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Money laundering and asset cloaking techniques

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Abstract

Purpose – The purpose of this paper is to explore the various typologies and methods used to cloak assets following the placement stage of money laundering.

Design/methodology/approach – Techniques used to hide assets and cloak ownership, ranging from simple nominee arrangements through to complex financial transactions are explored.

Findings – There are a myriad of methods available to money launderers to cloak their assets.

Research limitations/implications – More work needs to be done on the issue of information gateways.

Practical implications – Assets are cloaked to obfuscate the trail and make it difficult for law enforcement to "follow the money". Understanding the methodologies used is the first step to understanding the problem.

Originality/value – A number of cases from Canada, the USA and Australia were studied, as well as reference material advisors use for asset protection.

Keywords Money laundering, Criminal forfeiture, Canada, United States of America, Australia

Paper type Research paper

> Asset protection is consistent with the broad financial objectives of corporate and shareholder wealth maximization. Risk is balanced with opportunity in pursuit of wealth[1].

This paper explores the various typologies and methods used to cloak assets[2] following the placement stage of money laundering. Successfully laundered money has a concealed provenance. In a long and engaging article, Cuellar (2003) argues that there is an all too tenuous relationship between the techniques and detection systems used against money laundering and law enforcement's goal of disrupting criminal finance. He argues that the focus on cash creates systemic blind spots. The argument is misguided: cash and the placement of cash into the financial system bears continued focus and attention[3]. Organized crime is vulnerable at the point of sale: 44 pounds of cocaine translates to 220 pounds of $10 bills at street level; handling that cash, particularly in the face of barriers like currency transaction reporting, complicates drug dealing and potentially exposes the business to law enforcement (Simser, 2006). There is merit, however, in asking what happens to the cash that gets into the financial system. This paper focuses on that question reviewing asset cloaking techniques. This paper intentionally ignores large issues relevant to money laundering (*hawala, hundi,* and *da shu gong si* and so on)[4].

The views expressed herein are those of the author and do not represent the views of Ministry of the Attorney General or the Government of Ontario.

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As proceeds are laundered at various levels discussed in this paper, both domestically and internationally, the role and importance of civil asset forfeiture as an anti-money laundering device becomes very apparent (Linn, 2004). Civil asset forfeiture proceedings are brought generally against the "thing" not the person. The proceedings follow property as it transmogrifies from one format to another. The civil forfeiture practitioner faces challenges. How does one access the right information? How does one obtain an order in a foreign jurisdiction? This paper does not answer those questions. Rather, this paper offers the investigator and practitioner ideas about where to look for laundered assets. Where did the money trail go? Why was a trust used? What might lie behind the corporate veil?

Assignments: you have the wrong person

The simplest technique for hiding an asset is to assign title to a trusted nominee. Simple nominee ownership works for both operational assets and for profits. In Canada, there are large numbers of marijuana grow operations[5]. The indoor "grow op" typically requires a primary operational asset, a suburban house, which is then converted into a tropical growing facility. Nominees typically own the house. They mortgage the property. Grow op owners usually claim that the property was rented and that as mere landlords they had no knowledge of the unlawful use. This creates practical problems for law enforcement. Is it worth pursuing a property damaged by the growing operation (mold, etc.) and with the equity diluted by a secured creditor through a mortgage? Was this an absentee landlord victimized by growers? Was this a nominees related by blood or membership to an organized criminal group? Was the owner also the cultivator of the marijuana? What will happen in a prosecution? Canadian criminal law provides special protections to dwelling houses in a grow op prosecution (Controlled Drugs and Substances Act, 1996).

Simple nominee ownership can also be used to protect the profits of unlawful activity. A trusted confederate, a girlfriend, a boyfriend or a close relative, holds title to the desired form of property. On its face, this should not be difficult for law enforcement. For example, the mother of a gangster, an old age pensioner in her own right, is unlikely to have the means and wherewithal to acquire substantial luxury holdings. In practice, however, there are challenges. In several of our cases, the nominee lives offshore in places like Iraq, China and India. In a civil asset forfeiture proceeding, we have to provide service of documents to individuals potentially affected by the order. Living in Iraq does not immunize a property from forfeiture, but it can delay proceedings. In other cases, difficult facts can lead to troubling case law. In 1992, the US Supreme Court considered a house in Rumson, New Jersey that had been purchased by Joseph Brenna's girlfriend; he supplied the money, sourced through his narcotics business; she claimed to have no knowledge of the money's origins. The court held that the owner's lack of knowledge of the source of funds constituted a defence under the forfeiture laws of the day. Ultimately, the issue was addressed by statute[6]. Of course, finding a trustworthy nominee is not easy: fraudsters have terminated schemes fearing that their "laundering" partner would rob them (*US* v. *Piervinanzi et al.*, 1993); launderers have also been susceptible to undercover operations by law enforcement (*US* v. *Bancointernacional*, 2000).

Intermediaries: you still have the wrong person

The US Department of Justice is involved with on-going litigation to forfeit the proceeds of a telemarketing fraud. The fraudsters called elderly victims in the USA from a boiler room in Canada, telling them that they had won a lottery in Canada and they only needed to pre-pay the taxes by cashier's cheque to claim their winnings; there was no lottery winning. The cheques were sent to the fraudsters in Montreal who in turn sold them to a restaurant owner. From there, they went to a broker who sold them to a money exchanger in Jerusalem; from Jerusalem, they pass through several hands before ending up with a money exchange business in Ramallah. That firm deposited the cheques in their account; their bank then presented the cheques for payment in the US banking system. Currently, there is on-going litigation in the USA respecting that account[7]. The remarkable factual element of the case is that no one through the chain of transactions thought them unusual. As with many of the techniques used to launder money, in this case discounting and factoring cheques, the barriers are not insurmountable, but it did take a very determined group of people to solve the case[8].

The black market peso exchange utilizes intermediaries at a different level. Mr Posse was a Columbian stockbroker who also worked in a family business. He invested some of his money in safe US accounts. To avoid "Columbian tariffs" and the "delays" of the banking system, he arranged with his Columbian banker to have unknown third parties deposit money into his US account in Florida. In turn, he wrote a number of peso-denominated cheques to Columbian nationals in Bogota. Everything went well for Mr Posse until the US Government alleged that he was laundering drug proceeds. Posse claimed that he had no knowledge as to the source of the US deposits and that he was a *bona fides* purchaser, having paid in Columbia for the money placed in his US account. The court accepted that Posse lacked knowledge as to the source of funds, but also ruled that he was not a *bona fides* purchaser given his willingness to overlook and ignore the source of funds (*US* v. *Medinacuartes et al.*, 2001).

Trusts: hidden persons

There are a variety of perfectly legitimate trust arrangements designed to facilitate estate planning, premarital planning, wealth transfer or tax reduction strategies (Nenno, 2006). In the domestic context however, a trust is not a very effective shelter for illicit assets[9]. Courts in the USA, for example, will not protect the assets created for the benefit of the person settling the trust; similarly, a fraudulent transfer to a trust will be set aside. A domestic trust arrangement can conceal the identity of the real owner: a search in a land registry system will only uncover the trustee's name, not that of the beneficiary. If the trustee happens to be a lawyer, two confidentiality barriers will be erected: the trust deed may compel them to secrecy; they will also claim solicitor-client confidentiality.

Moving the trust offshore can, depending on the chosen jurisdiction, offer a number of protective features. As a rule, the trust instrument is established to protect assets from creditors, the tax authorities and the like. Some jurisdictions create barriers and protective features that include: narrow definitions of "fraudulent transfer" short limitation periods, high burdens of proof to open up a trust, and a refusal to recognize foreign orders. Discretion can be vested in the trustee as to how assets are to be settled with beneficiaries. Trusts can have flight clauses: the governing law can be changed or the assets moved upon the occurrence of a triggering event, such as a Mareva

injunction seeking to freeze the underlying assets[10]. A trust can be structured so that the beneficiary's interest terminates upon any transfer or attachment of their interest. Similarly, there can be "duress" clauses: the trustee is instructed to ignore orders of the courts or the settlor of the trust.

For law enforcement, a trust is not in and of itself an insurmountable barrier. Civil asset forfeiture proceedings, for example, pursue the property not its owner. Transferring proceeds of crime into a trust arrangement, either domestic or offshore, does not alter their characteristics as a proceed[11]. Further, statutory provisions that recognize and protect "legitimate" owners often set preconditions; in Ontario, a transfer of proceeds to a trust for no value would not deflect or defeat a civil forfeiture proceeding. There are a number of tactical challenges that can be created by trusts. The first is an informational barrier: who actually owns the property? For a forfeiture proceeding to succeed, the state must link the property to unlawful activity; there must be a causal chain leading back to an illegitimate provenance. Further, third parties may seek to exclude property from a proceeding. Trust devices shroud and hide those linkages. Secondly, offshore trusts are, by design, difficult to litigate against, irrespective of who the plaintiff is. A civil forfeiture proceeding or a conventional lawsuit faces challenges ranging from statute of limitation periods to recognition of foreign judgments. Finally, offshore trusts can be designed with flight or asset stripping provisions. Attempts to attach assets can trigger an obligation to move those assets offshore. Trusts can also be set up to hold certain assets and move all future value (interest, dividends and so on) offshore to other trusts or beneficiaries. In other words, finding one trust may simply initiate the further pursuit of assets. None of these challenges will defeat an able and determined jurisdiction, but they will make the job more difficult.

In the Australian case of *CDPP* v. *Hart*[12], the court had to consider a trust. Hart had been charged with fraud. He ran a company with 300 employees that provided services as a mortgage broker, insurance broker and financial advisor. A complex trust had been set up and in turn it had purchased a series of vintage warplanes. In Australia, the state can obtain a pecuniary penalty order and attach it against assets under the control or influence of the subject (there are similar value-based systems in the UK and the USA has provisions for substitute assets). The prosecutor argued that the assets of the trust were under the control of the accused, Hart. The trust contested the state position, claiming that Hart exercised no control or influence over its affairs. The trustees, as it happens, were, respectively, Hart's wife and girlfriend. At trial, the court found that Hart exercised control. Ultimately, the trust did not work for Mr Hart. The trust did create at least two visible barriers: one, the State was unable to trace proceeds of unlawful activity directly into the hands of the trust. They did have the option of freezing trust property and making it available for a pecuniary penalty order. Secondly, while not successful, Hart did slow down the litigation. The trust filed 22 volumes of appeal documents numbering 5,000 pages. The appeal was dismissed. This creates a practical barrier to the limited resources of law enforcement.

Corporations are people too

In Canada, there is no registry naming the shareholders of privately held corporations (OBCA, 1990, Corporations Information Act, 1990). The very act of transferring assets to a corporation creates a barrier to detection. There are registries for officers and

directors, but nominees of the shareholder can hold those positions. Corporate commercial law offers an almost endless number of ways through which assets can be held. A corporation can be a bare trustee of property; further, the beneficial owner, as the shareholder, can transfer title by selling their shares in the company leaving the underlying asset and title arrangement undisturbed. A series of corporations can be structured through horizontally or vertically integrated entities, both domestic and offshore, that will cloud and obfuscate the trail of property. A corporation can be set up with the launderer holding undesirable assets, such as non-participating preferred shares[13] with transfer restrictions and non-cumulative dividend rights. Other business structures, limited partnerships for example, can be designed to the same end. This will not fool a determined investigator, but it will impose barriers (time, resources and information gaps). Additionally, in a forfeiture proceeding great care needs to be taken in identifying the precise nature and interests of the assets being forfeited[14].

Asset stripping: right person, no property

Asset collateralization and equity stripping are techniques equally available to launderers and persons evading creditors. You place a tainted asset, say for example $100,000 in drug sale proceeds, into a corporate entity. That asset can then be stripped out of the corporate entity, making it harder to trace, in a number of ways. You can maintain a thinly capitalized corporate entity, stripping out assets through dividend payments. The other technique involves asset collateralization. Staying with our example, let us assume that the $100,000 is converted by the corporate entity into land and a building. The corporate entity could then approach any conventional financial institution and borrow money on the strength of their equity in the building. Now, a portion of the drug money has been transformed into cash from a seemingly legitimate loan[15].

There are unlimited variations on this technique. The launderer can control the loan through trusted associates instead of a bank. Alternatively, the credit facility can be contingent: an unused revolving line of credit that can be accessed in an emergency, instantly encumbering the asset. A corporate structure can be created whereby the asset is placed in one entity (Holdco), a related entity (Parentco) then lends money to Holdco, Holdco gives security over the asset to Parentco and Parentco strips all surplus money (including the proceeds of the loan) out of Holdco through dividends. This type of structure does not work with legitimate conventional lenders (who would encumber the entire structure through to the shareholders), but it will work with closely held entities. False invoices can be used moving money and services or assets (fictional or not) through a chain of companies; the transactions can dilute or reduce the value of the assets at each step, diffusing and diminishing the value of those assets that are traced. Leases can be used to strip out and hide value: legal title is with one entity; the property is then leased on preferential terms to a related entity; lessee payments can then be used to launder future proceeds. Unique types of property holding, such as joint tenancies or tenancies in common can be used to similar effect[16]. The launderer's objective for all of these techniques: remove assets from the scrutiny of forfeiture.

The cleansing power of insurance

The insurance sector generates premiums on an international scale in the order of $2.9 trillion US. The FATF have identified typologies involving insurance and laundering.

A launderer may make substantial payments into a life-insurance premium policy. He is not interested particularly in insurance, but very interested in the investment possibilities. A policy can be later surrendered for early redemption or cashed in during a "cooling off" period. In either case, the money is now sourced with an insurance payment and thus cleansed. Decisions to obtain the money in this fashion were made even though penalties made the withdrawals uneconomic (FATF, 2005, report, Note 2, pp. 41-65).

The potential of derivatives

One of the largest, and perhaps least understood, financial markets in the world is the derivatives market; according to recent statistics, the over the counter market is worth roughly $284 trillion and the exchange market saw turnover of $344 trillion in 2005[17]. At the most basic of levels, a derivative is a type of financial investment in which the yield is determined or "derived" from the performance of an underlying transaction. Underlying transactions can include equity indices, money markets, bonds, shares, foreign exchange and credit. Common classes of derivatives include: futures/forwards whereby the parties agree to buy or sell an asset at a future date; options (an asset can be bought at a future date); and swaps where the parties agree to exchange cash flows from an underlying asset at a future date. Companies apply derivatives to forecast and fix their costs (cost of credit, cost of supplies and so on). Derivatives can be used by speculators: Barings Bank collapsed following the rogue trading of Nick Leeson; in 1994 Orange County California went bankrupt with $1.6 billion lost through derivatives trading. Derivatives can also be used to hide money trails and confuse investors and regulators; the collapse of Enron is a good example of this (Partnoy, 2003). The laundering potential for this device is massive. To access the system, you would need to have an organized crime entity with an above average capability and a complicit intermediary or gatekeeper. Most derivatives are used not to make profit but to hedge risks (for the cost of commodities, the cost of foreign currency, the cost of borrowing and so on). One counter party might use laundered cash, for example, to settle a swap. This will not defeat a determined forfeiture practitioner, but if the right level of sophistication is applied, it will make following the money difficult.

Pump and dump

Fraudsters manipulate capital markets, particular junior markets (exchanges in Alberta, Winnipeg and Vancouver for example). This gives them a unique laundering platform. If you know that a stock will likely climb to a certain price, depending on how well your boiler room operates and how many small investors you can lure, you can pay for drugs or contraband with investment advice. You can assign shares in the issuer you are promoting in payment and sell them at the acme of the market (the same time that you "dump" everything you have "pumped"). The money is now cleansed through the accounts of small investors victimized by the scheme[18].

Two Texan brothers used a variety of techniques to stash $720 million offshore. They operated a series of shell companies and trusts in offshore jurisdictions and moved money they had made in their computer software and art supply business there. In fact, there were 58 such companies and trusts. One of the techniques used to transfer money was the sale of $190 million stock options in companies that the brothers had

founded or directed; the buyer was one of the controlled trusts or shells which then collected on a deferred annuity through the option[19].

Prepaid credit cards

Credit cards are more than a useful convenience that dominates the market. If you are engaged in unlawful activity, a credit card can be both a liability and a lifeline. The card can be a liability in the sense that transactions can be traced. If you are evading law enforcement, a credit card can lead them to you. However, certain types of credit cards can be a lifeline as well as a laundering vehicle. Financial institutions offer prepaid credit cards. This product is presumably designed for individuals who want the convenience of a card but who lack the creditworthiness to obtain one (www.vancity.com/, accessed 29 August 2006). In one of our cases, still under litigation, the drug distributor kept a Visa card, prepaid for $3,000. Should he need an emergency flight to leave the jurisdiction, the card is there.

Cyberlaundering

There is an immense potential in the internet to launder. Electronic money and stored value cards essentially convert "cash" into computer code. For this to work, money must be placed domestically, layered and wired offshore. The offshore financial intermediary must have the capacity to convert the money into e-cash or a stored value card. Once the money is given electronic form, the launder can evade detection sending the money electronically and using asymmetric encryption or they can convert the money into a stored value card, which becomes a bearer instrument. Electronic money can also be used to launder through the multiplicity of offshore casinos that offer internet gaming (Weaver, 2005).

The ubiquitous cell phone

The Philippines are currently implementing an anti-money laundering regime. The Philippine economy relies heavily on the remittance of overseas wages; in 2001, seven million Pinoy abroad remitted $6.23 billion back home[20]. Many of those remittances can be made over a cell phone and without a bank account. To send money from Canada to the Philippines, one needs some basic information about the recipient, including basic information about their cell phone. One then goes to a money remitter in Canada. The recipient in the Philippines will get a text message with a 16-digit number. At some locations, like pawn shops, they can simply collect their pesos. At other locations, they can collect a stored value card, which in turn can be used at a number of bank ATMs. There will be a challenge for the financial intelligence units in both Canada (FinTrac) and the Philippines (AMLC)[21].

Conclusions and next steps

All of the vehicles and ideas surveyed in this paper can create obstacles to law enforcement. They can conceal the true owner, even with simple techniques, in the hope that the assets will be missed. They can use trusts and corporations to reduce the prospect of detection primarily by hiding key information. They can, in higher order cases, make assets unappealing when found by stripping out their value, a technique long used by people seeking to avoid their creditors. Launderers can also misapply existing vehicles, insurance, the capital markets, derivatives and means of electronic

commerce, to hide the money trail. One advantage a launderer has is that law enforcement, by definition, pays heed to borders. While there is a long-established treaty process to address criminal law matters, there is no such process for civil forfeiture practitioners. Anthony Kennedy has done some thinking on the issue of inter-agency cooperation[22] as well as overcoming some of the information gaps that exist. There are other developments including the advent of groups like CARIN[23]. Finally, over the next decade, one can expect developments around gatekeepers, the intermediaries that launderers rely on to access the legitimate financial market (Hutman *et al.*, 2005).

Notes

1. Doyle's (2005 p. 89) book colourfully defines techniques and phrases including: asset cloaking, decanting devices, bed and breakfast deals, peck-a-boo trusts and double exit transactions. There are numerous resources on "asset protection" including Adkisson and Riser (2004); generally, texts respecting estate and tax planning will also cover this area as well.
2. Considerable attention was paid in 2001 to the report of the OECD (2001); responses to the report included *Toward a Level Playing Field* (Toronto: Int' Tax and Investment Org, 2002).
3. Consider the modest case of *US* v. *Saenz* [2006]: Texas drug dealers used wire transfers in small denominations under $10,000; obviously, that was not sufficient; they were caught in a single traffic stop smuggling $116,000 to Texas in the spare tire of their pickup truck. Barriers like suspicious transaction reporting altered the way they conducted business. This paper is more interested in where the $116,000 would have gone had it not been interdicted.
4. FATF (2005) covers the subject nicely.
5. Mulgrew (2005 p.2) estimates the Canadian industry to be worth $5.7 billion annually ($19.5 billion retail).
6. *US* v. *92 Buena Vista Avenue* [1992]; the "innocent owner" defence was codified in the Civil Asset Forfeiture Reform Act, 2000 at s. 2.
7. The litigation largely relates to the US power to freeze corresponding bank accounts. The power has presented interesting challenges in other jurisdictions; consider: *European Bank* v. *Citibank* [2004] and *Evans* v. *European Bank* [2004] – the Australian banks were not permitted to set off amounts frozen in their US-denominated accounts in New York.
8. I am grateful to Stefan Cassella for sharing his notes from presentations to the 22nd and 23rd Cambridge Symposiums on Economic Crime given in 2004 and 2005. The agreed statement of facts for the case can be found at *United States* v. *Funds on Deposit in Account No. 890-0057173 Maintained at the Bank of New York by the Union Bank for Savings and Investments Jordan,* No. 02-472-B, *Joint Statement of Undisputed Facts,* filed 22 November 2004.
9. Constructive trusts have been used in US courts by victims unwilling to wait for the forfeiture and hoping to jump the queue on the larger pool of victims: *US* v. *Boylan* [2004] petition for rehearing denied USA pp LEXIS 26813 (USCA, 9th Cir).
10. Consider *FTC* v. *Affordable Media* [1999] and Re: *Stephen J Lawrence, Debtor* [1999]; an offshore trust had been established and the court ordered the assets repatriated failing which there'd be a civil contempt. Lawrence was jailed in 2000 for refusing to provide details of his trust or to repatriate the money; as of writing he still incarcerated: (accessed August 25, 2006, available at: www.assetprotectionbook.com/directors_officers_liability.htm).

12. Where the facts are convoluted and complex funds in a trust account can move beyond the reach of law enforcement. $50,000 in a lawyer's trust account was excluded from freezing orders in *Clevemore Pty Ltd* v. *State of Queensland* [2003].
12. QDC 121; see also *R* v. *Hart* [2005]; *DPP* v. *Hart* [2005]; *Flying Fighters Pty Ltd* v. *CDPP* [2005].
13. Depending on the constating law, there are some limits to this technique: see s. 170 of the OBCA (1990) and *Corporations Information Act* (1990).
14. Consider one in a series of decisions respecting a limited partnership and casino: *US* v. *Gilbert* [2001].
15. A variant, the "back-to-back" loan has been used but the typology does not seem to be prevalent. (FATF Report, Note 3, at p. 82)
16. See *Szabo* v. *The State of W Australia* [2006] in which the interests of a joint tenant were excluded and protected from forfeiture.
17. Figures as of June 2006 as tracked by the Bank of International Settlements – the OTC market consists of contracts traded directly between two parties; the largest exchange markets are the Korea Exchange, Eurex, the Chicago Mercantile Exchange and the Chicago Board of Trade; accessed 25 August 2006, available at: www.bis.org/statistics/otcder/dt1920a.pdf and http://en.wikipedia.org/wiki/Derivative_(finance)
18. Higher capability organized crime groups deal not only in traditional contraband like drugs, but also in fraud, market manipulation and money laundering (CISC, 2006).
19. R.L. Coleman *Sen. Levin blasts firms that helped clean funds by obscuring ownership* September 2006 *Money Laundering Alert* 3.
20. Simser, J see note 4.
21. The example used was for a company called Smart Padala (web site accessed 25 August 2006, available at: www.smart.com.ph/SMART/Value + Added + Services/SmartPadala/).
22. He anticipates publishing an article in the *Journal of Financial Crime* entitled "Winning the information wars" in 2006.
23. Camden Asset Recovery Information Network; my jurisdiction is an observer.

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