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

Real estate investment involves many risks with which real estate investment managers are familiar. These range from “micro” risks, such as tenant disputes and defective property maintenance, to “macro risks” such as negative demographic trends and instability in global capital. Increasingly, among these “macro risks” are bribery, money laundering, and sanctions concerns. In addition to meaningful enforcement concerns, the potential reputational harm that accompanies these risks should not be underestimated. These risk areas impact the real estate industry in Asia in particular, due to (1) the number of government touch points, (2) its reliance on third parties, especially in emerging markets or higher risk markets, and (3) the frequency with which bad actors seek to launder ill-gotten gains through the purchase of property.

In this Alert, we describe some of these risks in more detail and provide some suggestions about what real estate investment managers can do to protect themselves against such risks in the Asian markets in particular.

### 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, entities 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 India, China, Africa, 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:** Asset owners and developers may be required to interact with government officials for a variety of reasons, including negotiating contracts, obtaining construction

permits or environmental approvals, overseeing inspections, and meeting the requirements for daily operation. Moreover, 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. In China, too, there is increased focus on bribes through third parties. For instance, China has expanded penalties for bribery and corruption through its Ninth Amendment to the PRC Criminal Law (the “Amendment”), which became effective on November 1, 2015. The Amendment adds the crime of providing bribes to current and former state functionaries’ close relatives or other persons closely related to them; adds monetary penalties in addition to other punishments for corruption-related crimes for individuals; replaces specific monetary figures that trigger different levels of punishments with more general standards such as “relatively large,” “huge,” and “especially huge”; and restricts the circumstances in which bribe-givers will be exempted from punishment. 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 involve conduct by third parties.
  - “Cracking down on corruption is what all countries must do and what their people wish to see.” – Xi Jinping
- **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 UK’s first national AML risk assessment identified significant gaps with respect to real estate holdings. Soon, however, as is explained in more detail in our recent alert “An Englishman’s Home is His Castle – Just!,” corporate entities that own property will be required to disclose their ultimate beneficial owners as UK regulators seek to crack down on corruption in this space.
    - “Corrupt individuals and countries will no longer be able to move, launder and hide illicit funds through London’s property market.” – David Cameron
  - Similarly, in January, the U.S. Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) implemented Geographic Targeting Orders that 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. 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.”
- **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 or launder money. As to sanctions, 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 involving our own clients in this space throughout the world. The facts below have been altered to preserve the anonymity of our clients:

- 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, in China, payment of bribes and other luxury gifts to government officials in order to obtain assistance with rezoning applications, removal of squatters and approval of a development project have raised concerns for investment companies with real estate portfolios.

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.

In our experience, we have seen instances in which issues similar to those above have been identified by real estate investors during the due diligence process or self-monitoring, both of which are discussed in more detail below, allowing them to protect against such enforcement. For example:

- During the due diligence process, a global real estate investor learned that a proposed property manager in India had sped up the environment 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.

Thus, there are ways to protect against the aggressive reach of regulators, or at least to mitigate the harms.

## 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. Indeed, under the UK Bribery Act, the only defense to a failure to prevent a bribery offense is to have in place adequate procedures to prevent bribery. While not an affirmative defense in the United States, the DOJ and SEC will take a company's compliance program into

account when evaluating whether and how to pursue FCPA actions. For example, the DOJ and SEC cited Morgan Stanley's strong compliance program and internal controls in 2012, in declining to take action against the company, when a Morgan Stanley employee conspired to sell the company's ownership interest in a Shanghai building to a local government official who had helped the employee secure business for Morgan Stanley in China.

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 their heightened obligations and potential individual liability for conduct at the investment. For example, investments in emerging Asian markets will likely involve undeveloped property or property that needs significant repair or redevelopment. In these instances, anti-corruption risk is heightened because construction and development of properties require government permits, licenses, and approvals.
- **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. 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 developers and investors 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, and U.S. Attorneys' offices nationwide, 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.