

VERACITY INSIGHTS

FACELESS COMPANIES, HIDDEN OWNERS: LESSONS FROM THE PANAMA PAPERS

By Barbara Yu Levy

In the aftermath of the Panama Papers leak, investors should expect more rigorous oversight and scrutiny of transactions involving opaque intermediaries. Revealing that for years numerous wealthy individuals have hidden assets in secretive corporate structures, like shell companies, the scandal has accelerated calls for corporate transparency and the elimination of secrecy loopholes. Global interest in the various methods by which these funds were obscured also suggests that the reforms will be far-reaching, affecting not only shell companies but any entity that can be used for similar ends, such as shelf companies and special purpose vehicles (SPVs). Understanding how these structures work, as well as the backgrounds of registered agents like Mossack Fonseca & Co., the Panamanian law firm at the heart of the scandal, is therefore critical to protecting one's investment – and reputation.

EXPECT MORE OVERSIGHT

Although there are legitimate uses for shell companies, the fallout over the Panama Papers indicates that any association with one in the current atmosphere could jeopardize an investor's reputation, or even lead to formal investigation. As discussed in a previous Veracity Insight ("Lifting the Veil of Secrecy – Investigating Shell Companies and Their Agents," March 7, 2016), identifying hidden beneficial ownership has been a major priority for US and EU authorities in recent months, and the Panama Papers leak has spurred even more robust measures. For example:

- ▶ The US may soon issue a "customer due-diligence rule," or CDD, that would require financial institutions with branches in the US to know the identities of customers who set up accounts through shell companies, as well as those who control or own 25 percent or more of corporate entities that open bank accounts in the US.
- ▶ The EU, which already requires its member states to share tax information, now appears set to require companies operating there to disclose their tax information country-by-country.
- ▶ Despite historical resistance to outside interference in the country's economic affairs, Panama's president, Juan Carlos Varela, has pledged to set up an independent panel to examine current practices and propose effective transparency measures.

CONSIDER THE TYPE OF ENTITY INVOLVED

These regulatory changes will likely affect the protections afforded to other opaque structures (see below), and, in turn, heighten scrutiny of any associated investors or partners. Like shell companies, shelf companies and SPVs can be used for legitimate purposes, but their distinctive attributes also make

them likely candidates for hidden illegal or unethical activity, to the detriment of a potential investor. Broadly speaking, the three structures named above can be defined as follows:

- ▶ A **shell company** generally refers to a corporate entity that is non-traded, does not have a bricks-and-mortar location, and exists in name only. Ownership details are often intentionally obscured, and available records may show only registration through a corporate agent.
- ▶ A **shelf company** is an entity that was created for no specific purpose, has no initial assets, and is intentionally “left on the shelf” until someone purchases it, or puts it “back on the shelf” after a transaction. Consequently, it can be difficult to discern how long a shelf company has been in existence, or whether it was previously operated in a manner that could result in bad credit or tax liability for subsequent owners.
- ▶ A **special purpose vehicle (SPV)** is specifically created for a particular transaction and serves to minimize a firm’s financial risk by allocating only certain assets to that entity. An SPV may also hide corporate debts, making the parent entity look healthier than it is, as well as isolate the parent entity (and its principals) from any potential liability arising from a given transaction.

INVESTIGATE THE REGISTERED AGENTS

According to the website of the British Virgin Islands (BVI) Financial Services Commission, the BVI alone boasts more than 130 registered agents, highlighting the need to conduct thorough due diligence in advance of a deal. Even cursory diligence into Mossack Fonseca would have shown that for years journalists had been covering the links between that firm and several high-profile allegations associated with the companies it has helped create, suggesting that more proactive investigatory efforts were not only prudent, but feasible.

- ▶ Since 2012, Mossack Fonseca has served as the registered agent for at least two companies sanctioned by the US Treasury Department’s Office of Foreign Asset Control for their connections to Syrian president Bashar al-Assad and Zimbabwean president Robert Mugabe.
- ▶ Press reports from the past three years have connected Mossack Fonseca-registered companies to kleptocracy, bribery, and money laundering schemes on multiple continents.
- ▶ Mossack Fonseca remains embroiled in litigation in a Nevada district court regarding a subpoena to disclose the beneficial ownership of 123 companies suspected of embezzlement activities involving former Argentine presidents Néstor and Cristina Kirchner.

While not all registered agents have as prolific a history as Mossack Fonseca, targeted inquiries into an agent’s past may provide insight into why it was chosen. *The Guardian* recently reported that between 2005 and 2008, in more than 100 requests by official BVI authorities, Mossack Fonseca could only name a company’s beneficial owner in five instances.

In the near term heightened interest in shell companies and offshore activity will likely continue, along with pressure to institute transparency measures designed to reveal beneficial ownership. Therefore, accommodating new disclosure requirements, understanding the specific risks posed by entities used in offshore dealings, and investigating registered agents like Mossack Fonseca will go a long way toward protecting one’s investment and business reputation.