THE PRECEDENT DECISIONS -- UNPRECEDENTED RESTRICTIONS ON FOREIGN INVESTORS

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This article presents a summary of the new requirements imposed upon alien entrepreneurs who seek to obtain U.S. permanent resident status based upon an investment pursuant to §203(b)(5) of the Immigration and Nationality Act. This article will not attempt to detail the history of opinions of INS General Counsel or other INS officials interpreting the regulations nor the history of prior INS adjudications consistent with those opinions. This article also will not attempt to predict the future of the immigrant investor program in the United States, which will likely be determined by Congressional action, federal court litigation and/or new regulations.

These new requirements are imposed by four precedent decisions issued by the INS Administrative Appeals Unit: Matter of Soffici, (A76 472 614 June 30, 1998); Matter of Izumii, (A76 426 873 July 13, 1998); Matter of Ho, (WAC-98-072-50493 July 31, 1998); and Matter of Hsiung (A76 854 232 July 31, 1998). These four precedent decisions create significant and extensive new requirements and new hurdles for any investor to meet, whether the investor is investing in a pooled investment enterprise or in his or her own business. Although the author believes that these precedent decisions represent a mere transition stage between the course of adjudications from 1990 to 1997 and the legislative, regulatory and judicial changes expected within the next year or two, it is nevertheless important to understand the present state of the law in order to advise those investors who dare to brave the minefield involved in the filing of an immigrant investor petition.

The four above-noted precedent decisions establish new law in the following areas:

I. PROMISSORY NOTES.

Promissory notes are expressly included in the definition of "capital" in 8 C.F.R. 204.6(e) so long as they are "secured by assets owned by the alien entrepreneur, provided that the alien entrepreneur is personally and primarily liable and that the assets of the new commercial enterprise upon which the petition is based are not used to secure any of the indebtedness." The precedent decisions impose further restrictions on the use of promissory notes as investment capital that are so extensive as to render promissory notes unusable in a large majority of investor petitions. The new requirements fall into three categories: valuation of the promissory note; term of the promissory note; and security for the promissory note.

1. Valuation of the Promissory Note: Matter of Izumii requires that the promissory note be valued at fair market value and not at its face value. This apparently requires a present value analysis in order to determine what a third party would pay for the note at the present time. This is a completely unrealistic requirement, as well as being completely inconsistent with practice under the treaty investor regulations. Presumably, written appraisals of independent sources would be required to show that the note is marketable and to prove what the present value of the note as discounted for inflation would be.

2. Term of the Note: Neither the regulations nor past practice place limits on the terms of promissory notes. However, Matter of Izumii states that "at a minimum, nearly all of the money due under a promissory note must be payable within two years, without provisions

for extensions." As a matter of practice, in order to avoid dealing with what constitutes "nearly all", the practical impact of this requirement is to limit promissory notes to a term of two years.

3. Security for Promissory Notes: Although an unsecured promissory notes is acceptable for purposes of a treaty investor visa application (9 F.A.M. 41.51n.7.1-2), for purposes of an immigrant investor petition the promissory note must be secured by assets owned by the alien entrepreneur. In addition, the alien entrepreneur must be personally and primarily liable; and the assets of the new commercial enterprise cannot be used to secure any of the indebtedness. (8 C.F.R. § 204.6(e)). These regulatory requirements regarding security for the note were clarified by a series of opinions of INS officials which established that:

--The security does not need to meet the requirements for secured transactions under Article 9 of the Uniform Commercial Code;

--There is no requirement that the lender perfect a security interest in the assets;

--The investor must be able to identify specific assets that the investor actually possesses and that can be used as security for the note;

--The Service has the right, in a particular case, to require the alien to identify specifically those assets that are being set aside as security for the note;

--Where the note is secured by foreign assets, the commercial enterprise must be able to enforce against the collateral; and

--The fair market value of the assets used to secure the note must, both at the time the indebtedness is entered and until the removal of conditions on the permanent residence status, continue to have a fair market value equal to or greater than the amount of indebtedness.

The new precedent decisions add significant additional and inconsistent requirements regarding security for the note. In addition to requiring that all notes be fully secured, the Service now requires that the security interest must be perfected under the Uniform Commercial Code. Matter of Hsiung In addition, apparently bank accounts cannot be used as security since "bank accounts can be easily dissipated." Matter of Izumii. Finally, when foreign assets are used as security, the investor must establish that the laws of the foreign country in which the assets are located would recognize, and permit execution of, a judgment of a U.S. court; or in the alternative, the petitioner must establish that the courts of that foreign country would recognize and enforce the promissory note absent the judgment of a U.S. court. Matter of Hsiung. Finally, assuming an investor could present acceptable proof of the laws of the foreign country, the investor would then have to subtract the "considerable expense and effort" that would be involved in executing on such foreign assets and reduce the fair market value of the promissory note by such amount.

Obviously the effect -- and undoubtedly the purpose-- of these rules regarding promissory notes is to, in most cases, eliminate the use of promissory notes by EB-5 petitioners.

II. RETURNS TO THE INVESTOR

The precedent decisions stray far from business reality on the issue of returns to the investor. The decisions clearly restrict returns to the investor while the investor stills owes money to the business. It is not clear to what extent the precedent decisions would disallow guaranteed returns to the investor as being violative of the "at-risk" provisions where the investor does not owe any money to the business.

Matter of Izumii expressly holds that guaranteed annual payments by an investor do not constitute a contribution of capital where the investor's obligation to make annual payments to the partnership is conditioned upon the annual distributions from the partnership. Even more troubling is the following statement: "The AAU does not at this time reach the issue of whether it is ever appropriate for a business to distribute profits to an alien who still owes money to the business." This portends the possibility that no investor could receive any returns whatsoever from the investment – whether guaranteed or speculative – at least during the period of time in which payments under a promissory note had not been completed.

III. REDEMPTION AGREEMENTS

Prior to the precedent decisions, the INS recognized business reality in holding that 8 C.F.R. 204.6(j)(2)'s requirement that the capital be "at risk" does not prohibit an investor from taking normal steps to protect his investment:

> "Neither the statute nor the regulations require, however, that that risk be an absolute one. We believe that aliens investing the relatively large amount of capital required for immigrant investor classification under Section 203 (b)(5) of the Act should be able to expect a relatively risk-free minimum return on their investments... Certainly, nothing in the statute or the regulations requires an alien investor to engage in unsound or unorthodox business practices in order to obtain benefits under Section 203(b)(5) of the Act. (Opinion of INS General Counsel, C.O. 204.6 (September 10, 1993))."

Compare this statement with the language contained in `the opinion in Matter of Izumii:

> "The alien must go into the investment not knowing for sure if he will be able to sell his interest at all

> after he obtains his unconditional permanent resident status; and if he is successful in selling his interest, the sell price may be disappointingly low or surprisingly high and more than what he paid. This way, the alien risks both gain and loss."

In other words, the alien is required to engage in unsound or unorthodox business practices in order to obtain the benefits of Section 203(b)(5).

Matter of Izumii apparently prohibits any agreement between the investor and the new commercial enterprise prior to the end of the two year period of conditional residence whereby the investor could be assured of redemption rights. In the event that the term of the promissory note goes beyond the two year period of conditional residence, there can be no agreement with regard to redemption prior to the conclusion of the payments on the promissory note. These prohibitions go well beyond the Opinion of INS General Counsel dated December 19, 1997, which allowed redemption provisions so long as they were at fair market value.

It appears that Matter of Izumii also prohibits third party guarantees to the investor whereby a bank, insurance company or other institution commits to reimburse an investor if the investment enterprise becomes insolvent or if the investment enterprise is unable to meet its commitments to the investor. Although the INS had previously stated that only a third party guarantee backed by an unconditional federal, state or municipal obligation would be considered to remove impermissibly the required risk, it would appear that all such third party guarantees are now prohibited. Apparently, the possibility of an investor being able to sell back or liquidate his investment at any time in the future cannot be discussed or agreed to, at least until after the removal of conditional residence. The investor is therefore required to invest the

full amount of his money without knowing if he will ever be able to exit the investment. This requirement, obviously, strays far from any semblance of business reality.

IV. AMOUNT OF INVESTMENT

The precedent decisions exclude from the calculation of the amount of capital investment certain amounts that appear to qualify under the regulations and that would normally be considered investments of capital in a commercial enterprise for any purpose other than an immigrant investor petition:

1. Any amount related to the establishment of the new commercial enterprise must be deducted from the amount of capital contributed to the new commercial enterprise. Matter of Izumii. Presumably, this includes administrative fees, legal fees, finders fees and start-up costs. Certainly, such start-up costs and expenses of a business in attracting foreign investments are common in investment arrangements and included for all purposes in the calculation of the total amount of investment.

2. Funds set aside by the new commercial enterprise as "reserve funds" to cover extraordinary expenses or contingencies are not considered available for purposes of job creation and therefore are not considered part of the capital placed at risk. Matter of Izumii. Again, reserve funds are perfectly normal business practices; and reserve funds are considered assets of a business enterprise. Nevertheless, these amounts that would be considered contributions of capital for other purposes are not considered contributions of capital for purposes of an immigrant investor petition.

3. Funds deposited into a corporate bank account are not considered part of the investor's contribution of capital, at least if the investor is the sole shareholder of the

business. Matter of Ho. The theory of this is apparently that these amounts are not at risk because the investor could withdraw the funds from the corporate bank account. It is not clear to what extent this restriction would apply if the investor owns less than 100% of the business.

V. ESTABLISHMENT OF A NEW COMMERCIAL ENTERPRISE

One of the most untenable of the propositions put forth in Matter of Izumii is the concept that an investor is not considered to have "established a new commercial enterprise" if the commercial enterprise was formed before -- even one day before? -- the investor's investment. The investor must have a "hand in its creation" and be "present at its inception." This effectively eliminates for purposes of EB-5 the possibility of any pooled investment, limited partnership with multiple investors or any investment enterprise seeking multiple foreign investors.

In addition, Matter of Ho requires the investment enterprise actually be undertaking business activity at the time of the filing of the petition. Signing a lease agreement or "simply formulating an idea for future business activity" is not sufficient.

8 C.F.R. 204.6(h)(2) considers "the purchase of an existing business and simultaneous or subsequent restructuring or reorganization such that a new commercial enterprise results" to be sufficient to meet the requirement of establishing a new commercial enterprise. Matter of Soffici states that new ownership, a new corporation, a new marketing strategy and changes to the decor of a hotel are not sufficient restructuring and reorganization to be considered the establishment of a new commercial enterprise. This leaves severe doubt as to what types of activities would be considered sufficient restructuring or reorganization in the context of the purchase of an existing business.

VI. EMPLOYMENT CREATION

The precedent decisions set forth numerous requirements relating to employment creation:

1. Although it is not necessary for the investment enterprise to create employment for ten full-time workers at the time of filing of the initial petition, the enterprise must submit a "comprehensive business plan", which must include, at a minimum, a description of the business; the business' objectives; a market analysis including names of competing businesses and their relative strengths and weaknesses; a comparison of the competition's products and pricing structures; a description of the target market and prospective customers; a description of any manufacturing or production processes, materials required and supply sources; details of any contracts executed; marketing strategy including pricing, advertising, and servicing; organizational structure; and sales, cost and income projections and details of the bases therefor. In addition, specifically with respect to employment, the business plan must set forth the company's personnel experience, staffing requirements, job descriptions for all positions and a timetable for hiring. Matter of Ho.

2. Although 8 C.F.R. 204.6(e) considers a holding company and its wholly-owned subsidiaries to constitute a "commercial enterprise", Matter of Izumii does not allow any of the investment capital to go to the holding company. Rather, "the full amount of money must be made available to the business(es) most closely responsible for creating the employment upon which the petition is based."

3. 8 C.F.R. 204.6(m)(7) allows an investor to meet the employment creation requirement by showing indirect employment creation if the qualifying investment is within an

approved "regional center". Matter of Izumii expands upon this requirement by stating that (apparently) all of the activities of the enterprise must benefit the targeted geographical area, or else the investor must establish direct employment creation. Similarly, Matter of Izumii requires that, in order for an investor to avail himself of the reduced capital investment requirement based upon an investment in a "targeted employment area", the investor must prove that the transactions in which the enterprise engages benefit (exclusively?) the targeted employment area.

VII. CONCLUSION

To state the obvious, this area of law is highly unsettled. The four precedent decisions shall govern investor petitions until Congress or the courts state otherwise, or until the INS issues new regulations in accordance with the Administrative Procedure Act. In the meantime, investors are left to discard normal investment opportunities in favor of investments structured to meet the unrealistic requirements of the precedent decisions. Counsel, in turn, is left to proceed at his or her peril in advising clients given this restrictive regulatory posture and this unsettled state of affairs.

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