the operative

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provisions of the Offering Documents and then disclose any material information relating thereto, including without limitation: (i) any conditions required to release proceeds; (ii) the name of the bank where EB-5 investor funds will be held pending release and the identity of the party that controls funds prior to release (such as an escrow agent or administrator); and (iii) how the NCE would return EB-5 investor funds following the denial of an I-526 Petition once the holdback funds have been deployed. In order to properly insulate the NCE from potential securities laws liability, any Supplement should include copies of the material agreements being described in the Supplement (such as the amended Escrow Agreement that authorizes the early release mechanism or a copy of any proposed amendment to the LPA). As detailed above, the NCE should require all EB-5 investors to sign a copy of the Supplement to acknowledge and consent to the changes being effected therein. Going forward, each prospective EB-5 investor should also receive a copy of the Supplement (along with the other Offering Documents) so the prospective EB-5 investor is also made aware of the changes effected by the Supplement. To the extent that an EB-5 investor does not consent to the changes presented in the Supplement, the NCE may offer the EB-5 investor the right to rescind his or her investment in the NCE (though any such rescission rights may jeopardize an EB-5 investor's ability to receive conditional permanent residency under the EB-5 Program). Additionally, if the information contained in the Supplement is deemed material from a securities laws perspective, the NCE would be well advised to offer all of the EB-5 investors a similar right to rescind their investments in the NCE (especially since the failure to disclose material information to EB-5 investors could be deemed a violation of the anti-fraud provisions of applicable securities laws). However, if an EB-5 investor consents to the changes disclosed in the Supplement and remains invested in the NCE (even after full disclosure of potentially material changes contained in the Supplement), such consent may prevent the EB-5 investor from prevailing on a later rescission claim. Similarly, offering rescission rights following disclosure of a material change provides a helpful defense should an EB-5 investor later make a claim against the NCE or its principals for failure to disclose material information.

If an NCE elects to eliminate a Holdback Structure and allows for the EB-5 investors' entire capital contributions to be released prior to adjudication of the I-526 Petitions, the EB-5 investors lose one essential protection afforded by the Holdback Structure – the NCE's availability of funds to return capital to an EB-5 investor following a denial of his or her I-526 Petition. Unfortunately, there is no "standard" practice with respect to when and how funds will be returned following an I-526 Petition denial. While these provisions can range in application – from imposing a hard obligation to return capital immediately to returns of capital being required only if the denial is project-related, the best-case scenario is that the provisions of the Offering Documents provide a clear mechanism to return funds such as an I-526 Petition Denial Refund Guaranty from an entity with a balance sheet healthy enough to support the refund obligation, or clearly articulate that there is no commitment to refund a denied EB-5 investor at all. In such event, the EB-5 investor would be bound by the provisions of the Offering Documents. If, however, the Offering Documents are also silent on the issue of denials, the NCE and individual EB-5 investor may be free to negotiate how such funds would be returned. The NCE could also proactively seek to supplement the Offering Documents in order to establish clear mechanisms for future returns of capital related to I-526 Petition denials but would be well-advised to handle those changes in the same Supplement that serves to modify the existing release mechanics. One popular mechanism would allow the NCE to procure a substitute EB-5 investor, whose capital contribution, once invested into the NCE could provide the liquidity necessary to return funds to the denied EB-5 investor. The substitute EB-5 investor option, however, would only be available if the offering period has not expired. Another common alternative is where the NCE requires the JCE to repay a portion of the EB-5 loan (or preferred equity investment) as soon as proceeds become available. Of course, this may not necessarily allow for an immediate return and there is always the possibility that funds are not available until the occurrence of a liquidation event or the exit strategy contemplated in the Offering Documents (e.g., a sale or refinancing).

The Future – A New Face of Escrow

It may seem to some that the need for subscription escrow accounts in EB-5 has gone by the wayside. In fact, there still remains a need and a purpose. Lest we forget that the vast majority of banks in the United States have zero appetite for accepting and holding funds from EB-5 investors who have no continuing relationship with those banks. And country by country there are currency export restrictions that are best managed by having a subscription escrow account to receive the deposits. And most importantly, the utilizing a subscription escrow structure provides an escrow agent who acts as an independent third party and who is responsible for ensuring that the funds leave escrow at the appropriate intervals and for the benefit of the appropriate beneficiaries. The sad reality is that the escrow structure itself can no longer, by itself, be the mechanism to facilitate refunds to EB-5 investors whose I-526 Petitions may be denied because such adjudication will occur long after the funds are released from the escrow agent's control. It would be safe to expect that any new escrow agreements and the corresponding provisions found in the Offering Documents will either provide an I-526 Petition denial refund guaranty, or more likely, will offer no promise of refunds at all. In this respect, the EB-5 offerings will become more inline with traditional private equity offerings.

At the end of the day, the subscription escrow structure has been a staple component in EB-5 offerings. It has weathered many changes in the market (some more gracefully than others) and the industry has adapted accordingly. What will the next era hold in store? Only time will tell.