

Part 3 – Money laundering and other illegal activity

There are steps you can take to proactively protect yourself from clients seeking to exploit you and your CTA for nefarious purposes. The key is to recognize the red flags and to implement preventative controls.

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This is Part 3 of a three-part series about Client Trust Accounts (CTAs): Protecting Yourself and Your Clients. The first article [addressed the basics of CTAs](#), the second examined [internal and external threats](#). In this third article we will discuss the most serious and potentially career-ending types of external risk related to your trust accounts: money laundering and other criminal activity.

Money laundering

The unique role of the attorney and their practice makes them susceptible to fraud, theft, and money laundering schemes from external parties. Attorneys are needed to help establish legal entities; receive, hold, and transfer capital between parties through CTAs - both IOLTA and non-IOLTA accounts; transfer property; and, in general, provide an appearance of legitimacy and respectability to transactions and activities. Attorneys handling client money are capable, even if unwittingly, of "cleansing" money by simply putting it into their CTAs.

Attorneys may believe they can rely solely on and trust their financial institutions to detect and deter fraud and money laundering; however, an attorney has certain ethical obligations to ensure that they are not receiving and handling money from illicit activities and participating - knowingly or unknowingly - in the furtherance of illegal acts. See rules 1.2.1, 8.4. See also ABA Model Rule 1.16(a).

Certain legal services are particularly susceptible to misuse by criminals in the context of money laundering and other illegal activity, including real estate transactions; establishment and management of trusts, companies, and charities; and the use of CTAs to hold and transfer client funds. The attorneys' involvement can range from innocent involvement to negligent or willful blindness to complicit involvement.

What is money laundering?

Money laundering is the process of making illegally gained proceeds appear legal. First, the illegitimate funds are furtively introduced into the legitimate financial system, such as an attorney's CTA. Then, the money is moved around to create confusion, sometimes by wiring or transferring through numerous accounts. Once the funds are integrated into the financial system, the illegal or "dirty" money appears legitimate, or "clean." Money laundering can facilitate crimes such as drug trafficking and terrorism and adversely impact the global economy.

Historically, large-scale money laundering in the U.S. first occurred during the Prohibition era of the 1920s and '30s, as those who were in the profitable business of illegally selling alcohol needed a way to move their cash into the banking system. Al Capone famously opened laundromats - cash businesses - to mix illicit earnings with legitimate ones. Capone did not pay taxes on the illicit earnings and was thus successfully prosecuted for tax evasion (money laundering was not yet a crime). Capone's laundromats were the perfect metaphor for taking "dirty" money and washing it in the system, making it "clean."

In the 1970s and '80s, money laundering became formally defined because of the massive drug trade in the U.S. The Bank Secrecy Act of 1970 required banks to report cash transactions exceeding \$10,000, and by 1986 money laundering became a federal crime.

Other illegal activity

There are other types of illegal activity that can be funded or secreted through money laundering. The risk of an attorney's practice being exploited for these nefarious purposes may arise with certain practice areas, legal services, or in certain countries or areas. Customer due diligence (CDD) is a process to confirm the identify of your client and understand the purposes behind the instructions they give you. Thorough CDD will help ensure your legal services are not abused for facilitating criminal activity and help guard you and your firm against the risks that money laundering and other illegal activity may expose you to, including terrorist financing. In consideration of accepting a new client or matter, you may consider assessing whether the client poses a higher risk of money laundering, including terrorist financing.

Terrorist financing and the financing of proliferation of weapons of mass destruction

When considering a new client, the [Financial Action Task Force \(FATF\)](#) advises consideration of countries or geographic areas that represent higher risks, whether the domicile of the client or the location of the transaction or source of funds are in or from a specific region. The Office of Foreign Asset Control (OFAC), within the U.S. Department of the Treasury, administers and enforces economic sanctions and embargoes that target countries, geographic regions, and individuals identified as providing funds or support for terrorist activities, including funding weapons of mass destruction or having high levels of organized crime, including drug trade and

human trafficking. Lists of countries, regions, companies, and individuals may be found on [OFAC's website](#).

Politically exposed persons - corruption and bribery

A politically exposed person (PEP) is an individual who is or has been entrusted with a prominent function, such as heads of state, senior politicians, senior government, judicial or military officials, senior executives of state-owned corporations, or important political party officials. Many PEPs hold positions that can be abused for the purpose of laundering illicit funds or other predicate offenses such as corruption or bribery that may be a component of a more serious crime. Because of the risks associated with PEPs, attorneys are advised to understand the nature of the transactions being requested, and in some cases, understand the source of the person's funds to be used in a transaction. As the attorney, you should be satisfied that the funds come from a legitimate source. For example, a PEP who receives a modest official salary, but who has substantial funds, without any apparent business interests or inheritance, might raise suspicions of bribery, corruption, or misuse of position.

Your potential liability for the acts of others

Failing to proactively protect yourself from potential clients or clients who intend to exploit your CTA for money laundering can place an attorney in a difficult situation. Once activity has begun, unraveling your involvement could take time and present problems that require the balancing of multiple duties, including the duty to refrain from violating the law under Business and Professions Code, section 6068, subdivision (a), the duty of client confidentiality under Business and Professions Code, section 6068, subdivision (e)(1) and rule 1.6 of the Rules of Professional Conduct, and duties associated with the careful and proper termination of the attorney-client relationship under rules 1.13 and 1.16. In addition, the disposition of funds you received from the problematic client and deposited into your CTA could raise even more compromising issues.

Proactively protecting yourself is one way to avoid such complex and potentially incriminating matters. The proactive measures discussed below are important considering recent trends.

Federal lawmakers and the U.S. Department of Treasury officials have urged the ABA to strengthen Model Rules to address concerns that attorneys' services can be used for money laundering and other criminal and fraudulent activity.

On Aug. 6, 2023, the ABA voted to amend Model Rule 1.16: Declining or Terminating Representation. The amended Model Rule added language that "[a] lawyer shall inquire into and assess the facts and circumstances of each representation to determine whether the lawyer may accept or continue the representation." To enforce this language would be to require an attorney to proactively investigate the client's purposes before commencing or continuing with representation. The comments to the Model Rule make clear that the

obligations continue throughout the entire engagement. The Model Rule was further amended to state that a lawyer shall withdraw from the representation of a client if "the client or prospective client seeks to use or persists in using the lawyer's services to commit or further a crime or fraud, despite the lawyer's discussion ... regarding the limitations on the lawyer assisting with the proposed conduct."

Although California has not adopted these changes in its version of rule 1.16, imposing proactive inquiry before and throughout the engagement, the trajectory is a good practice. In California, rule 1.16 prohibits an attorney from accepting representation, and requires an attorney to terminate representation when, "the lawyer knows *or reasonably should know* that the representation will result in violation of these rules or of the State Bar Act." (Emphasis added.) This means that the facts relating to your level of knowledge as to your client's intent to launder money through your CTA could be judged on a "reasonably should know" standard, as opposed to the "knows" standard.

Rule 1.0.1(j) defines the phrase "reasonably should know" to mean "that a lawyer of reasonable prudence and competence would ascertain the matter in question." The trends observed in the ABA Model Rule amendments could affect a trier of fact's determination of what questions an attorney of reasonable prudence and competence should have asked in a given situation.

Proactively protecting yourself

There are steps you can take to proactively protect yourself from clients seeking to exploit you and your CTA for nefarious purposes. The key is to recognize the red flags and to implement preventative controls, as discussed below.

Red flags

When considering a new engagement, there are several red flags that should lead you to make further inquiry, and to ultimately decide whether you are assured no criminal activity is taking place:

1. Client is secretive or evasive about their identity or that of the beneficial owner; the source of funds; or the purpose and method of the transaction.
2. Client has known convictions or is currently under investigation for financial crimes.
3. Client will only use intermediaries and avoids personal contact.
4. Client is reluctant to provide information necessary for a legal transaction.
5. Client is a business entity that cannot be identified online.
6. Client pressures the attorney to deposit funds or execute transfers quickly.
7. The requested services or transactions do not make sense.

Preventative controls for money laundering

1. Conduct a risk assessment. Consider your practice areas and services provided to the public. In what ways might you or your firm be vulnerable to criminal activity? In other words, how could someone with illegal funds use your services to hide their crime? Assess your risks and educate yourself and your staff about these potential vulnerabilities and identify ways to mitigate them. See [FATF's Guidance for a Risk-Based Approach for Legal Professionals](#).
2. The most effective control to prevent an outside party from using your services and trust account for criminal activity is to know your client through CDD.
 - a. Verify identity based on a reliable independent source (such as a passport).
 - b. Meet face to face, if possible. Clients seeking to engage in criminal activity will want to limit in-person contact and what you know about them.
 - c. Identify the client and the beneficial owner (if you are asked to handle funds on behalf of an entity or organization). LLC ownership is generally not sufficient, especially if there are multiple layers of separate entity ownership. Research until you can confirm the identity of one or more people.
 - d. Obtain adequate information to understand a client's circumstances, business, and objectives.
 - e. Understand the purpose and intended outcome of the transaction for which your services are being retained, including the duration.
3. Ask questions. If a client does not want to reveal the purpose for their transactions and is generally evasive as to the nature of their business or purpose for the transaction, further research or decline the engagement.
4. Restrict the amount of cash you allow for payment of your services.
5. Restrict any unexplained third-party payments.
6. Use reliable, independent source documents, data, and information. If dealing with a corporation, request an organization structure chart and details of beneficial ownership.
7. Monitor the business relationship and services on an ongoing basis to ensure they accord with your knowledge of the client, its source of funds, and ongoing business purpose.

If you need additional guidance about your trust accounts obligations, or if you have specific questions, see the State Bar's [Client Trust Accounting Resources](#), or contact the State Bar's Ethics Hotline at 800-238-4427 (toll-free in California), or 415-538-2150 (from outside California).