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# EB-5 Due Diligence Matters: Industry at Point of Inflection Regarding Securities Compliance

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EB-5 Financing Matters

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Private placement offerings are an increasingly active part of the securities business. One especially complicated and emerging area of private placements is the EB-5 Investor Visa Regional Center Program. Under the current rules of the program, an investor interested in a U.S. green card may place $500,000 or $1 million into an at-risk investment, issued by or affiliated with a United States Citizenship and Immigration Services (USCIS) designated regional center. Under current law, the per investor minimum for participation in the EB-5 Program is $500,000 for an investment in a new commercial enterprise capitalizing or facilitating a project based in a rural area or in a specific geographic location of high unemployment known as a “Targeted Employment Area” (TEA). This is a downward adjustment from the $1 million that is required in any area outside a TEA.

See *Immigration and Nationality Act*(INA), Section 203(b)(5)(B). If job creation requirements are met as anticipated in the investment deal, an investor will be eventually eligible to secure lawful permanent residence in the U.S.

The EB-5 regional center program is spiking in popularity along with other citizenship-by-investment programs around the globe. With the increase in interest in EB-5 and efforts by lawmakers to reform the program, securities compliance and due diligence are now more important than ever before for all stakeholders in an EB-5 deal. We have published an article entitled EB-5 Due Diligence Matters. Written with my colleagues Peter Saparoff and John Nucci, this article discusses why due diligence matters to various parties in EB-5 offerings. We also provide strategic guidance and pointers about EB-5 due diligence to practitioners, regional centers, and issuers of EB-5 securities. The summary below provides our readers with our main conclusions from our article. The EB-5 industry is at a point of inflection, with more SEC activity on the horizon. Here are our conclusions on EB-5 due diligence at 10,000 feet.

## *What are EB-5 regional center investments?*

The short answer is that they are almost always securities under U.S. law. EB-5 investments are also almost always illiquid, even if structured with a debt facility such as a loan. As with many forms of illiquid investments, EB-5 deals offer an exit strategy premised on an entity or business stabilizing and having funds to pay back investors. Investors who lose their money may well file lawsuits against issuers and any other party who induced them into a deal, including lawyers, brokers, or regional centers. Additionally, SEC complaints (with their Section 17(a) negligence standard) are almost a daily occurrence with respect to private placements. Given the likelihood that we will continue to see litigation and regulatory actions in this area, due diligence is essential. Investors seek due diligence for reassurance that a deal is sound, even if risky. Issuers, regional centers, and broker-dealers will find due diligence helpful in future litigation or investigations. Regardless of where you stand in a deal, due diligence is more important now than ever before in EB-5 transactions.

While the rules of SEC regulation applicable to all securities offerings are somewhat relaxed in a private placement context, a proper and thorough due diligence investigation is still required in a deal.

## *What is due diligence in the EB-5 context?*

Pursuant to the federal securities laws, an issuer, and any parties acting for that issuer, must exercise reasonable care in ensuring that the information given to the offerees and purchasers about a deal is complete and accurate. “Due diligence” is, in simplest terms, the process of ensuring – to the best of the investigator’s ability – that the statements, documents, and other information passing from the issuer to the purchasers are correct and devoid of any false or misleading information, to the same degree that the investigator would if evaluating his own property. Due diligence is a securities law spin on “kicking the tires” of a deal. There is a fact checking element to due diligence in a private placement. The process is not as stringent as due diligence conducted in a registered offering where an issuer is making disclosures to the SEC.

## *What are the parameters of due diligence?*

There are no crystal clear due diligence parameters in private offerings generally. What we know about due diligence is what we have gleaned from case law, statutes and regulations. The precise parameters of a due diligence investigation depend on the circumstances and facts in a deal. We also think that there are two general rules of due diligence in the private placement context that are very relevant to the EB-5 industry.

First, you cannot accomplish effective due diligence with a checklist. You need to turn to securities law statutes and regulations, as well as case law, to understand what is sufficient due diligence. The process is not mechanical. We think that the best due diligence in EB-5 deals is accomplished by integrating a team tasked with review of an offering and its terms, and material facts, early on in the incubation and development of a deal. Due diligence is not merely a third-party reporting on information in a prospectus.

Second, there is no simple formulaic definition of what rises to adequate due diligence. A regional center or issuer of an EB-5 security needs to work closely with qualified securities counsel to ascertain what is adequate on a deal-by-deal basis. In our view, due diligence also requires one to know what facts were omitted when deal documents were drafted and to assess that said facts need not be disclosed. The costs of excluding securities counsel and other experts to follow a deal could be high, if a material omission is uncovered later in an SEC investigation or lawsuit by investors.

## *What traps do regional centers and other professionals face when asked to enter a deal midstream?*

Coming into a deal after an investment offering document or “private placement memo” has been drafted is a potential trap for a due diligence provider, or any professional advising an issuer or regional center, particularly in a deal with related party transactions. Knowing first-hand the development of a business plan and prospectus enables a due diligence expert or professional to follow a deal, including facts that may be buried in a private placement memorandum or even excluded from the total mix of information that investors need have access to in order to make a decision. By not being present with the team that conceived a business plan and deal documents, a lawyer or other expert is reviewing only selected data and only evidence that made the final cut into a deal. After-the-fact due diligence can run the risk of being legally inadequate, looking more like an empty gesture on the part of an issuer or regional center to check off a box to investors. Taking over a deal midstream is especially risk laden for both attorneys and due diligence providers.

## *Why does due diligence matter so much?*

Due diligence is not only an investigation to ensure that disclosures are in line with what is required from a securities law standpoint. Due diligence can also be useful in future litigation, and therefore an important concept for any EB-5 regional center, issuer, or broker-dealer. Due diligence operates to mitigate risk in litigation. As we explore in our lengthier article, due diligence can be a defense in securities litigation. We think that regional centers and affiliated entities issuing securities may well be held to a reasonable care standard in litigation that develops in the EB-5 context. Having a due diligence process that reflects an issuer's attempt to exercise reasonable care and to conduct an objectively reasonable investigation would also assist a party with a defense in a claim of securities fraud brought under Section 10(b) of the Securities Exchange Act of 1934 or SEC Rule 10b-5, which is codified at 17 C.F.R. 240.10b-5.

## *What are due diligence traps in the EB-5 industry?*

There are three traps that make the EB-5 industry particularly susceptible to having inadequate approaches to due diligence institutionalized or entrenched in the marketplace.

The first is the commoditization of due diligence — meaning the sale of due diligence checklists or strategies, whether through lawyers or service providers. Due diligence in EB-5 offerings is about identifying red flags in an offering. This means that the professionals engaged in the process need to have the opportunity to develop a deal-specific process. They come in as outsiders to the issuer or regional center.

The second related issue is conflicts. Due diligence should be performed with independence. Regional center owners or issuers cannot and should not steer such a process, or engage a service that has a stake in the financial outcome of a deal such as a market-maker. A due diligence or compliance provider with a stake in the sales process could offer observations that are compromised by conflicts. Due diligence should have independence.

The third trap is skipping due diligence altogether because of financial constraints to a project. Issuers or regional centers that cannot afford to be in the business of EB-5 should not be offering or issuing securities. EB-5 is an expensive business. Simply put, the inability to afford due diligence should give us all pause. Do we want EB-5 regional centers and issuers in this business if they cannot afford the nuts and bolts of compliance? Our answer is no.

## *Where do we see EB-5 due diligence headed? What are some tips to move us forward?*

EB-5 regional centers, issuers and broker-dealers are doing business in an industry that is high risk from a securities law standpoint. Due diligence, when properly performed, can help mitigate risk. We therefore see due diligence as taking on more relevance in the EB-5 industry. Here are Mintz Levin's tips for regional centers, issuers and broker-dealers thinking about due diligence:

First, every EB-5 due diligence investigation must be customized and tailored to the facts and circumstances of the offering. This means that you need to involve a team early on to follow your deal as it develops. This is a best practice.

Second, a due diligence team should involve a range of people, beyond simply attorneys. A proper due diligence investigation likely requires highly experienced counsel, accountants, experts, and supervision by persons with in-depth knowledge of the subject matter and intricacies of the company and/or market being investigated.

Third, based on case law and existing securities law doctrine, it is important to verify all documents, statements, and other information resulting from the investigation. A reasonable investigation has to require more effort than the merely re-stating facts offered by an issuer or regional center. In other words, due diligence cannot be adequately performed by simply taking statements and information from the party being investigated at face value and relying on their veracity.

Finally, a party performing due diligence should also be wary of any red flags, or any information which would (or should) otherwise "strip underwriters of their confidence in the accuracy of an offering memorandum premised on audited financial statements." *In re WorldCom, Inc. Sec. Litig.*, 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

## *Conclusion*

Due diligence is an ongoing process in a private placement. Those involved in performing activities in a due diligence process should constantly be on alert for any changing conditions that may have an impact on their ultimate decision or conclusion in a matter. Due diligence is not a static process, but it is ongoing and dynamic. And for investors, regional centers, and issuers in an EB-5 transaction, due diligence matters.

EB-5 transactions pose special challenges precisely because of the more lax requirements that come with not being required to register an offering with the SEC. With EB-5 investments becoming a normative part of the securities law landscape, due diligence will become a more fundamental part of a deal, and a part of the bundle of protections that investors will look for when seeking durable EB-5 investments. EB-5 issuers, regional centers and broker-dealers cannot afford to do business without it.



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