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The "Panama Papers" and the Secret World of Shell Corporations

Reducing Liability Exposure and Seeking Insurance Coverage

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A leak of 11.5 million documents from a law firm in Panama may implicate politicians, criminals, and celebrities in sheltering of fortunes in offshore tax havens through the use of shell companies. Called the "Panama Papers," the release of information is creating shock waves across the globe—leading to the resignation of at least one head of state and exposing billions in assets belonging to politically exposed persons (PEPs).

The leaked information is unraveling a secret world of shell companies used by wealthy individuals to allegedly hide assets, and the potential involvement of attorneys and bankers in allegedly facilitating the hiding of such assets. The International Consortium of Investigative Journalists reports that the law firm of Mossack Fonseca worked with more than 14,000 banks, law firms, company incorporators and other middlemen to set up companies, foundations and trusts for customers. In light of these events, financial institutions and other entities may need to consider whether they are implicated, how to assess the risks, how to minimize exposure, if any, and whether insurance coverage is available.

Understanding the Legal Risks

As prosecutors and bank regulators continue to follow the money trail, US domestic financial institutions and foreign banks with branches, agencies or other offices in the United States may face scrutiny if the Panama Papers directly implicate the institution or the institution maintains accounts for the hundreds of individuals or more than 200,000 shell companies contained in the Panama Papers. Prosecutors and bank regulators are likely to question the adequacy of anti-money laundering policies and programs required under the Bank Secrecy Act, including Know Your Customer policies, due diligence procedures and the risk level assessment and monitoring of accounts controlled by PEPs. In recent years, Bank Secrecy Act violations have resulted in highly public prosecutions and millions in penalties against banks.

Money laundering statutes, 18 U.S.C. Sections 1956, 1957, may also be implicated. Specifically, prosecutors may explore aiding and abetting liability for institutions that knowingly assisted the laundering of illicit proceeds or, more likely, willfully failed to inquire as to the source and ownership of illicit proceeds. Significantly, money laundering statutes specifically provide for extraterritorial jurisdiction if the conduct is by a US citizen, or, in the case of a non-US citizen, if the conduct occurs in part in the United States and the value of the funds exceeds $10,000.

Similarly, prosecutors are likely to explore conspiracy or aiding and abetting theories under the Foreign Corrupt Practices Act (FCPA) if any of the monies were used to bribe foreign officials. The FCPA applies to issuers of securities in the United States, or that have a principal place of business in the United States—or certain persons and entities, other than issuers and domestic concerns, acting while in the territory of the United States. The FCPA also has extraterritorial reach, and the Department of Justice has recently announced its intent to focus on more high-impact cases. The DOJ also recently hired more prosecutors, resulting in the increase of the Fraud Section's FCPA Unit by fifty percent.

The offshore shell companies and financial institutions maintaining such accounts could also be implicated in the avoidance of economic and trade sanctions based on US foreign policy. Without proper mechanisms in place to monitor the nature and source of wire transfers, some financial institutions may have dealt with entities that are specifically barred by the Department of the Treasury's Office of Foreign Assets Control (OFAC). Sanctions violations can result in criminal charges and penalties which have reached billions of dollars.

Financial institutions may also be subject to investigation for conspiracy to facilitate tax evasion by their US customers through the use of offshore entities.

Should an institution be publicly disclosed as being the subject of an investigation or ensuing prosecution, it is not uncommon thereafter to face shareholder lawsuits. Implicated or accused customers and/or clients may also sue, claiming the advice to participate in these shell companies was improper.

Internal Investigations

As a result of the media coverage and the dissemination of specific information, financial institutions may now be deemed to be on notice of potential wrongdoing within. It is likely that prosecutors and bank regulators will be issuing information requests and subpoenas to many financial institutions. Such institutions may be well advised, to the extent not already initiated, to conduct internal investigations to understand the facts and assess the criminal and civil exposure, if any. It is a significant benefit to have conducted an investigation before the first subpoena arrives.

As in other circumstances, the investigation should be conducted with a view toward protecting the attorney-client privilege. Institutions may thus opt for outside counsel to conduct the investigation, rather than in-house counsel or compliance personnel, in order to ensure the protection of the privilege, particularly where policy deficiencies are systemic and/or senior management is implicated. Significantly, outside counsel can protect findings and ensuing discussions under the attorney-client or work product privileges. That protection extends to consultants retained by outside counsel to assist in identifying and analyzing the facts.

Following an assessment of the results of the investigation, and in the event wrongdoing is in fact uncovered, a voluntary disclosure to regulators or the appropriate government agency should be considered to attempt to minimize criminal and civil exposure and fines. Following the issuance of the Yates Memorandum, prosecutors will be looking for individuals who may be held accountable, and the institutions must take this into account. The new policy affirmatively directs prosecutors to focus aggressively on individual employees from the very beginning of an investigation, regardless of whether it begins in the civil or criminal context, and government attorneys are also expected to pursue internal referrals between their respective units. Other remedial action, such as updating and refining compliance policies and programs, may be in order.

Insurance Coverage for Investigations

Financial institutions will likely face high costs in conducting their own internal investigations, responding to government subpoenas and other demands, and possibly defending a shareholder lawsuit and any customer or client claims. Directors and Officers (D&O) and Errors and Omissions (E&O) liability insurance policies might be the first line of defense. But these are often confusing and complex, and frequently contain multiple variables, any one of which can affect whether, and in what amount, insurance dollars are available to respond.

While some insurance companies in recent years have offered specific coverage extensions for certain investigations, such as FCPA, that coverage frequently is limited to costs incurred by individuals or is subject to a relatively low policy sub-limit. Policyholders should be aware, however, that even in the absence of a specific provision for FCPA investigations, coverage may be available under a policy's standard coverage terms. Both D&O and E&O policies generally cover investigative costs associated with responding to a "claim."

But what constitutes a "claim" triggering coverage varies widely across policies. Some policies make it more likely that coverage is available when the government serves a subpoena or civil investigative demand because they either do not define "claim" (creating an ambiguity in the policy) or define "claim" broadly to include lawsuits, administrative proceedings, investigations and target letters.

Other policies might define "claim" to include only demands for monetary and non-monetary relief, civil or criminal proceedings, or actions commenced by the return of an indictment. Some newer policy language can even provide coverage for certain "pre-claim" inquiries from governmental agencies and specifically for subpoenas, which would cover reasonable attorneys' fees and costs for interviews or meetings with government enforcement agencies.

Coverage might also be available for resulting shareholder lawsuits because such lawsuits more commonly fit into the definitions of "claim" in D&O insurance policies and may, under certain circumstances, also fall under the coverage provided by an E&O policy. And if, for example, customers or clients bring claims alleging improper advice, then financial institutions might be able to look to their E&O policies for defense and indemnity coverage.

Companies should also generally be aware of common "conduct exclusions" that deny coverage for intentional conduct, including fraud or self-dealing. In most policies, however, only a non-appealable judicial finding of wrongdoing triggers this type of exclusion. Thus, in most cases, insurance companies cannot withhold defense costs during the pendency of the investigation or proceedings.

Conduct exclusions are not the only hurdle. Notice must be provided as soon as possible to any insurance company under whose policy it might seek coverage. Notice, at the initial stage, need not be too detailed, and instructions might differ from policy to policy, such as the date by which notice must be provided, to whom notice must be provided, and the form the notice must take. But the claimant must adhere strictly to the directions in each insurance policy regarding notice.

Most policies, under what is commonly known as the “voluntary payment” exclusion, also exclude costs that are incurred without the insurers’ knowledge and consent. And in almost every case, the insurers are only responsible for “reasonable” attorney’s fees and costs. Getting insurers involved early is critically important to maximize coverage potential.

Financial institutions should also carefully evaluate their indemnification obligations to other companies and/or their rights to be indemnified by others as well as their additional insured rights under other companies’ D&O and E&O insurance policies. Notice is equally important under these policies as it is under one’s own policies. And because the limits of these policies are almost always eroded by defense costs, it is critically important to get in line early before available limits are exhausted by others.

Best Practices

- Investigations
    - Involve counsel early, whether in-house or outside counsel, to protect attorney-client privilege.
    - Evaluate whether any client accounts have been set up or organized by Mossack Fonseca.
    - Determine whether beneficial ownership information for all structured and corporate account holdings has been obtained, particularly for offshore entities.
    - If a foreign entity, consider whether US taxpayers are using shell companies to evade tax payments.
    - Assess whether risk ratings of customers are sufficient to detect illegal activity, and whether transactions and wires are being properly monitored on a regular basis.
    - Review policies and procedures for politically exposed persons and other high-net-worth individuals.
    - Revise policies and procedures as appropriate.
- Insurance
    - Get advice from competent coverage counsel—the advice will be protected by the attorney-client privilege, whereas conversations with a broker will not be.
    - Review insurance policies, particularly the definition of “claim” and exclusions.
    - Review and understand indemnification obligations to others.
    - Review and understand rights to be indemnified by others.
    - Know what other insurance might be available as an additional insured.
    - Calendar important deadlines, including deadlines to give notice, and file suit if you dispute the insurance company’s coverage determination.
    - Provide notice of a potential claim to any insurance company under whose policy coverage may be sought.
    - Talk to your broker and coverage counsel before the next renewal to address gaps in coverage for investigations and criminal and civil demands.

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