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Drafting Private Placement Memoranda for EB-5 Securities Offerings

WHAT THE TREATISES DON'T TELL YOU

By Steven T. Anapoell

General Overview

Your client is raising money from individuals desiring to participate in the Employment Based Fifth Preference Program ("EB-5 Program") and you are now tasked with preparing adequate disclosure documents. Preparing a private placement memorandum ("PPM") can be a daunting experience for the uninitiated. We have all been there —asking ourselves— what should I read before starting? Are the PPMs I cobbled from colleagues, friends and the Internet worthy precedent or appropriate for the type of financing or entity for which I must prepare the PPM? What are my more experienced colleagues doing? What are best practices?

This article includes a pragmatic, step-by-step approach to drafting a PPM that has been well received by investors, accountants and other securities attorneys. I do not intend to provide you with an overview of applicable US, federal, state and foreign securities laws. There are a plethora of treatises and secondary resources that will provide you more than you care to know about the securities laws and the exemptions your client will want to satisfy when conducting a private placement (as opposed to a public offering) of securities.¹ Rather, my intention is to impart a sense of what securities lawyers do, so that immigration lawyers and their clients can better understand the process of preparing a PPM and to comprehend that a PPM is not a "fill-in-the blank" exercise that can be undertaken by leveraging a pre-existing form.



PPMs take a variety of forms and, by their nature, are customized to the particular offering. No form can provide a substitute for a well thought out document based on a thorough understanding of the issuer and its business. For example, PPMs used in connection with the private placement of securities to sophisticated, institutional investors typically contain less detail than those required under Regulation S or Regulation D to less sophisticated or high net-worth individuals, commonly referred to as a “retail investors.” PPMs prepared for start-up entities seeking their first round of financing may be much shorter and contain less detail than those of later stage entities with historical operations, multiple debt or equity financings or material contracts in place.



Also, PPMs for limited liability companies and partnerships are more labor intensive than those typically prepared for a similarly situated corporation because they involve substantial additional disclosures regarding the rights of security holders, such as a discussion of fiduciary duties, conflicts of interest, material federal tax consequences and a summary description of the limited liability company agreement or limited partnership agreement. If you were to design your PPM to comply with Regulation D, for domestic offers or sales to alien investors within the United States, in addition to Regulation S, for offers and sales of securities to foreign investors located outside the United States, additional disclosure may be required.²

Regulation S does not require specific items of disclosure. Accordingly, Regulation D can serve as an excellent guide to assist the drafter with identifying what is considered material information to be disclosed in the PPM as well as the form, manner and order of disclosure in the PPM. Although other federal regulations, such as Regulation A (17 CFR §§230.251-230.264), can be used as a guide for disclosure, Regulation D is less cumbersome than other possible guides.

Step 1.

Send the client a letter outlining the benefits of using a PPM, the anticipated securities law exemptions you will be relying upon, including the specific requirements to qualify for such exemption (e.g., no offer or sale of securities to investors while they are in the United States under Regulation S).

Step 2.

Ask the client for a copy of its business plan. If the client does not have a written business plan or the business plan is substantially deficient, refer the client to a business plan writer experienced with the nuances of the EB-5 Program and the applicable business plan requirements. If the client's business is regulated, contact a lawyer that practices in the regulated field (e.g., healthcare, telecommunications, banking) to review the client's business plan and provide guidance regarding the lawfulness of the proposed business and its structure. Such counsel will also be invaluable when drafting the risk factors and the regulatory portions of the PPM.³

Additionally, you should provide the client with a key management questionnaire (similar to that of a corporate directors' and officers' questionnaire) which must be completed and returned to you prior to releasing the PPM. The questionnaire will provide you with material information that must be included in the PPM. You should also provide the client with a due-diligence questionnaire of a similar nature to that provided to a seller when representing a buyer in a financing, merger or acquisition transaction. The due diligence questionnaire typically requires the recipient to provide material information about its business, operations, structure and management (including, related material agreements). You will need that information when preparing the PPM.

Step 3.

If you plan on relying on Regulation D in addition to Regulation S, you should review Rule 502(b)(2) of Regulation D (17 CFR §230.502(b)(2)). Rule 502(b)(2) describes the type of non-financial and financial information information that must be included in the PPM if any investors is not an “accredited investor.” In the context of the EB-5 Program, “accredited investor” includes individuals whose net worth⁴ (or joint net worth with the person's spouse) exceeds \$1,000,000, or whose income⁵ was in excess of \$200,000 (or, together with that

person's spouse, in excess of \$300,000⁶) in each of the two preceding years and who reasonably expects to reach the same level of income in the current year.

Regarding non-financial information, Rule 502(b)(2)(A) directs us to include, at a minimum, "the same kind of information as required in Part I of a registration statement filed under the Securities Act on the form that the issuer would be entitled to use."⁷ In other words, the PPM must include, at a minimum, that information that would be required to be disclosed in the applicable registration statement if the issuer were conducting a public offering of securities. Accordingly, the drafting attorney must review the various registration statement forms to ascertain which form the issuer would be required to use if conducting a public offering (e.g., Form S-1, S-11). Once the appropriate form is identified, the drafting attorney will have a checklist of disclosure items to be included, if material, in the PPM. Industry Guides 1-6, issued by the SEC, should also be reviewed by the drafting attorney to ascertain whether particular disclosure items must be placed in a particular order or format or whether additional information must be included in the PPM.

Please keep in mind that the disclosure items of Rule 502(b) and those required by the applicable registration statement are not exclusive. The PPM must include all information that is material to an understanding of the issuer, its business and the securities offered. Material information must be disclosed regardless of whether it is a listed disclosure item in the applicable registration statement. The drafting attorney may omit listed disclosure items that are not material to the offering. Also, Regulation D does not require that information included in the PPM be presented in the same order as that of the corresponding registration statement.

The following checklist identifies materials that prescribe the contents of a prospectus to be prepared under Form S-1 and, therefore, also prescribe the recommended contents of a Regulation S disclosure document of a company that does not report under the Securities Exchange Act of 1934.

Step 4.

Now that you have your checklist of disclosure items (and order and manner of disclosure), you should customize the form of PPM provided below to incorporate the material information contained in your client's business plan and responses to the management personnel's questionnaire.

Additionally, you should read the registration statements of various public companies to obtain examples of the manner in which material information is disclosed.

Step 5.

Once you have completed substantially a first draft of the PPM, focus on the section titled "risk factors." First, review and incorporate applicable risk factors found in the registration statements of public companies engaged in similar businesses. Second, ask the client to identify any particular risks associated with the operation of its business and/or the industry in which it conducts business. Third, review the other sections of the PPM to determine if there is information or items that give rise to additional risk factors (e.g., if the company does business in a foreign country, that fact may give rise to political risks, currency exchange risks, and repatriation of U.S. dollar risks.).



Step 6.

Provide a copy of the PPM to a partner for review and comment. The partner should not have had any prior involvement with the project. This is known as a "cold review" and is intended to ensure that the PPM is clear, unambiguous and drafted in a manner that makes sense to an uninitiated or first time reader.

Step 7.

Provide a copy of the PPM to the client for review and comment. Discuss comments with the client and incorporate into the PPM, as appropriate. Again, provide the revised PPM to "cold review" partner for final review.

Step 8.

Provide the PPM to the client for final review and comment. Make sure you have a draft stamp or watermark on the PPM indicating that it is a draft. If approved by client, provide client with a back-up certificate to be signed and returned to you certifying the accuracy of the information included in the PPM. I have included a form of back-up certificate at the end of this article for your information. Once you receive the back-up certificate, you can release the PPM to the client for distribution along with the above-mentioned subscription agreement and confidential investor questionnaire. You should also provide the client with a cover letter reminding it to review the previously sent memorandum regarding the use of a private placement memorandum, the maintenance of an investor control log and a reminder to avoid general solicitations. Also, prepare and provide to the client an investor

subscription agreement and confidential investor questionnaire for delivery along with the PPM to prospective investors.

Form S-1 Checklist

Form S-1 refers to Regulation S-K for specification of most of the non-financial information required by the form. The outline below lists the categories of information typically found in a private placement memorandum for an offering of securities by a private company. The outline identifies the applicable Form S-1 item and the corresponding Regulation S-K disclosure item. The drafting attorney may use the following outline as a checklist of disclosure items for a private placement memorandum. However, the applicable Form S-1 or Regulation S-K disclosure item description should be referred to in the drafting of the memorandum.

Disclosure Items for Private Placement Memorandum

1. Outside Front Cover Page of PPM

Set forth on the outside front cover page the information required by Item 501 of Regulation S-K (17 CFR §229.501)

2. Inside Front and Outside Back Cover Pages

Set forth on the inside front cover page or, where permitted, on the outside back cover page, the information required by Item 502 of Regulation S-K (17 CFR §229.502)

3. Summary Information and Risk Factors

Furnish the information required by Item 503 of Regulation S-K (17 CFR §229.503)

4. Use of Proceeds

Furnish the information required by Item 504 of Regulation S-K (17 CFR §229.504)

5. Offering Price

Furnish the information required by Item 505 of Regulation S-K (17 CFR §229.505)

6. Dilution

Furnish the information required by Item 506 of Regulation S-K (17 CFR §229.506)

7. Plan of Distribution

Furnish the information required by Item 508 of Regulation S-K (17 CFR §229.508)

8. Description of Securities to be Registered

Furnish the information required by Item 202 of Regulation S-K (17 CFR §229.202)

9. Interests of Named Experts and Counsel

Furnish the information required by Item 509 of Regulation S-K (17 CFR §229.509)

10. Information with Respect to Issuer

Furnish the following information with respect to the Issuer:

- (a) *Description of Business*: Information required by Item 101 of Regulation S-K (17 CFR §229.101)
- (b) *Description of Property*: Information required by Item 102 of Regulation S-K (17 CFR §229.102)
- (c) *Legal Proceedings*: Information required by Item 103 of Regulation S-K (17 CFR §229.103)
- (d) *Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters*: Where common equity securities are being offered, information required by Item 201 of Regulation S-K (17 CFR §229.201)
- (e) *Financial Statements*: Financial statements meeting the requirements of Regulation S-X (17 CFR Part 210) (Schedules required under Regulation S-X shall be filed as "Financial Statement Schedules" pursuant to Item 16, Exhibits and Financial Statement Schedules, of this Form), as well as any financial information required by Rule 3-05 and Article 11 of Regulation S-X
- (f) *Selected Financial Data*: Information required by Item 301 of Regulation S-K (17 CFR §229.301)
- (g) *Supplementary Financial Information*: Information required by Item 302 of Regulation S-K (17 CFR §229.302)
- (h) *Management's Discussion and Analysis of Financial Condition and Results of Operations*: Information required by Item 303 of Regulation S-K (17 CFR §229.303)
- (i) *Changes In and Disagreements With Accountants on Accounting and Financial Disclosure*: Information required by Item 304 of Regulation S-K (17 CFR §229.304)
- (j) *Market Risk Disclosures*: Information required by Item 305 of Regulation S-K (17 CFR §229.305)
- (k) *Directors and Executive Officers*: Information required by Item 401 of Regulation S-K (17 CFR §229.401)
- (l) *Executive Compensation*: Information required by Item 402 of Regulation S-K (17 CFR §229.402)
- (m) *Security Ownership of Certain Beneficial Owners and Management*: Information required by Item 403 of Regulation S-K (17 CFR §229.403) and
- (n) *Certain Relationships and Related Transactions*: Information required by Item 404 of Regulation S-K (17 CFR §229.404)

11. Disclosure of Commission Position on Indemnification for Securities Act Liabilities

Furnish the information required by Item 510 of Regulation S-K (17 CFR §229.510)



Steven T. Anapoell is a shareholder in the Irvine office of Greenberg Traurig, P.C., where he focuses his practice on forming private equity, distressed debt, real estate, venture capital and special strategy funds, mergers and acquisitions, private and public securities offerings, debt and equity investments and financings, and structuring and negotiating complex corporate transactions. He has extensive experience in representing start-up and emerging growth companies and regularly advises clients on such issues as capital formation and financing strategies, general corporate governance and tax planning. Mr. Anapoell also advises clients interested in raising capital for, and establishing regional centers to administer, projects qualifying for investment under the EB-5 Entrepreneur Investment Visa Program. Mr. Anapoell has been selected by *Los Angeles Magazine* as one of Southern California's "Super Lawyers" in the areas of Securities & Corporate Finance, Business/Corporate and Tax for the years 2009 – 2012. He also holds a rating of preeminent in his field by *Martindale-Hubbell*. Mr. Anapoell is the former Chair of the Limited Partnerships and Limited Liability Companies Committee, State Bar of California Business Law Section. He is the author and 2011 update author of Chapter 6A – Drafting a Private Placement Memorandum Under Regulation D (the Continuing Education of the Bar-California) – *Financing and Protecting California Businesses*; the 2011 update author of Chapter 5A – Issuing Common Shares to Founders and Investors (the Continuing Education of the Bar-California) – *Financing and Protecting California Businesses*; and the co-editor and co-author of *Guide to Organizing and Operating a Limited Liability Company in California* (second edition), Business Law Section of the State Bar of California. Mr. Anapoell received his LL.M (Taxation) from Georgetown University Law Center, his J.D. from the University of California (Hastings College of the Law), and his B.S. in Business Administration from the University of California (Berkeley).

ENDNOTES:

- ¹ "A PPM is frequently used to satisfy federal and state disclosure requirements. Although a written disclosure document is not technically required under federal law (unless Rule 502(b) applies) or the laws of most states, such a document provides an invaluable record of disclosure in the event of lawsuits by disaffected investors. Producing a written document also ensures that the appropriate disclosure is made in a complete and methodical manner." *Drafting a Disclosure Document for a Private Offering in California*, Charles P. Ortmeeyer (*California Business Law Practitioner*, Volume II, Number 2, Spring 1987).
- ² "Regulation D's guidelines are extensive and compliance can be expensive. This concern is especially relevant when analyzing the type of disclosure documented needed in cases in which potential purchasers are accredited, sophisticated investors and there is a clear exemption under §4(2) (private offerings). In these situations, the added costs of complying with Regulation D disclosure requirements may not be justified by the extra protection of a broader disclosure. Sophisticated, accredited investors who purchase shares as venture capitalists may be unlikely to sue a small company if such an investment goes sour. In these situations, a disclosure memorandum with less detail than required under Regulation D will probably suffice, e.g., an updated business plan or a scaled down private placement memorandum." *Drafting a Disclosure Document for a Private Offering in California*, Charles P. Ortmeeyer (*California Business Law Practitioner*, Volume II, Number 2, Spring 1987).
- ³ A few years ago, I recommended a client seek the advice of healthcare counsel to review its business plan. The client was adamant that he did not need such an expert and insisted that we draft the PPM. We prepared the PPM and delivered it with the caveat that it should be reviewed by appropriate regulatory counsel and that we were instructed not to do so by the client. The client then conceded, and we referred him to appropriate counsel. Healthcare counsel indicated that the client's anticipated structure and/or operations were not legal in a number of states. The client thanked us for insisting on regulatory counsel and was upset with himself for not heeding our advice at the inception. The PPM had to be substantially re-written, and the client incurred substantial additional costs for its error. We would have been quite embarrassed had we not alerted the client to our concerns or worse, if the client were prosecuted or otherwise penalized for a faulty business plan and related PPM.
- ⁴ For purposes of this item, "net worth" means the excess of total assets at fair market value, including cash, stock, securities, personal property and real estate (other than the investor's primary residence), over total liabilities (other than a mortgage or other debt secured by the investor's primary residence). In the event that the amount of any mortgage or other indebtedness secured by the investor's primary residence exceeds the fair market value of the residence, that excess liability should also be deducted from the investor's net worth. Any mortgage or indebtedness secured by the investor's primary residence incurred within 60 days before the time of the sale of the securities offered to the investor pursuant to the PPM, other than as a result of the acquisition of the primary residence, shall also be deducted from the investor's net worth.
- ⁵ For purposes of this item, "individual income" means adjusted gross income as reported for U.S. federal income tax purposes, less any income attributable to a spouse or to property owned by a spouse, increased by the following amounts (but not including any amounts attributable to a spouse or to property owned by a spouse): (i) the amount of any interest income received which is tax-exempt under Section 103 of the United States Internal Revenue Code of 1986, as amended (the "Code"), (ii) the amount of losses claimed as a limited partner in a limited partnership (as reported on Schedule E of Form 1040), (iii) any deduction claimed for depletion under Section 611 et seq. of the Code, and (iv) any amount by which income from long-term capital gains has been reduced in arriving at adjusted gross income pursuant to the provisions of Section 1202 of the Code prior to its repeal by the Tax Reform Act of 1986.
- ⁶ For purposes of this item, "joint income" means adjusted gross income as reported for U.S. federal income tax purposes, including any income attributable to a spouse or to property owned by a spouse, increased by the following amounts (including any amounts attributable to a spouse or to property owned by a spouse): (i) the amount of any interest income received which is tax-exempt under Section 103 of the Code, (ii) the amount of losses claimed as a non-managing member in a limited liability company (as reported on Schedule E of Form 1040), (iii) any deduction claimed for depletion under Section 611 et seq. of the Code, and (iv) any amount by which income from long-term capital gains has been reduced in arriving at adjusted gross income pursuant to the provisions of Section 1202 of the Code prior to its repeal by the Tax Reform Act of 1986.
- ⁷ You should review information required in Part II and include any such information material to investors in your offering.
- ⁸ The SEC issued these disclosure guidelines for use in connection with the preparation of registration statements and reporting requirements for entities engaged in particular industries. You can find a copy of these guides in Vol. 1, Fed Sec L Rep. (CCH) at §§3825-3830.
- ⁹ "Some practitioners include disclosure items listed in the applicable registration form, even when such items are not material, to demonstrate compliance with the norm deemed appropriate by the SEC." *Drafting a Disclosure Document for a Private Offering in California*, Charles P. Ortmeeyer (*California Business Law Practitioner*, Volume II, Number 2, Spring 1987).
- ¹⁰ The placement of certain information in a private placement memorandum may be an integral part of the disclosure required. For example, Regulations S-K, Item 503(c) (17 CFR 229.503(c)), requires that the summary of risk factors be placed on the page immediately following the prospectus cover page, or following the summary description of the issuer and its business. Also, don't forget to review applicable industry guides. Those guides often times prescribe the physical placement of information.