

## **The USA Patriot Act: Surprising Implications for Real Estate Lawyers©**

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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 September 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”). 31 U.S.C. §§ 5311-5355. 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

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program, and (4) an independent audit function to test programs. USA Patriot Act § 352(a), 31 U.S.C. § 5318(h).

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, 2003, and after almost a year of delay, FinCEN finally issued a notice of proposed rulemaking ("Notice") for the remaining financial institution: "persons involved in real estate closings and settlements." 68 Fed. Reg. 17571, April 10, 2003.

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 § 6185(a) of the Anti-Drug Abuse Act of 1988 (Pub. L. 100-690), which amended the BSA in 1988. It is thus left to FinCEN to define this phrase. Through the Notice, FinCEN sought to solicit public comments on a "wide range of questions" pertaining to the requirement that financial institutions establish anti-money laundering ("AML") programs for "persons involved in real estate closings and settlements."

In its April 10, 2003 Notice, FinCEN identified 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?

The deadline for submitting comments was June 9, 2003, and FinCEN received 52 comment letters from interested parties. Until recently, persons interested in

reviewing the comment letters had to inspect them in person at FinCEN's offices in Washington, D.C. Now, these letters are available for review on FinCEN's website at [http://www.fincen.gov/reg\\_352comments.html](http://www.fincen.gov/reg_352comments.html). The purpose of this article is to highlight several practical, policy, and legal issues raised by various prominent bar-related and other professional organizations that submitted comments to FinCEN.

The Section of Real Property, Probate, and Trust Law of the American Bar Association ("ABA Real Property Section"), the American College of Real Estate Lawyers ("ACREL"), the ABA Task Force on Gatekeeper Regulation and the Profession ("ABA Gatekeeper Task Force"), and the Section of Real Property, Probate and Trust Law of the Florida State Bar Association ("Florida Bar") submitted detailed comment letters to FinCEN. In addition to these organizations, the American College of Mortgage Attorneys ("ACMA"), the American Land Title Association ("ALTA"), and the Mortgage Bankers Association of America ("Mortgage Bankers") also submitted thoughtful comment letters. The approaches taken by each organization differ markedly in important respects, but the consistent themes among most of the comments is the concern that (a) the AML requirements may adversely affect the attorney-client privilege and the duty of client confidentiality (collectively, the "Privilege"), and (b) the AML requirements would impose onerous burdens on the real estate industry with no corresponding benefit to the fight against money laundering and terrorist financing. Copies of the ABA Real Property Section, ACREL, and Florida Bar comment letters are attached.

### **ABA Real Property Section Approach**

The ABA Real Property Section believes that imposing the Section 352 AML program requirements on lawyers would adversely affect the Privilege and would detract from the role that lawyers play in assisting members of society to understand and comply with the rule of law. The ABA Real Property Section requested that FinCEN give due regard to the critical role played by lawyers in the American legal system, which depends on lawyers to advise clients regarding the scope, meaning, and application of law to business transactions.

To the extent FinCEN seeks to impose the Section 352 requirements on lawyers, the ABA Real Property Section indicated that these requirements should be carefully tailored so that they apply, at most, to those lawyers who act as financial intermediaries and actually handle the receipt and transmission of cash proceeds through accounts that they actually control in the act of closing a commercial real estate transaction. Under this "financial intermediaries" test, the ABA Real Property Section is of the view that the AML requirements should be imposed only on clearly defined financial intermediaries and then only in a commercial real estate transactions of a sufficient size to warrant the increased cost of compliance with the regulations.

### **ACREL Approach**

ACREL took the position that FinCEN needs to develop a clear and specific protocol whereby one of the parties to a real estate closing and settlement be required to provide a written confirmation to the other parties that the appropriate AML due diligence has been undertaken under Section 352. The other parties to the closing and settlement would be entitled to rely reasonably on this confirmation and would not be required to engage in costly and time consuming due diligence investigations that would be duplicative and redundant of the confirming party's due diligence investigations. ACREL believes that it is neither economical nor sensible to impose the Section 352 AML requirements on *all* of the other participants in a real estate closing and settlement if one or more participants in a commercial real estate closing and settlement has already undertaken and performed the Section 352 AML due diligence investigations.

The AML requirements, which include the development of internal policies, procedures, and controls and the requirement that a participant involved in a real estate closing and settlement develop an independent audit function to test the AML programs, are in ACREL's view at odds with the Privilege. To the extent any Section 352 AML requirements are imposed on lawyers, ACREL advocates that those requirements must be carefully developed so that they do not conflict with the Privilege.

ACREL suggested in its comment letter that certain real estate closings and settlements should be exempt from the Section 352 AML program requirements. These exemptions include real estate and loan transactions below a significant amount (e.g., \$10,000,000) where the transaction is financed by an institutional lender, certain transactions to the extent AML due diligence has been previously performed (e.g., the resale of individual loans as part of a securitization should not require new AML due diligence on the underlying transaction, but only on the source of the funds for the securitization), transactions where real estate is not the principal asset being conveyed at the closing and settlement (e.g., the sale of a business that, in part, owns commercial real estate), transactions not involving the conveyance of an interest in real estate at the closing and settlement (e.g., the payment of monthly mortgage payments, the execution and delivery of a lease, delivery of a real estate contract, and the funding of deposits into escrow), and mineral and royalty interests.

In concluding its comments, ACREL made the following observation:

These rules must be developed in light of the critical roles that the attorney-client privilege and duty of client confidentiality play in the American judicial system. At the same time, we have recommended a proposal that would impose the burden of AML requirement compliance on the party who is best positioned to perform the Section 352 due diligence and to have the other parties reasonably rely on that due diligence.

## **Florida Bar Approach**

Because of Privilege concerns, the Florida Bar took the position that lawyers should not be subject to any AML requirements in any respect. Unlike ACREL and the ABA, the Florida Bar's per se approach does not envision any exceptions. The Florida Bar pointed to both practical and legal reasons for its position. The practical reasons why the AML requirements should not be imposed on real estate lawyers are that these requirements would (a) unnecessarily duplicate the AML compliance practices already conducted by financial institutions, (b) protract the closing process, and (c) result in significant compliance fees and expenses being passed on to the parties to a real estate transaction. The Florida bar noted two legal reasons for not imposing AML requirements on real estate lawyers:

[T]he inclusion of real estate attorneys within the USA PATRIOT Act Section 352 AML program requirement would: (1) impose on real estate attorneys a duty to conduct basic due diligence on the identity of their clients—which would cause clients to feel distrustful of their attorney and would discourage clients from communicating fully and frankly with their attorney; and (2) impose on real estate attorneys a de facto obligation to report questionable transactions to law enforcement authorities—thus conflicting with long-standing rules of client confidentiality and attorney-client privilege.

## **ABA Gatekeeper Task Force Approach**

The ABA Gatekeeper Task Force was formed in February 2002 to address issues arising from national and international governmental action to enlist the assistance of various professionals in combating money laundering and terrorist financing. These professionals, viewed as “gatekeepers” to the domestic and international monetary systems, include lawyers.

In its comments, the ABA Gatekeeper Task Force emphasized the importance of the Privilege and the independence of the bar. The comments noted that, although the Notice does not specifically seek to impose a suspicious activity reporting requirement on “lawyers or other persons involved in real estate closings and settlements, the risk is that once anti-money laundering requirements of due diligence, record-keeping, and internal audit are imposed, the [suspicious activity reporting] requirement may not be far behind.”

The ABA Real Property Section and the ABA Gatekeeper Task Force took essentially the same position on identifying those persons who should be subject to AML requirements in the context of real estate closings and settlements. Based on its reading of the BSA, the ABA Gatekeeper Task Force concluded that “only those lawyers who actually conduct or are responsible for actually conducting the receipt of transfer of proceeds from a buyer to a seller in the context of a real estate closing and settlement should fall within the ambit of ‘persons involved in real estate closings or settlements.’”

### **American Land Title Association Approach**

In its comment letter, ALTA urged FinCEN to proceed “very cautiously” in developing the AML requirements for the real estate industry. ALTA proposed that FinCEN consider exempting residential mortgage loan refinances and similar transactions because of the low risk of money laundering, and expressed the hope that FinCEN would be sensitive to the practical problems of imposing AML requirements on solo practitioners and for persons settling few transactions.

Consistent with comments from others (including the ABA Real Property Section), ALTA believes that the risk of money laundering in real estate closings is “relatively small, compared to other types of financial assets.” ALTA supported its view by describing in detail the steps involved in money laundering and why those steps posed little money laundering risk in a typical real estate closing. ALTA thus concluded that the limited evidence of money laundering in connection with the real estate closing process does not justify “imposing a significant compliance burden on real estate closers.”

### **American College of Mortgage Attorneys Approach**

Similar to the position advocated by the Florida Bar, ACMA commented that “mortgage and real estate attorneys should not be subject to any requirements under the [USA Patriot Act], i.e., they should be exempt from being considered as ‘financial institutions’ or ‘involved in real estate closings and settlements.’” ACMA noted that the imposition of AML requirements on mortgage and real estate attorneys would “significantly—and detrimentally—alter the attorney-client relationship in connection with an attorney’s representation of parties to a real estate transaction involving the transfer by deed, or otherwise, and/or the financing of real estate.

ACMA suggested that it “would be more practical and effective to impose the requirements of the proposed rule only on those ‘financial institutions’ that are customarily and directly involved in providing or handling funds at commercial real estate purchase and financing transactions, such as banks, insurance companies, and other mortgage lenders.” ACMA proposed that the AML requirements should not apply to secondary-market mortgage transactions where the mortgage loans are “packaged,” securitized, and sold to investors.

### **Mortgage Bankers Association of America Approach**

The comment letter from the Mortgage Bankers contained a number of interesting observations. First, the Mortgage Bankers argued that FinCEN should not adopt an overly inclusive definition of “persons involved in real estate closings and settlements.” The Mortgage Bankers proposed that regulations in this area “should be limited to those individuals who are directly responsible for conducting the real estate settlement or closing.” Second, the Mortgage Bankers strongly support the Treasury Department’s suggestion that financial institutions already covered or to be covered by separate USA

Patriot Act AML regulations should not be included in the definition of “persons involved in real estate closings and settlements.”

The Mortgage Bankers echo the concern raised by many of those who submitted comments that the AML requirements would impose significant costs, burdens, and delays on the real estate industry that are disproportionate to the harm being prevented. Based on these concerns, the Mortgage Bankers outlined several considerations that FinCEN should consider in developing the final regulations. These considerations include the following:

- Rules should recognize the rapidly developing electronic real estate settlement and electronic note and related documents. Any rule implementing the USA Patriot Act must provide sufficient flexibility not to disrupt or overly burden this option.
- A safe harbor should be offered to “persons involved in real estate closing[s] and settlements” if they contract with other financial institutions to collect or verify customer identification. Likewise, financial institutions, including “loan and finance companies,” must be granted that safe harbor if using a person involved in real estate closings and settlements to perform customer identification and verification procedures.

#### **“The OFAC List”**

Although outside the scope of this article, it is nonetheless worth noting that as part of their due diligence some practitioners check the list of “Specially Designated Nationals & Blocked Persons”, which is published and regularly updated by the Treasury Department’s Office of Foreign Assets Control and names the persons and entities with whom transactions are blocked by Executive Order 13224. The order, issued by President Bush shortly after the terrorist attacks on September 11, 2001, prohibits transactions not only with persons who are determined by the Secretary of State, Secretary of Treasury and Attorney General to have committed or pose a significant risk of committing terrorist acts, but also persons who act for them or who assist, sponsor or provide services to or support for them. Penalties for noncompliance are severe, including civil penalties up to \$10,000 for non-willful violations. The list is available on-line at [www.treas.gov/ofac](http://www.treas.gov/ofac).

#### **Conclusion**

The comments submitted these organizations reflect the difficult practical, policy, and legal issues facing FinCEN in developing AML regulations for “persons involved in real estate closings and settlements.” The overarching concern is that any AML regulations imposed on real estate attorneys may force the attorneys to breach important 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 and terrorist financing.