

August 11, 2016

## Anti-Corruption Laws and Other International Risks – What it Means for the Real Estate Industry and How to Protect against Risks

Bribery, money laundering, and sanctions are key international risk areas for any global business, particularly those investing or operating in high-risk jurisdictions and industries. In addition to meaningful enforcement concerns, the potential reputational harm that accompanies these risks should not be underestimated as corruption cases are regular headlines in the international press. The real estate industry is commonly viewed to be higher risk in light of the numerous government touch points, the heavy reliance on third parties such as joint venture partners or property managers, particularly in emerging or higher risk markets, and the frequency with which bad actors seek to launder ill-gotten gains through the purchase of property. However, as described in more detail below, these risks can effectively be managed by investors with robust compliance controls, including pre-transaction due diligence and post-investment compliance monitoring.

### Attorneys

[John M. \(Jack\) Creedon](#)

[David C. Djaha](#)

[Marc D. Lazar](#)

[Kim B. Nemirow](#)

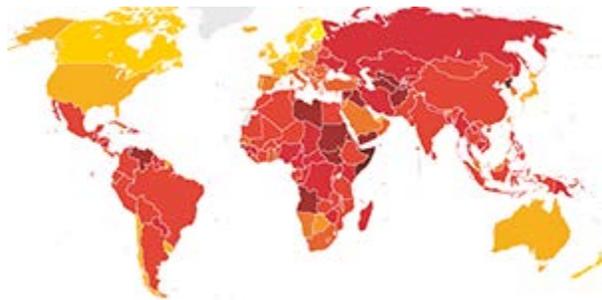
[Amanda N. Raad](#)

[Asheesh Goel](#)

[James P. Dowden](#)

[Alexandre H. Rene](#)

### The Real Estate Industry Is Highly Exposed to Key Corruption, Money Laundering, and Sanctions Risks



*Transparency International's Corruption Perceptions Index scores and ranks countries on an annual basis based on the level of perceived corruption within each country. As indicated by the corresponding map, the majority of the world is perceived to be subject to significant corruption. Transparency International "Corruption Perceptions Index 2015" © 2015 by Transparency International. Licensed under CC-BY-ND 4.0.*

- **Anti-Corruption:** Across industries, investors are subject to a heightened corruption risk if they operate in high-risk locations, have extensive interactions with government officials, give gifts and entertainment to potential business partners, and rely extensively on third parties. The real estate industry is considered to be particularly high-risk because it hits on so many of these risk areas:
  - **High-Risk Markets:** Many real estate investors are rapidly expanding into emerging markets that are perceived to have high levels of corruption. In particular, we have seen growing asset portfolios across Africa, India, China, Latin America and the Middle East. This enhanced corruption risk is further complicated by the fact that asset owners typically are not located in the same geography as the asset, and thus rely heavily on local third-party property managers or local joint venture partners.

- **Extensive Government Interactions:** Depending on the jurisdiction, asset owners, developers, and property managers may be required to interact with government officials for a variety of reasons, including negotiating contracts, obtaining construction and development permits or environmental approvals, overseeing inspections, and meeting the requirements for daily operation. Indeed, the government requirements necessary to acquire and develop property vary significantly by jurisdiction, which only compounds the need to rely on local partners to navigate the sometimes very technical approval and permitting processes.
- **Reliance on Third Parties:** U.S., UK, and other regulators are keyed in on the use of third parties to funnel improper payments to prospective business partners and government officials. To be clear, if a property manager, asset manager, environmental consultant, or any other third party offers a bribe to further the business of a real estate owner, developer, or investor, those individuals and entities could be exposed to liability pursuant to global anti-corruption laws. Indeed, nearly all corruption cases brought by the U.S. DOJ and SEC involve conduct by third parties.
- **Money Laundering:** Bad actors, including sanctioned individuals and entities, frequently attempt to launder ill-gotten gains, including the profits of corrupt activity, through disguised property investments. In many jurisdictions, it is easy to disguise the ultimate beneficial owners of a particular asset through intermediate entities. This exposes real estate investors to the risk of inadvertently facilitating illegal money laundering. The U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) is taking steps to address these risks and drive greater transparency in real estate purchases.
  - **Geographic Targeting Orders:** In January, FinCEN implemented Geographic Targeting Orders (GTOs), which will temporarily require U.S. title insurance companies to identify the beneficial owners of limited liability companies (LLCs), partnerships, and other legal entities used to pay all cash for high-end residential real estate. We described the potential implications of the GTOs in an earlier client alert, which can be found [here](#). Then-FinCEN Director Jennifer Shasky Calvery stated that the move was intended to address the perceived information gap posed by all-cash purchases and "to understand the risk that corrupt foreign officials, or transnational criminals, may be using premium U.S. real estate to secretly invest millions in dirty money."
  - **Enhanced Customer Due Diligence Requirements for Financial Institutions:** In May, FinCEN finalized "enhanced" due diligence requirements, including a requirement to identify and verify the ultimate beneficial ownership of account holders, applicable to certain regulated financial institutions, including banks. FinCEN specifically cited increased scrutiny of money laundering through U.S. real estate purchases as one of the drivers of the new rules. Covered financial institutions must comply by May 2018.
  - **AML Requirements for Real Estate Investment Advisers:** FinCEN is also considering implementing new minimum AML standards for SEC-registered Investment Advisers who are not covered by the new rules for financial institutions noted above. Many real estate private equity managers qualify as Investment Advisers, however, and as a result of these proposed rules may need to develop additional screening, diligence and reporting requirements for investors and co-investors seeking, amongst other investments, to invest in U.S. real estate.
- **Sanctions:** Economic sanctions programs, including those administered by the U.S. Office of Foreign Assets Control, the United Nations Security Council, Her Majesty's Treasury, and the European Union, include

prohibitions on dealings with restricted, or “sanctioned,” individuals and entities. In parallel with increased attention on corrupt individuals laundering money through real estate, regulators are also focused on ensuring that sanctioned individuals and entities do not evade those sanctions through opaque third-party asset holdings.

## International Regulators Are Aggressively Enforcing International Risk Laws

Regulators charged with enforcing anti-corruption, anti-money laundering, and economic sanctions laws and regulations have turned new attention to the real estate industry, and investigations and enforcement efforts span the globe. Over recent years, U.S. and UK authorities have investigated real estate investors and their employees for allegedly making payments to government officials in order to construct and sell properties, as well as the conduct of management companies and the use of third parties to pay bribes, launder money, or evade economic sanctions:

- U.S. regulators, along with their counterparts around the world, are currently investigating the laundering of funds belonging to Malaysian development fund 1MDB through companies, including those owned by a close confidant of the Malaysian Prime Minister, to purchase significant U.S. real estate properties.
- In 2012, in a matter for which Morgan Stanley was lauded by DOJ for having very strong compliance controls that an executive conspired to evade, a former managing director at Morgan Stanley’s real estate investment and advisory business was sentenced to prison for including a Chinese government official in real estate investment deals as a quid pro quo for gaining additional business.
- In 2013, prosecutors won a bid to seize a high-profile Fifth Avenue skyscraper after it found that it was owned by entities that were a front for Bank Melli Iran, an institution wholly owned by the Iranian government, and thus subject to U.S. economic sanctions.

Aside from public U.S. and UK investigations relating to bribery, money laundering and sanctions, we have also seen non-public investigations in this space throughout the world, including, for example:

- In Hong Kong, we have seen an increase in enforcement in this area, particularly with investigations into payments made by property managers, at the request of government officials, in order to pass inspections or to obtain licenses in order to carry out daily operations.
- Similarly, Turkish authorities recently investigated a foreign-based property management company for allegedly paying bribes to a government official in order to resolve a safety issue. During an internal investigation, we also came across additional requests for donations and sponsorships by officials related to approvals and relationship building.

While enforcement actions and legal liability are certainly compelling risks, the reality of holding an asset tainted by corruption extends much further. The accompanying financial and reputational damage from investigations, assets that cannot be sold, and the mere appearance of impropriety can destroy investment value. As such, it is imperative that real estate owners, developers, and investors take sufficient measures to assess these risks prior to investing, implement corresponding controls to mitigate the risk, and monitor the investment’s activity on a regular basis.

## How to Protect Yourself Against Liability and Other Harms

Regulators enforcing anti-bribery, sanctions and anti-money laundering laws will look to a real estate investor’s compliance program when evaluating a case and any potential penalties. The DOJ and SEC will take into account a company’s compliance program, alongside factors such as self-reporting, cooperation, and other remedial actions, when evaluating whether and how to pursue FCPA actions. Under the UK Bribery Act, the only defense for companies charged with a failure to prevent a bribery offense is to have in place adequate procedures to prevent bribery.

When implemented effectively, a strong compliance program can allow an investor to potentially avoid a high-risk transaction, or at a minimum ensure that the investor avoids liability for conduct of a rogue third party. Two examples we've seen in practice are described below:

- During the due diligence process, a global real estate investor learned that a proposed property manager in India expedited the environmental approval process for a different property by paying small amounts of cash to local government officials. By identifying the situation prior to engagement, the investor was able to proceed with the acquisition but engaged a different property manager.
- An investor's proactive audit into a property management company identified dozens of small gifts and gift cards given to government officials in several cities throughout China in order to generate goodwill. The investor and the property manager then conducted a joint investigation into the conduct, took appropriate remedial steps against the employees giving the gifts, and enhanced the compliance program at the property management company to deter and detect such conduct going forward.

Compliance programs are not one-size-fits-all and should be tailored to a company's operations and risk areas. With that said, what follows are guideposts for an effective compliance program in the real estate industry.

### An Effective Compliance Program

Establishing an effective compliance program starts with a strong tone at the top from management expressing the importance of ethical business conduct and requiring compliance with laws, including appropriate anti-corruption, anti-money laundering, and economic sanctions regimes. It will also consist of tailored policies, procedures, and training addressing relevant risk areas, as well as monitoring procedures aimed at assessing the effectiveness of the compliance program. Policies, procedures, training, and monitoring should be proportionate and tailored to the company's risks.

- Enterprise-Level Compliance Program: A real estate investor's compliance program should begin with appropriate policies and procedures for its own business and employees. Investment professionals should be trained on the risks of doing business internationally and, importantly, anyone serving as a board director should understand his or her heightened obligations and potential individual liability for conduct at the investment.
- Pre-Acquisition Due Diligence – Assets: Prior to acquiring an asset or making an investment, diligence should be conducted on the seller and asset to determine whether there are any past issues with the property or corrupt conduct on behalf of the seller. For established, fully operational properties, this might include looking at prior investors and property managers to determine if they have been involved in any criminal conduct that might raise red flags, or how prior contracts or licenses with government officials were negotiated or renewed. In the case of developing properties, or the purchase of land to build a property, the investor will need to understand what permits and licenses will be required to construct the property and how those will be obtained (including whether they will be obtained prior to or as a condition to the closing of the acquisition). In all cases, investors will want to pay particular attention to any red flags indicating that the seller may not have proper and clear title to the property.
- Pre-Acquisition Due Diligence – Property Managers: Similarly, a company's compliance program should set out risk-based due diligence steps to be taken when engaging property managers or partnering with local sponsors or operators through joint venture arrangements. Heightened due diligence will often be required for these parties, particularly in high-risk countries, given that they may be interacting with government officials to obtain approvals, permits and licenses, and will also be working with prospective business partners to lease the property and provide management oversight.

For both assets and property managers, the due diligence steps to be conducted will largely depend on the risk presented, but may include a public media search on the relevant parties and key individuals, including

checking individuals and entities against sanctioned party lists, review of relevant documents, policies and procedures, and a discussion with management or completion of a due diligence questionnaire. Appropriate representations, warranties and covenants in contractual agreements should also be considered.

- **Portfolio Risk Assessment:** In order to have an efficient and effective compliance program, it is imperative that real estate investors and developers understand their risks. Conducting a risk assessment across all properties and property managers in an investor's portfolio will allow the investor to tailor its compliance program and effectively allocate resources. The risk assessment should include an analysis of the location of the assets, the extensiveness of government contacts, the use of third parties, and any existing compliance program in place.
- **Monitoring Assets and Third-Party Property Managers:** Just as companies must monitor compliance at an enterprise level, they should also monitor compliance at the asset and property manager level. Depending on ownership stake and risk level, the type of monitoring will vary, but might include conducting periodic audits and obtaining compliance certifications. Moreover, in addition to proactive monitoring, owners, developers, and investors should take appropriate steps to investigate any red flags that might arise in relation to the property, including via an allegation or other complaint. We have seen whistleblowers report concerns about a property or property manager directly to the investor, and it is imperative that the investor take appropriate steps to investigate all reasonably credible allegations.

There is no doubt these risks are real, and regulators are paying close attention. While no compliance solution is failsafe, your best protection is to closely examine your unique risk profile and to create a tailored compliance program.

### Our Experience in this Area

Ropes & Gray has market-leading experience developing and implementing international risk due diligence programs for real estate transactions. When evaluating risk of liability under anti-corruption and international risk laws, we work closely with deal teams to provide guidance concerning the appropriate contractual language to address compliance issues, as well as strategic advice to avoid potential post-investment violations. Our team includes 20 former federal prosecutors and enforcement attorneys from the U.S. Department of Justice, the U.S. Securities and Exchange Commission, U.S. Attorneys' offices nationwide, as well as the U.K. National Crime Agency, who have undertaken around 200 such instructions in relation to real estate investments across the world. Our Real Estate Investments & Transactions attorneys provide advice on sophisticated investment and financing transactions in the real estate area throughout the world and have the industry experience to be able to identify heightened risk situations with precision. We utilize the resources of our highly ranked interdisciplinary practice groups around the globe to craft the right solution for virtually any type of real estate transaction. With 11 offices across three continents, our Real Estate Investments & Transactions team of more than 85 highly skilled real estate attorneys have worked on complex real estate deals to service a broad spectrum of clients globally. Our real estate clients include private equity firms, REITS and global banking and investment firms. We are well equipped to provide advice on this emerging area of risk in real estate investment transactions and on enforcement matters, as well.