

AUGUST 2003

Land Mine for Lenders: Treasury Announces Right to Nullify Loans Made to Suspected Terrorists on Government List

The United States Department of Treasury last month announced new regulations giving it the right in certain circumstances to declare a residential mortgage loan **null and void** if the mortgagor is on the government's terrorist list. Shortly after the tragic events of September 11, 2001, President Bush issued Executive Order 13224 (the "Order"), which immediately blocked the property of, and prohibited transactions with, persons and entities who committed, threatened to commit, or supported terrorism. Lenders have been subject to the restrictions of the Order since it went into effect on September 24, 2001. The United States Treasury Department's Office of Foreign Assets Control ("OFAC") oversees enforcement of the Order.

OFAC issued an interim final regulation on June 6, 2003 to respond to the ongoing need to block assets and prohibit transactions of those who pose a threat to the United States. The new regulation continued and elaborated upon the prohibitions of the Order. This regulation took effect immediately upon issuance. Like the Order, the regulation blocks the property of, and prohibits transactions with, persons and entities that commit, threaten to commit, or support terrorism. K&L published an Alert in January 2002, describing in detail the initial Order and its requirements. That Alert may be accessed on the K&L website at: http://www.kl.com/files/tbl_s48News/PDFUpload307/7783/MBCALERTABLOCKING.pdf. We are providing this updated Alert to describe OFAC's new interim final regulation. As the interim final regulation codifies much of what was already discussed in the previous Alert, this Alert will summarize new parts of the regulation and highlight key elements that may be of importance to mortgage and other consumer finance lenders.

It is important to distinguish between the continued requirements to comply with OFAC restrictions and recent efforts to require financial institutions to adopt anti-money laundering compliance programs. Right now, all lenders are subject to OFAC restrictions. However, independent mortgage and loan companies are not yet subject to a requirement to have an anti-money laundering compliance program.

SCOPE OF COVERAGE

The new OFAC regulation covers all United States individuals and businesses wherever located, including all lenders. The regulation prohibits any person or entity covered by the regulation from conducting transactions with any of the people listed in Appendix A to Title 31, Chapter V of the Code of Federal Regulations. Any person or entity on that list is referred to as a "blocked person." An updated version of the list of blocked persons is available on OFAC's web site, www.treasury.gov/ofac. Those with questions about any OFAC rules or about specific transactions or parties that might be on the list of blocked persons can also send e-mails to OFAC directly from the OFAC web site.

All types of accounts and financial services transactions are covered by the OFAC prohibitions, including payments, refunds, loans, lines of credit, wire transfers, ACH transfers, fee payments, escrow accounts, credit cards, deposit accounts, trust accounts, safety deposit boxes, check cashing, money orders, cashier's checks, and letters of credit. Any transaction involving a "blocked person" in any way is likely covered by the new regulation.

The regulation applies to both the making and servicing of all loans. Credit transactions are specifically included in the regulations at 31 C.F.R. § 594.410, "Credit Extended and Cards Issued by U.S. Financial Institutions." For originations, lenders are prohibited from either accepting the payment of fees from or consummating a closing with a blocked person. For loan servicing, lenders are prohibited from accepting monthly payments from a blocked person or disbursing all or any portion of such payments to, among others, investors. In addition, a servicer cannot refund any surplus in an escrow account or make refunds in any other way to any blocked person.

POTENTIAL ISSUES

Recently, as money laundering and the USA PATRIOT Act have received significant coverage in industry publications, federal banking regulators have reminded their regulated entities about the continuing importance of OFAC compliance. For entities without a primary federal banking regulator, OFAC compliance still needs to remain a priority because of the potential penalties and damage from violations. Even if not subject to a requirement to adopt an anti-money laundering compliance program, all entities still need to comply with OFAC restrictions.

Relying on the authority of the International Emergency Economic Powers Act and the United Nations Participation Act, laws that impose economic sanctions against hostile targets in order to further U.S. foreign policy and national security objectives, the new regulation provides, in relevant part:

Any transfer after the effective date [June 6, 2003] that is in violation of this part or any regulation, order, directive, ruling, instruction, or license issued pursuant to this part, and that involves any property or interest in property blocked pursuant to [the regulation], is null and void and shall not be the basis for the assertion or recognition of any interest in or right, remedy, power, or privilege with respect to such property or property interests. [31 C.F.R. § 594.202(a)]

The new regulation defines "transfer" as "any actual or purported act or transaction," including all mortgages and other loans. Therefore, under the regulation, any loan to someone on the OFAC list of blocked persons would be null and void, except as described below.

While OFAC prohibitions are absolute, if an entity engages unknowingly in a transaction with a blocked person, that entity may, promptly upon discovery of the transaction, be able to file a report with OFAC containing a full account of the transaction and thereby possibly avoid having the transaction determined null and void. If the transaction did not represent a willful violation of the regulation and the entity did not have reasonable cause to know or suspect, in view of the facts and circumstances available, that the transaction was prohibited, OFAC may subsequently determine that the transaction should not be deemed "null and void."

The regulation includes sections on the pre-penalty notice a person will receive if OFAC believes the person has violated the new regulation or other licenses, regulations, order, and instructions issued by OFAC as well as responses to and settlement of pre-penalty notices. If OFAC has reasonable cause to believe that a person violated an OFAC regulation, license, order, or instruction, it will notify the person of the alleged violation and OFAC's intent to impose a monetary penalty. The pre-penalty notice will include the facts of the alleged violation and provide the person with an opportunity to respond in writing within 30 days.

Before a pre-penalty notice is actually issued, an alleged violator (who is aware that OFAC is investigating an alleged violation) may request that OFAC withhold issuance of the pre-penalty notice to try to settle OFAC's claims. If OFAC grants the request, it will begin negotiations with the alleged violator for a period of up to 60 days. Readers will find a more complete discussion of possible penalties for OFAC violations in the attached Alert.

HOW TO MINIMIZE OR AVOID OFAC PENALTIES AND OTHER LOSSES

Entities should have an OFAC compliance program to ensure that they do not run afoul of OFAC-enforced prohibitions. If an entity does have an OFAC compliance program, including personnel trained in OFAC compliance, such a program will benefit the entity if it ever does have an inadvertent OFAC violation. OFAC recognizes the inherent limitations in time, resources, and manpower that entities can devote to compliance efforts. To the extent that such entities establish reasonable compliance procedures appropriate for their industry and undertake good faith efforts to comply with the OFAC regulations and other prohibitions, OFAC will likely treat such efforts as mitigating factors in considering assessment of penalties.

If an entity already has an anti-money laundering program, as many lenders voluntarily or mandatorily have, OFAC recommends that entities incorporate their OFAC compliance program into their overall anti-money laundering program. As part of the OFAC compliance program, OFAC also advises entities to develop internal audit procedures for OFAC compliance and designate an OFAC compliance officer. Any compliance program must remain dynamic and be revised as appropriate to reflect changes in an entity's operations, industry standards, and applicable law, including the designations of blocked persons identified by OFAC.

One part of any effective OFAC compliance program is to check the names of borrowers against the list of blocked persons established and updated by OFAC. In addition, entities should check the names of all other persons with whom they conduct business, including employees, vendors, and brokers. While this process can be difficult if performed manually, entities might consider electronic solutions to assist in checking names against the OFAC list of blocked persons. On a basic level, several private OFAC compliance web sites offer free name-checking devices that allow a person to type a name in, and the web site will determine if that name (or one similar to it) might appear on the list of blocked persons. We would be happy to provide you with references to these web sites.

Other entities are purchasing off-the-shelf or customized software programs that integrate with their current systems so that the system automatically checks if a name is on the OFAC list when the name is otherwise entered onto the system, such as when a person applies for a loan or when servicing of a loan is transferred. Some core processing software vendors include an OFAC compliance product as part of the basic package that they offer.

Although the regulation discussed above is an interim final rule that became effective June 6, 2003, OFAC is accepting comments on the interim final rule until August 5, 2003 and will consider such comments in drafting its final regulations. OFAC further noted that it will also attempt to consider comments that it receives after August 5, 2003.

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If you have any questions in connection with OFAC's interim final rule or would like assistance preparing a comment for submission, please contact Melanie Brody (202-778-9203), Sam Ozeck (202-778-9085) or any member of the Mortgage Banking/Consumer Finance Group.

MORTGAGE BANKING/CONSUMER FINANCE GROUP

Kirkpatrick & Lockhart LLP was founded in 1946, and, with more than 650 lawyers, is one of the 50 largest law firms in the United States. K&L attorneys are based in ten offices in key U.S. cities—Boston, Dallas, Harrisburg, Los Angeles, Miami, Newark, New York, Pittsburgh, San Francisco, and Washington. Our firm represents a broad range of clients in a wide variety of matters, including corporate and securities, e-commerce, investment management, insurance coverage, financial institutions, mortgage banking and consumer finance, creditors' rights, intellectual property, tax, labor, environmental, antitrust, health care, and government contracts. More than half our attorneys are litigators. We litigate class actions on a range of financial issues, generally defending financial institutions, broker-dealers, public companies, and investment companies and their officers and directors against claims of violations of securities laws, consumer credit laws, and common law tort and contract claims. You can learn more about our firm by visiting our Internet website at www.kl.com.

The Mortgage Banking/Consumer Finance Group provides legal advice and licensing services to the consumer lending industry. We counsel clients engaged in the full range of mortgage banking activities, including the origination, processing, underwriting, closing, funding, insuring, selling, and servicing of residential mortgage loans and consumer loans, from both a transactional and regulatory compliance perspective. Our focus includes both first- and subordinate-lien residential mortgage loans, as well as open-end home equity, property improvement loans and other forms of consumer loans. We also have experience in multi-family and commercial mortgage loans. Our clients include mortgage companies, depository institutions, consumer finance companies, investment bankers, insurance companies, real estate agencies, homebuilders, and venture capital funds. Members of the Mortgage Banking/Consumer Finance Group and their telephone numbers and e-mail addresses are listed below:

ATTORNEYS

Laurence E. Platt	202.778.9034	lplatt@kl.com
Phillip L. Schulman	202.778.9027	pschulman@kl.com
Costas A. Avrakotos	202.778.9075	cavrakotos@kl.com
Melanie Hibbs Brody	202.778.9203	mbrody@kl.com
Steven M. Kaplan	202.778.9204	skaplan@kl.com
H. John Steele	202.778.9489	jsteele@kl.com
Irene C. Freidel	617.261.3115	ifreidel@kl.com
Jonathan Jaffe	415.249.1023	jjaffe@kl.com
R. Bruce Allensworth	617.261.3119	ballensworth@kl.com
Daniel J. Tobin	202.778.9074	dtobin@kl.com
Anthony P. La Rocco	973.848.4014	alarocco@kl.com
David L. Beam	202.778.9026	dbeam@kl.com
Emily J. Booth	202.778.9112	ebooth@kl.com
Eric J. Edwardson	202.778.9387	eedwardson@kl.com
Suzanne F. Garwood	202.778.9892	sgarwood@kl.com
Tara L. Goebel	202.778.9261	tgoebel@kl.com
Laura A. Johnson	202.778.9249	laura.johnson@kl.com
Kristie D. Kully	202.778.9301	kkully@kl.com
Christopher G. Morrison	202.778.9245	chris.morrison@kl.com
Sam A. Ozeck	202.778.9085	sozeck@kl.com
Krista Patterson	202.778.9257	kpatterson@kl.com
Nanci L. Weissgold	202.778.9314	nweissgold@kl.com

DIRECTOR OF LICENSING

Stacey L. Riggan 202.778.9202 sriggan@kl.com

REGULATORY COMPLIANCE ANALYSTS

Dana L. Lopez	202.778.9383	dlopez@kl.com
Nancy J. Butler	202.778.9374	nbutler@kl.com
Joelle Myers	202.778.9093	jmyers@kl.com
Marguerite T. Frampton	202.778.9253	mframpton@kl.com
Jeffrey Prost	202.778.9364	jprost@kl.com
Patricia E. Mesa	202.778.9219	pmesa@kl.com
Kenasha Scott	202.778.9384	kscott@kl.com
Heidi M. Evans	202.778.9241	hevans@kl.com

LEGAL ASSISTANTS

Mera C. Choi 202.778.9415 mchoi@kl.com



Kirkpatrick & Lockhart LLP

Challenge us.®

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BOSTON ■ DALLAS ■ HARRISBURG ■ LOS ANGELES ■ MIAMI ■ NEWARK ■ NEW YORK ■ PITTSBURGH ■ SAN FRANCISCO ■ WASHINGTON

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