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Business Entities

Anonymous LLC Ownership of Real Estate: A Lawyer's Obligations

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While real estate ownership by limited liability companies (LLCs) remains an area of focus for government agencies seeking to root out money laundering and terrorism financing, a growing area of interest is the obligations of real estate lawyers in preventing the use of these entities to further criminal activities. To date, lawyers have not been subjected to formal reporting requirements as other real estate transaction participants such as financial institutions have. Given the continuing focus on these criminal activities in real estate transactions, real estate lawyers should consider developing more robust client diligence procedures to mitigate money laundering and terrorism financing risks in these transactions as well as to minimize the reputational risk associated with participating in such transactions.

FinCEN's GTOs

Since January 2016, the Financial Crimes Enforcement Network (FinCEN) of the U.S. Department of the Treasury has issued a series of Geographic Targeting Orders (GTOs) to collect information regarding "all cash" residential real estate transactions in certain markets in an effort to better understand the use of LLCs in such transactions. FinCEN has speculated that individuals use LLCs in these transactions to mask their identity in an effort to facilitate money laundering and terrorism financing. On Aug. 22, 2017, FinCEN issued its most recent GTO that expanded the number of locations and the types of real estate transactions subject to reporting requirements. Honolulu joined the list of covered areas, which also includes New York, Miami, San Diego, Los Angeles, San Francisco and San Antonio. In addition, the GTO added wire transfers to the list of covered payment mechanisms, which closed a significant gap in the transactions requiring reporting. In connection with this GTO, FinCEN issued an advisory aimed at real estate transaction participants, including lawyers, noting that as of May 2, 2017 "over 30 percent of the real estate transactions reported under the GTOs involved a beneficial owner or purchaser representative that had been the subject of unrelated Suspicious Activity Reports (SARs) filed by U.S. financial institutions." This data point supports FinCEN's concern that individuals involved in suspicious activities are using LLCs to mask their identities.

As with previously issued GTOs, FinCEN required title companies to report transaction information. Since a real estate transaction may not involve a title company but almost always involves lawyers, the question of why not impose such reporting obligations on lawyers arises. To date, although financial institutions in real estate transac-

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tions are subject to anti-money laundering and combatting terrorism financing program requirements, lawyers are not subject to a comparable set of obligations.

Federal Legislative Efforts

While the federal government has made progress with respect to imposing "know your customer" requirements on financial institutions, including those involved in real estate transactions, lawmakers have made little progress with respect to beneficial ownership transparency efforts, particularly as they relate to imposing reporting obligations on lawyers. In 2017, Rhode Island Senator Sheldon Whitehouse sponsored the "Incorporation Transparency and Law Enforcement Assistance Act," which has been introduced multiple times in both houses of Congress. In addition to requiring an LLC to file information on the natural persons who are its ultimate beneficial owners with either the LLC's state of formation or the U.S. Department of the Treasury, the bill includes provisions that would subject lawyers to certain provisions of the Bank Secrecy Act. More specifically, the bill proposes adding "formation agent," who is a person that assists in an entity's formation, to the definition of "financial institution" under the Bank Secrecy Act. The bill would require a formation agent to establish an anti-money laundering program in accordance with the Act's requirements. In addition to the Incorporation Transparency bill, Sen. Whitehouse also reintroduced the "Stop Tax Haven Abuse Act", which again seeks to curb the use of shell corporations by requiring a formation agent to develop an anti-money laundering program. Although the proposed legislation would suggest that real estate lawyers who are often involved in setting up LLCs in connection with real estate transactions would become subject to the anti-money laundering program requirements, it is important to note that each of the proposed bills includes an exception for lawyers who use paid formation agents in connection with entity formation. While there is some question as to how one should interpret the proposed language, the exception suggests real estate lawyers who typically work through a corporate service provider could avail themselves of the exception to the requirements imposed by the proposed legislation.

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ABA Guidance

To date, much of the legal community, including the ABA, has resisted these legislative efforts on the grounds that the obligations imposed conflict with both the attorney-client privilege and confidentiality obligations of lawyers. In addition to these concerns, the ABA points to guidance it has issued in an effort to help lawyers prevent becoming involved in money laundering and terrorism financing activities. The guidance adopted in 2010, "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing," offers a risk-based approach that seeks to balance money laundering and terrorism financing prevention measures with the risks identified to avoid the creation of a costly and overly burdensome process. In its May 2013 Formal Opinion 463, the ABA reiterated its position that lawyers use the guidance to develop risk-based client due diligence processes consistent with the Model Rules particularly as they relate to attorney-client privilege and confidentiality.

For a real estate lawyer undertaking a transaction for a new client, the risk-based approach outlined in the ABA guidance advises that a lawyer undertake sufficient client due diligence to assess the "true identity" of the client and the "true nature" of the transaction being undertaken. In general, a lawyer should base the risk assessment on: (1) geographic risk, (2) client risk and (3) service risk. To assess geographic risk, a real estate lawyer can look to countries subject to embargoes or sanctions or countries identified by watch groups as having high levels of criminal activity to assess whether the client or the transaction itself requires a heightened level of due diligence. For client risk, the guidance identifies 11 client categories, such as clients who "mask beneficial ownership" or who are in cash-intensive businesses, that would warrant heightened scrutiny. As noted earlier, FinCEN's GTOs have identified "all cash" residential real estate transactions as a particular area of criminal activity concern. To assess service risk, the guidance identifies 14 types of services, including accelerated real estate transfers and concealment of beneficial ownership, that should cause a lawyer to undertake a heightened level of diligence. This framework would enable a real estate lawyer to assess the level of risk that a potential transaction is being used to facilitate criminal activity.

FATF Findings

The ABA adopted its 2010 guidance to address recommendations made by the Financial Action Task Force (FATF), which is an international intergovernmental body focused on the promotion of policies aimed at combatting money laundering and terrorism financing. The FATF's 2008 guidance applied to five specified activities, which included the buying and selling of real estate because FATF viewed these transactions as particularly susceptible to money laundering and terrorism financing. The impetus for the ABA's guidance is important to note because in December 2016 FATF issued its mutual evaluation report regarding the effectiveness of measures taken in the United States to combat money laundering and terrorism financing. The FATF noted in its key findings that while the United States has a "well developed and robust" system for combatting money laundering and terrorism financing, the system has "some significant gaps" such as the lack of anti-money laundering and combatting of terrorism financing obligations for lawyers, particularly for those involved in high-end real estate transactions. The report identifies the high-end real estate market, along with financial institutions and casinos, as especially vulnerable to money laundering, and notes that while financial institutions and casinos are subject to anti-money laundering and suspicious activity reporting, this is not the case for many high-end real estate transaction participants. As a result, the report recommends, among other things, that FinCEN use the information gathered from its GTOs to develop a more comprehensive anti-money laundering and combatting terrorism financing regime for real estate transaction participants. While acknowledging the existence of the ABA's guidance for lawyers, the report highlights that the guidance is not enforceable and not sufficiently known among lawyers. FATF's report indicates that a rules-based approach would provide a more effective means to enabling real estate participants to prevent money laundering and terrorism financing in real estate transactions.

While lawyers can take some comfort from the fact that financial institutions have "know your customer" and reporting obligations, financial institutions are not always involved in real estate transactions.

Given the increasing scrutiny that real estate transactions face in terms of money laundering and terrorism financing, real estate lawyers should educate themselves on appropriate client diligence procedures and proactively strengthen such procedures. While lawyers can take some comfort from the fact that financial institutions have "know your customer" and reporting obligations, financial institutions are not always involved in real estate transactions. Real estate lawyers would benefit from undertaking their own diligence to ensure they mitigate the potential risk of money laundering and terrorism financing in transactions, which would have the added benefit of also minimizing the reputational risk associated with participating in these transactions.