Understanding Loans in an EB-5 Context

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For several years, the EB-5 “loan model” structure has dominated the EB-5 industry. The loan model typically involves a special purpose vehicle ("SPV") that is formed to accept EB-5 investors. The SPV then makes a loan to the company that creates the jobs. The EB-5 investors in a loan model are invested in the SPV, as opposed to the company that operates the business and creates jobs. This means that the EB-5 investors in loan models are generally dependent upon the repayment of the loan for an exit. Therefore, for EB-5 investors in loan models that are concerned about the risk of loss in their EB-5 investment, it is important to ensure that the loan terms and quality of the borrower are suitable from a risk-tolerance perspective.

It is crucial for investors to understand the terms of the loan that supports their investment. The loan is often summarized by the issuer in an offering memorandum or other disclosure document. If the summary is not satisfactory or too brief, request a copy of the underlying documents. In some cases, the actual loan agreement is not finalized until close to the first draw from the borrower, which may be after marketing for the investment has begun or even after all of the funds have been raised. Investors may wish to reserve the right to view the agreement when it has been finalized and available or obtain assurances that the finalized loan agreement will not deviate from the proposed loan terms. In a transaction with related parties, such as is the case when a regional center has the same owners as the project developer, it may be particularly prudent for an investor to review the terms carefully to ensure that the affiliated nature between the parties does not materially affect the investor’s interest. This article touches upon a few things one should consider when evaluating the loans commonly found in EB-5 loan model structures.

Definitions: Definitions and vocabulary are the basis of language and communication. This is also true for legal agreements. How things are defined can dramatically affect the terms of a loan, including how friendly a loan is to a borrower versus a lender. For more complicated loan agreements, definitions of seemingly innocuous terms, such as “Material Adverse Effect” or “Default”, can have profound impacts on the loan.

Loan: How much is the loan? It’s important to look beyond a number. Many loans have a stated amount, but the actual amount that may be borrowed could vary dramatically. For example, some loans may have accordion features that allow the size of the loan to expand. Some other loans may have conditions on the loan so that the maximum loan amount may never truly be borrowed. Pay attention to

the mechanics of when a loan may be made and how it is made. It may give you insight into how the loan will be used and what it is used for. Look for language that discusses, minimums and maximums, and conditions that trigger changes.

Interest: The interest payments in EB-5 loan structures are important because they provide the SPV that acts as the lender with operating cash. The lender may need the operating cash to take care of expenses and to provide EB-5 investors with allowable payments. If a structure has interest that is too low, look to ensure that there are other funds to operate the SPV. Related party transactions often have low rates. Pay attention to when interest begins to accrue and when payments of interest are made, as well as how interest is charged (e.g. simple vs compounding).

Fees: What fees are involved with the loan agreement and, perhaps more importantly, who is earning those fees? Many EB-5 transactions have interested parties. This is not necessarily a bad thing depending on the quality of the underlying project and the sophistication and reputation of the parties involved, but it is something to note. If any fees look suspicious or outrageous, especially if they are not disclosed in an offering memorandum or otherwise, it may be an indication for you to review other elements of the overall transaction more carefully. All fees earned by the issuer or an affiliate of the issuer related to the transaction generally must be disclosed in the offering memorandum or other disclosure document.

Conditions to Loans: Are there conditions to the loans that protect against the money being lent out? Note that conditions could be favorable in some instances (e.g., to protect against the disbursement of cash if the borrower is not ready to accept it), but could be problematic in other instances (e.g., USCIS may have concerns about whether the money is actually at risk or going to be used to engage in the business and create jobs).

Representations & Warranties: The representations and warranties that a borrower makes in a loan agreement are one of the most useful areas to conduct diligence on a borrower or a project. Representations are essentially statements made by the borrower of facts that they claim to be true. Warranties imply some sort of promise of indemnity of a representation. This section can be quite extensive in bigger projects or loans with complicated documentation, but could be virtually non-existent with smaller projects or loans with simplified documentation. One must review the schedules to the loan agreement carefully in conjunction with the representations and warranties section to derive full value. In reviewing loan agreement representations and warranties, be sure to look for what the borrower does not represent or warrant, as what is *not* being certified often offers insight into the loan.

Covenants: Unlike representations and warranties, which assert a specific statement of fact, covenants are promises that need to be kept either affirmatively or negatively. Affirmative covenants by a borrower are things a borrower promises to do, while negative covenants by a borrower are things a borrower promises not to do. For example, a borrower may promise to create a certain number of jobs within two years while it also promises to not incur additional debt or liens. Certain covenants require the borrower to operate within certain financial thresholds and are known as financial covenants. Financial covenants can be affirmative (e.g., borrower shall maintain a leverage ratio of X:1 or less) or negative (e.g. borrower shall not allow fixed charges to exceed Y). Note that most covenants can be

drafted in the affirmative or the negative, so it is important to understand how the covenant is drafted. Reviewing the covenants and understanding why the covenants are there may give you insight into the underlying project. Just as with representations and warranties, pay attention to covenants that might be missing as that might give you useful insight into the loan.

Collateral & Priority: Is there any collateral backing up the loan? What is the collateral? How much is it worth? What priority does the lender have? Do not fall into the trap of thinking that a secured loan is safer than an unsecured loan. It really depends on the quality of the borrower, the underlying business, value of collateral, and priority of the lien against collateral. An unsecured loan in first position to a strong business with a strong management team and track record may very well be a much safer loan than a secured loan in third position to a questionable business and an inexperienced management team. Note that many lenders in first position will not allow a second position loan to be secured by the same asset that the lender has already lent against. If the asset is foreclosed on, the lender will generally possess the asset and have no obligation to pay junior creditors, if there are any. It is important to understand the priority of the loan that the SPV makes. Reviewing intercreditor agreements or otherwise understanding the intercreditor relationship and priority of payments and security will help an investor understand the risk they are taking in a deal. Take a careful look at the amount of equity in a deal that comes behind the lending obligations. If there is plenty of collateral value in an asset or equity in a structure to support all of the debt, then even the junior debt may be reasonably safe.

Default & Remedies: Ideally, there are clear provisions on what constitutes a default and what remedies are available to the lender in the event of a default. Some loans may have default interest provisions that escalate the rate of interest charged on the loan. Most loans will allow for some sort of acceleration of the loan such that the entire loan is due immediately. Note, however, that if a loan is accelerated and the borrower is left without funds to carry on its business and create sufficient jobs prior to final approval of all EB-5 visa applicants, it would likely jeopardize the immigration prospects of the EB-5 investors.

Guaranty: Is there a guarantor to the loan who will carry out the borrower's payment obligations if the borrower defaults? Who is the guarantor? What exactly are they guaranteeing, and how financially sound is the guarantor? Whether a guaranty is meaningful in a loan requires a similar analysis as required to determine whether collateral is meaningful in a loan. Many EB-5 projects could have worthless guaranties because the guarantor is financially incapable of honoring its guaranty obligations. Note that USCIS may have particular sensitivity to guaranties. Improper guaranties may cause a project to not qualify for EB-5 eligibility. Ask the issuer to provide you evidence supporting why the guaranty is strong and ask if the guarantor has made other guaranties (such as guaranties of senior debt in the same deal).

Boilerplate: Boilerplate language is in agreements not to waste time or paper, but because it has legal significance. For example, if the boilerplate allows for assignment of loans, that may create an EB-5 issue. As with the rest of the loan documentation, it is best to read through the boilerplate provisions. If

there is an assignment, confirm that the new party is obligated to maintain the EB-5 investment and restrictions for as long as needed to achieve the EB-5 purposes.

Affiliated Parties: Note that no matter how good the agreement, if all the parties are affiliated and there is no third party control mechanism, they can always waive or amend the agreements liberally. That means that even if there is a robust agreement in place, the parties could change it later to something less protective. There are strategies to better control situations where the parties are all affiliates, but case-by-case analysis is required. Remember also, that just because the parties are affiliated does not necessarily mean that a deal is bad. With trusted and sophisticated parties, it may actually be convenient for them to be able to adapt swiftly to situations that may arise.

This article is not meant to be comprehensive; entire treatises are written about loan agreements or even specific concepts within loan agreements. Ideally, this article gives the reader an insight into some of the provisions commonly found in loan agreements and how they might affect an investment analysis as it pertains to EB-5. The general logic is that a more comprehensive loan with the full range of bells and whistles may make for a safer and better loan; however, it is important to understand that a loan having all of the elements that would seem to make it a stronger and safer loan from a legal perspective does not unilaterally mean that it is actually the stronger or safer loan. Some of the safest loans in life can come from simple agreements or even oral agreements with trusted, honorable folks.

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