Viewpoint - Federalizing real estate transactions: Another surprise under the USA Patriot Act

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Countless real estate transactions occur each year in the United States, ranging from simple residential closings to highly complex sales of commercial real estate.
The underlying assets may be a home, an office building, a weekend cabin in the mountains, an industrial warehouse, an apartment building, a resort hotel or a condominium project.
The seller typically transfers ownership in the real estate by delivering a signed deed to the buyer. In some cases, the seller may effectively transfer ownership in the real estate by conveying the interests in the ownership entity itself, such as member interests in a limited liability company.
Financing is usually involved, with the lender making a loan secured by the real estate asset.
In the real estate transactions described above, federal law typically does not play a significant role. Most real estate transactions are governed by state law and local custom — not federal law.
But a massive federal law enacted shortly after the Sept. 11, 2001, terrorist attacks raises the specter that the federal government may intrude into residential and commercial real estate transactions in ways thought unimaginable before the attacks.
Known as the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act), the legislation has led the federal government to propose rules designed to combat money laundering and terrorist financing in these types of transactions.

Background

Title III of the USA Patriot Act amended a number of provisions of the Bank Secrecy Act (BSA). Known as the International Money Laundering and Abatement and Financial Anti-Terrorism Act of 2001, Title III sought to amend the BSA to facilitate the prevention, detection, and prosecution of international money laundering and the financing of terrorism.
As amended by Section 352 of the USA Patriot Act, the BSA now requires every "financial institution" to establish an anti-money-laundering program that includes the following minimal elements:
(1) the development of internal policies, procedures and controls;
(2) the designation of a compliance officer;
(3) an ongoing employee training program; and
(4) an independent audit function to test programs.
The BSA's definition of "financial institution" is extremely broad. The definition includes institutions that are already subject to federal regulation such as banks, savings associations, credit unions, and registered securities broker-dealers and futures commission merchants.
The definition also includes "money services businesses" (e.g., currency dealers or exchangers, check cashers, issuers of traveler's checks, money orders or stored value, and money transmitters); dealers in precious metals, stones or jewels; pawnbrokers; loan or finance companies; private bankers; insurance companies; travel agencies; telegraph companies; sellers of vehicles, including automobiles, airplanes and boats; persons engaged in real estate closings and settlements; investment bankers; investment companies; and commodity pool operators and commodity trading advisors that are registered or required to register under the Commodity Exchange Act.

The Treasury Department, through its Financial Crimes Enforcement Network (FinCEN), has issued a series of regulations or notices of proposed rulemaking covering nearly all of the defined financial institutions. On April 10, and after almost a year of delay, FinCEN finally issued a notice of proposed rulemaking for the remaining financial institution: "persons involved in real estate closings and settlements."

Neither the BSA nor its legislative history define or elaborate on the meaning of "persons involved in real estate closings and settlements."

Nor does the USA Patriot Act or its legislative history shed any light on the meaning of this phrase. The "real estate" language originated in Section 6185(a) of the Anti-Drug Abuse Act of 1988, which amended the BSA in 1988.

It is thus left to FinCEN to define this phrase. Through the notice, FinCEN seeks to solicit public comments on a "wide range of questions" pertaining to the requirement that financial institutions establish anti-money-laundering programs for "persons involved in real estate closings and settlements." Interested parties must submit their comments to FinCEN by no later than June 9.

In its April 10 notice, FinCEN identifies four broad issues for public comment:

What are the money-laundering risks in real estate closings and settlements?

How should persons involved in real estate closings and settlements be defined?

Should any persons involved in real estate closings or settlements be exempted from coverage under Section 352?

How should the anti-money-laundering program requirement for persons involved in real estate closings and settlements be structured?

This article will provide an overview of each issue in turn and then discuss preliminary observations on the four issues.

Money-laundering risks

FinCEN states that the real estate industry "could" be vulnerable during all three stages of money laundering because high-value products are involved.

In support of this premise, FinCEN points to a 1996 report prepared by the National Institute of Justice stating that "real estate transactions offer excellent money-laundering opportunities."

FinCEN seeks input on the experience of the real estate industry with money-laundering schemes, the existence of safeguards to prevent money laundering in this industry, and the additional steps that should be taken to ward off money laundering and terrorist financing in the real estate industry.

The notice acknowledges that the real estate industry has been proactive in identifying potential money-laundering vulnerabilities. The notice specifically notes that the American Land Title Association has identified several "red flag" situations where money-laundering activities may be afoot.

Definitions in closings and settlements

Because of the absence of any legislative history on the phrase "persons involved in real estate closings or settlements," FinCEN has focused on the word "involved" and has read it to mean that it is intended to cover participants other than those who actually conduct the real estate settlement or closing.

FinCEN then identifies the "potentially broad" universe of participants in real estate transactions, including brokers, escrow agents, lenders, title insurers, appraisers and lawyers.

According to FinCEN, the following are significant factors in defining the phrase:

(a) identifying those persons whose services rendered or products offered in connection with a real estate closing or settlement that can be abused by money launderers;

(b) identifying those persons who are positioned to identify the purpose and nature of the transaction;

(c) identifying the importance of various participants to successful completion of the transaction, which may suggest that they are well positioned to identify suspicious conduct;
(d) identifying the role of professionals in a transaction, ranging from a person highly involved in structuring the transaction to a property inspector; and
(e) identifying the level of involvement with the actual flow of funds used to purchase the property.

FinCEN seeks comment on which participants in the real estate closing and settlement process are in a position where they can effectively identify and guard against money laundering in real estate transactions.

Specifically, FinCEN wants input on:
(a) the extent to which various participants have access to information regarding the nature and purpose of the transactions at issue;
(b) the importance of the participants' involvement to successful completion of the transactions; and
(c) the real estate sector in general and on various transaction types, especially in the commercial real estate industry.

FinCEN observes that attorneys often play a "key role" in real estate closings and settlements and thus "merit consideration" along with the other professionals involved in the real estate closing and settlement process.

Exemptions

Parties already subject to separate anti-money-laundering programs will not, in FinCEN's view, be subject to anti-money-laundering rules for persons involved in real estate closings and settlements.

FinCEN seeks comment, however, on whether there should be an exemption for any category of persons involved in real estate closings and settlements. FinCEN indicates that it will undertake a cost-benefit analysis to determine whether the cost of imposing anti-money-laundering rules on a category of persons is outweighed by the benefit.

FinCEN notes that it does not intend to regulate the purchasers and sellers of their own real estate; rather, the question of exemption is specifically directed to real estate professionals and those who trade in real estate on a commercial basis.

Structure

FinCEN seeks comment on any particular concerns that smaller companies and sole proprietors may have regarding the implementation of an anti-money-laundering program as well as the types of programs persons involved in real estate closings and settlements have in place to prevent fraud and illegal activities.

In this regard, FinCEN recognizes that persons involved in real estate closings and settlements may have programs in place to meet existing legal obligations (e.g., requirement to report on Internal Revenue Service Form 8300 the receipt of over $10,000 in currency and certain monetary instruments).

Preliminary observations

As an initial matter, FinCEN fails to point to any statistical evidence or empirical data to support the notion that the real estate industry is a locus of money-laundering activities.

Other than citing three 1997 appellate decisions involving money laundering in the real estate context, FinCEN does not offer any compelling arguments in support of the need for federal anti-money-laundering regulation in the real estate industry.

Indeed, one of the cases cited in the notice, United States v. High, 117 F.3d 464 (11th Cir. 1997), involved residential real estate, not commercial real estate.

Absent more compelling empirical data, one may question whether the cost and burden of any anti-money-laundering program imposed on the real estate industry outweighs the benefit to be derived from such a program.

The notice contains conflicting discussions on what is meant by a “closing and settlement.” In one portion of the notice, FinCEN defines a closing and settlement as the “process in which the purchase price is paid to the seller and title is transferred to the buyer.”

By contrast, a later portion of the notice speaks of closings and settlements as including a vast array of real estate transactions that go far beyond a conventional purchase and sale consummated by the delivery of a signed deed.

For example, the notice points to lease agreements as being the basis of an acquired property right. By referring to lease agreements, FinCEN may be signaling that the proposed regulations may encompass not only traditional purchase and sale transactions but also every commercial lease transaction throughout the country.

It is unclear from the notice whether FinCEN intends to regulate those transactions involving the transfer of interests in a title holding entity as a means to acquire ownership of the underlying asset.

For example, rather than conveying ownership of real property by a deed, the parties may structure the transaction as the sale of member interests in a single asset limited liability company. There are legitimate reasons for structuring transactions in this manner, but it is unclear whether such a transaction would fall within the purview of a “real estate closing and settlement.”

If the phrase “persons involved in real estate closings and settlements” means anything, it means the actual purchasers and sellers of the underlying real estate. The notice, however, dismisses this notion by remarking that “FinCEN wishes to make clear that it does not intend to cover purchasers and sellers of their own real estate. ... The question of exemption is specifically directed to real estate professionals, and those who trade in real estate on a commercial basis.”

This statement apparently means that FinCEN does not desire to regulate every home sale in the nation. But what is meant by “trade in real estate on a commercial basis”?

Does it include the one-time sale of a second home, the periodic leasing of a duplex owned by retirees, or the consummation of a certain number of real estate transactions within a defined time period?

Does this standard mean all real estate other than a personal residence? Must one analyze the investment purpose and goal of the seller or buyer?

Does “commercial basis” include the purchase and sale of residential real estate?

Trigger

It is interesting to note that the notice does not contemplate a threshold dollar value that would trigger the imposition of anti-money-laundering program requirements. For example, an investor who buys and sells $30,000 inner-city row homes may have the same regulatory compliance obligations as a multi-billion-dollar real estate investment trust.

The notice correctly identifies the participants that may be involved in a real estate closing and settlement (e.g., brokers, title insurers, escrow agents, and appraisers) and notes that the level and scope of participation by any particular participant may vary significantly in a given real estate closing and settlement.

In most situations, the involvement of these professionals is usually a one-shot affair with no long term, on-going relationship. Absent such a long term relationship, it is difficult to determine how these professionals could be in a position to identify suspicious activity.

Of particular interest to the real estate bar is the notice’s discussion of the “key role” often played by attorneys in real estate closings and settlements. The notice, however, adopts an exceedingly narrow view of the attorney-client privilege.

The notice takes the position that the application of anti-money-laundering program requirements on attorneys “in connection with activities relating to real estate closings and settlements [does not raise issues of, or pose] obligations inconsistent with, the attorney-client privilege.”

FinCEN arrives at this surprising conclusion by drawing a parallel to the existing BSA requirement mandating the reporting of the receipt of cash or cash equivalents in an amount over $10,000 on a Currency Transaction Report (IRS Form 8300). FinCEN believes that attorneys “should take the basic steps contemplated by Section 352 to ensure that their services are not being abused by money launderers.”

FinCEN’s desire to impose anti-money-laundering program requirements on attorneys runs afoul of fundamental principles of the American legal system.

As noted in the February report of the ABA Task Force on Gatekeeper Regulation and the Profession, a requirement that attorneys report activities of their clients “would undermine the independence of the bar from the government, erode the essential trust relationship between the attorney and the client which is a bedrock of the U.S. administration of justice and rule of law, and compromise the principle of confidentiality in communications between a lawyer and the client.”

The notice states that the “guiding principle” in defining the phrase “persons involved in real estate closings and settlements” is to “include those persons whose services rendered or products offered in connection with a real estate closing or settlement that can be abused by money launderers.”

FinCEN notes that “involvement with the actual flow of funds used to purchase the property is a significant factor.” The flow of funds is certainly germane, and FinCEN should place particular emphasis on those persons involved in real estate closings and settlements who actually “touch the money.”

For example, an attorney who directs a third party escrow agent to release funds held in escrow should not be subject to anti-money-laundering requirements, but the escrow agent through whose account the funds flow should be subject to these requirements.

Cost

It is becoming increasingly customary to conduct closings and settlements by escrow, where physical attendance of the participants is not required. For example, the parties may send all of the closing documents to an escrow agent.

On receipt of the required documentation and funds, the escrow agent will close the transaction without other participants in physical attendance. The notice touches on this growing practice (which it refers to as a “Western style” closing), but it does not explain whether different standards or levels of due diligence should apply to these types of closings.

From a practical standpoint, this means that the closing documents are signed out of the escrow agent’s presence, thereby making identification of the transaction parties more difficult. Indeed, the signatories may not even be located within the United States or the local jurisdiction.

Commercial real estate transactions often involve the use of a single asset ownership entity to hold title to a real estate asset.

The person involved in the real estate closing and settlement may not know the identity of all of the members of a limited liability company or the partners of a partnership, particularly “lower tier” members or partners.

It may be impractical to impose a burden on such a person to ferret out the identity of all of the members or partners in such an entity. The notice does not appear to address this issue.

Finally, the cost of imposing an anti-money-laundering program on real estate professionals may be significant and may possibly outweigh the benefit of such a program.

The cost, both in terms of money and time, of anti-money-laundering training and the cost of hiring a “compliance officer” to audit the efficacy of the anti-money-laundering program may be significant.

It may be unrealistic to expect real estate professionals to steep themselves in the expansive gamut of domestic and international money-laundering schemes, nuanced

accounting issues, and to incur the cost of expensive and sophisticated software designed to detect money laundering.

Conclusion

The Sept. 11, 2001, terrorist attacks may unfortunately take yet another toll on the American economy if the notice is transformed into a set of regulations that impose onerous anti-money-laundering requirements on the real estate industry.

This issue is most acute with real estate attorneys, who run the risk of breaching ethical obligations to comply with a federalized real estate regulatory regime.

The requirements would also chill the attorney-client relationship with marginal benefit to the fight against money laundering. Interested parties must make their voices heard on this important issue by submitting written comments to FinCEN by no later than June 9.

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