



Trust Funds: Video™

Introduction to Trust Funds

Trust funds overview 1

Managing Trust Funds

Item or evidence of value 4

Holding Checks Undeposited

Holding checks undeposited 10

Advance Fees are Trust Funds

Advance fee trust fund accounting..... 12

Advance Costs are Trust Funds

Funds handed to the broker for marketing costs..... 15

Analyzing the Marketing Package Cost Sheet

Itemized costs the seller can expect to incur..... 18

Trust Account Management

The withdrawal of trust funds 20

Interest-Bearing Accounts

Interest-Bearing Accounts..... 23

Maintaining Trust Account Integrity

Improper commingling..... 25

Penalties for Misuse of Trust Funds

Commingling, conversion and restitution 30

The Real Estate Recovery Account

The Real Estate Recovery Account 35

Glossary 38



Introduction to Trust Funds

Trust funds overview

Real estate licensees often handle other people's items which have or evidence monetary value, called **funds**. Funds belonging to others which a broker and their agents handle when acting as agents in a transaction are called **trust funds**.

trust funds

Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

Trust funds generally include:

- rents and security deposits collected under a property management agreement [See **RPI** Form 550];
- good faith deposits tendered by a buyer with an offer to purchase;
- fees and costs handed to the broker in advance of their performance of agreed-to services;
- mortgage payments and funds on contract collection and mortgage brokerage; and
- any other personal property of value.

Trust funds are held by brokers for safekeeping and may not be treated casually. **Recordkeeping** and accounting requirements are imposed on brokers when they receive, transfer or disburse trust funds.

This chapter familiarizes brokers and their agents with the requirements and procedures for the handling of trust funds.

Identification of trust funds

Brokers, while acting on behalf of others in their capacity as agents in real estate transactions, receive funds which are not theirs and are *held in trust* for the owner of the funds. These trust funds include:

- deposits on offers to purchase and applications to rent or borrow;
- fees advanced for any brokerage services to be provided in the future, called *advance fees*;
- funds advanced for future costs;
- funds from sellers, borrowers and landlords as reserves to cover future costs;
- rental income and tenant security deposits;
- funding for a mortgage or the purchase of real estate; and
- proceeds from a sale or financing.

Trust funds are received by a broker, or by an employee acting on behalf of the broker.

Employees acting on behalf of a broker include:

- sales agents;
- broker-associates;
- resident property managers; and
- office personnel.



QUIZ

1. Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction are referred to as:
 - a. monetary funds.
 - b. trust funds.
 - c. mutual funds.
2. Trust funds may be received by:
 - a. a broker.
 - b. an employee acting on behalf of the broker.
 - c. Either a. or b.



Managing Trust Funds

Item or evidence of value

Trust funds include any *item or evidence of value* handed to the broker or the broker's employee while acting as an agent in a real estate transaction.

For example, a buyer enters into a purchase agreement. The buyer's **good faith deposit** is in the form of a bag of gems handed to the broker. The dollar value of the gems will apply toward the purchase price on closing.

Is the broker required to handle the bag of gems as trust funds?

Yes! All items of value received by the broker as part of a transaction, regardless of form, are trust funds subject to special handling — safekeeping and recordkeeping.

Trust funds come in many forms, including:

- checks;
- precious metals/stones;
- stocks/bonds;
- collectibles;
- promissory notes; and
- any other item or evidence of value. [Calif. Business and Professions Code §10145]

Trust funds in practice

Consider a broker who enters into a *property management agreement* with an owner of income-producing real estate. Management services to be performed by the broker under their license include locating tenants, collecting rent and deposits, and disbursing funds for payment of operating expenses and installments on a trust deed mortgage encumbering the real estate.

The broker is further authorized to withdraw their fee and send any funds remaining to the owner.

The broker takes possession of the property under the property management agreement. The broker locates several new tenants and collects monthly rent and deposits.

The broker deposits the rent and security deposits received into their **general account**. The broker then enters the amount of each transaction as trust funds on the client's **subaccount ledger**.

general account

A broker or agent's personal or business account, not to be commingled with trust funds.

subaccount ledger

An accounting document or file identifying the owner of trust funds and the amount held for the owner.

Although sufficient funds are held in the client's subaccount to meet operating expenses and make the mortgage payment, the broker first withdraws their fee before making the mortgage payment authorized by the owner. The disbursement of the brokerage fee reduces the balance on the client's ledger below the amount needed to make the mortgage payment.

The broker then issues a check to the lender for the mortgage payment. The check bounces due to insufficient funds remaining in the broker's general account. The owner is notified by the lender and contacts the broker who provides funds to cover the mortgage payment.

In this instance, the broker *illegally commingled* the owner's funds with their funds when the rent and security deposits were deposited into the broker's general account rather than a trust account. Even though a subaccount ledger for the client's trust funds was maintained, the funds were improperly commingled with funds belonging to the broker.

Further, the broker breached their agency duty owed the client by withdrawing the brokerage fee before paying all other obligations the broker agreed to disburse on behalf of the owner, including payment on the mortgage, known as a **conversion**. The brokerage/management fee is to be paid last, after agreed-to services have been performed, including all authorized disbursements.

conversion

The unlawful appropriation of another's property, as in the conversion of trust funds.

Lastly, by writing a check for the mortgage payment when the broker knew insufficient funds existed in the account to cover the check, the broker misrepresented the availability of immediate funds. This is considered fraud and is grounds for the revocation or suspension of the broker's license. [**Apollo Estates, Inc. v. Department of Real Estate** (1985) 174 CA3d 625]

Handling cash and checks

Funds received in the form of cash or checks made payable to the broker while acting as an agent need to be:

- deposited into the broker's trust account;
- held undeposited as instructed; or
- endorsed and handed to others entitled to the funds.

Further, the broker has a duty to *secure trust funds* that are not in the form of cash or checks, such as gems, coins, notes or other personal property, from loss or damage after they are received. These nonnegotiable types of trust funds cannot be deposited in a bank account. Thus, the broker is to place the nonnegotiable items in a safe or safe-deposit box for safekeeping until they are delivered to others.

Trust funds received in the form of checks or cash may only be used for expenditures authorized and incurred for the benefit of the owner of the funds.

Further, the broker needs to regularly account to the owner on the status, expenditure and location of the negotiable trust funds, called an owner's statement.

owner's statement

An accounting on the status, expenditure and location of negotiable trust funds provided to the owner of those funds.

Identifying the owner

A broker needs to know who owns and controls the funds held in their trust account at all times. Trust funds can only be disbursed on the authorization of the owner of the funds. Subaccount ledgers are set up to identify the owner of funds and the amount held for the owner.

However, persons other than the owner of the trust funds may have an interest in the funds. If so, their authorization is also required to withdraw the funds.

For example, a buyer, as a good faith deposit on an offer to purchase, issues a check payable to the broker with instructions in the purchase agreement to hold the check undeposited until acceptance of the offer.

The seller accepts the buyer's offer and the broker deposits the check in their trust account as funds held on behalf of and owned by the buyer.

The buyer is unable to obtain a purchase-assist mortgage to fund the purchase. The buyer cancels the transaction, consistent with the mortgage contingency provision in the purchase agreement. However, the seller does not sign *mutual cancellation* instructions or other instructions to authorize the return of the buyer's deposit. [See **RPI** Form 183]

The buyer makes an offer to purchase real estate owned by another seller, which is accepted.

To obtain the funds to close escrow on the second transaction, the buyer makes a demand on the broker to transfer the buyer's good faith deposit on the first transaction from the trust account to the escrow handling the second transaction. The broker refuses to withdraw the buyer's good faith deposit from their trust account without further instructions from the seller under the purchase agreement cancelled by the buyer.

Did the broker act correctly when retaining the buyer's good faith deposit?

Yes! When a buyer's offer, which includes receipt of a good faith deposit, is accepted by a seller and the buyer's good faith deposit is placed in the broker's trust fund account (or the purchase escrow),


the buyer's funds may not be withdrawn without written authorization signed by both the buyer and seller. If the funds are disbursed without mutual instructions, the broker is liable to the seller for losses due to an improper release of the funds. [**Mullen v. Department of Real Estate** (1988) 204 CA3d 295]

Prior to the end of the **third business day** following the day the broker receives negotiable trust funds, the broker needs to deposit the funds:

- with the *person or escrow* depository entitled to the funds (as payee or by endorsement); or
- in a *trust account* maintained by the broker at a bank or other state-recognized depository. [Bus & P C §10145; Department of Real Estate Regulation §2832(a)]

Also, when an agent of the broker accepts trust funds on behalf of the broker, the agent needs to immediately deliver the funds to the broker, unless directed by the broker to:

- deliver the trust funds to the person or the escrow entitled to the funds; or
- deposit the trust funds into the broker's trust account. [Bus & P C §10145(c)]



QUIZ

1. Prior to the end of the third business day after the broker receives negotiable trust funds, the broker must _____ the funds.
 - a. invest
 - b. deposit
 - c. embezzle
2. A(n) _____ is an accounting document or file used to identify the owner of trust funds and the amount held for the owner.
 - a. owner's statement
 - b. take sheet
 - c. subaccount ledger



Good Faith Deposit

Date _____

Pay to the Order of _____ \$ _____

_____ Dollars

Signature Member _____

For _____

Holding Checks Undeposited

Held until occurrence of an event

Generally, when a broker negotiates the purchase or lease of real estate, they receive a check as a good faith deposit.

The broker may hold the check undeposited until an event occurs, such as the offer is accepted or escrow is opened, when:

- the check is made payable to someone other than the broker; or
 - the check is made payable to the broker with written instructions, typically from the buyer or tenant, to hold the check undeposited until acceptance of the offer or escrow is opened; and
 - the person to whom the offer is submitted, usually the seller or landlord, is informed the check for the good faith deposit is being held by the broker when the offer is submitted. [DRE Reg. §2832(c)]

The instructions to hold the check undeposited until acceptance are included in the terms for receipt of the deposit contained in the offer to purchase or lease.

After a buyer's offer is accepted, the broker may continue to hold the buyer's check for the good faith money undeposited when the seller has given the broker written instructions to continue to hold the check undeposited.

However, without instructions to further retain the check undeposited, the broker needs to deposit or deliver the funds no later than *three business days* after

acceptance:

- to the payee entitled to the funds, such as a title company or escrow;
- into the broker's trust account at a bank or other state-recognized depository, such as a thrift; or
- to an escrow depository on the broker's endorsement, when the broker is the payee and does not want to deposit and disburse the funds from their trust account to escrow. [DRE Reg. §2832]



1. When a broker negotiates the purchase or lease of real estate, they generally receive a check as a(n):
 - a. kickback.
 - b. advance on their broker fee.
 - c. good faith deposit.
2. After a buyer's offer is accepted, the broker may continue to hold the buyer's check for the good faith money undeposited when the seller has given the broker _____ to continue to hold the check undeposited.
 - a. verbal instructions
 - b. written instructions
 - c. Either a. or b.

client



broker



Advance Fees are Trust Funds

Advance fee trust fund accounting

Broker fees deposited with the broker before they are earned are called **advance fees**. Advance fees will be deposited in the broker's trust account. The funds belong to the client of the broker, not the broker, and cannot be withdrawn by the broker before they are earned and a statement is sent to the client.

advance fee

A fee paid in advance of any services rendered.

In addition to trust fund *accounting requirements*, a broker will send the client a verified accounting for the advance fees:

- no later than at the end of each calendar quarter, and
- at the time the contract between the broker and client is fully performed.

The verified accounting for the advance fees will include:

- the name of the broker;
- the name of the client;
- a description of the services rendered or to be rendered;
- an identification of the trust fund account and where the advance fee is deposited; and

- the amount of the advance fee collected (Department of Real Estate Regulation §2972).

In addition, the verified accounting will include the amount disbursed for each of the following:

- costs for *agreed-to services*;
- fees paid to field agents and representatives; and
- *overhead costs and profits*. [DRE Reg. §2972(f)]

If an agreed-to service disbursed from the account is made for advertisement, the verified accounting will include:

- a copy of the advertisement;
- the name of the publication in which the advertisement appeared; and
- the number of ads published and the dates they appeared. [DRE Reg. §2972(g)]

Further, if the advance fee is for the arrangement of a mortgage, the verified accounting will include a list of the names and addresses of the persons to whom the information pertaining to the mortgage requirements was submitted, and the dates the information was submitted. [DRE Reg. §2972(h)]

The amounts placed in the trust account may be withdrawn:

- when expended for the *benefit of the client*; or
- on the *fifth day* after the verified accounting is mailed to the client. [Calif. Business and Professions Code §10146]

Approval of advance fee agreements

Before a broker may solicit, advertise for and agree to receive an advance fee, the paperwork material is to be submitted to the Commissioner of the **California Department of Real Estate (DRE)** for approval at least **10 calendar days** prior to use. [DRE Reg. §2970]

If the Commissioner, within 10 calendar days of receipt, determines the material might mislead clients, the Commissioner may order the broker to refrain from using the material. [Bus & P C §10085]

To be approved by the Commissioner, the *advance fee agreement* and any materials to be used with the agreement will:

- contain the total amount of the advance fee and the date or event the fees will become due and payable;
- list a specific and complete description of the services to be rendered to

earn the advance fee;

- give a definite date for full performance of the services described in the advance fee agreement; and
- contain no false, misleading or deceptive representations. [DRE Reg. §2970(b)]

Further, the advance fee agreement may not contain:

- a provision relieving the broker from an obligation to perform verbal agreements made by their employees or agents; or
- a guarantee the transaction involved will be completed. [DRE Reg. §§2970(b)(4), 2970(b)(5)]



1. Broker fees deposited with the broker before they are earned are called:
 - a. advance fees.
 - b. kickbacks.
 - c. referral fees.
2. Before a broker may solicit for an advance fee, the paperwork needs to be submitted to the California Department of Real Estate (DRE) for approval at least _____ prior to use.
 - a. 5 days
 - b. 10 days
 - c. three months



Advance Costs are Trust Funds

Funds handed to the broker for marketing costs

Funds advanced by the client directly to the broker for costs the client agrees to pay belong to the client. Typically, the seller will incur costs for acquiring property reports and marketing the property to prospective buyers.

On receipt of an **advance deposit** from the client for the payment of costs, the broker will place the funds in their trust account since they are trust funds. [Calif. Business and Professions Code §10146]

An **advance cost sheet**, also referred to as a *marketing package cost sheet*, acknowledges the broker's receipt of any deposit towards marketing costs. Further, it authorizes the broker to make disbursement from the funds as the itemized costs are incurred. The *advance cost sheet* is best included as part of the marketing package as an attachment to the listing agreement.

advance cost sheet

An itemization of the costs incurred to properly market a property for sale which are to be paid by the owner.

When the listing terminates, the broker is to return all remaining trust funds to the client. The broker may not use trust funds to offset any fees the client may owe them, unless instructed to do so.

An accounting of all funds held in trust will be handed to the client every calendar quarter. However, a monthly accounting by way of a print out of the client's *trust account ledger* creates a better business relationship.

Accounting of funds

A *final accounting* of the funds will be made when the listing agreement expires. When any funds remain, they will be returned to the client with the final accounting. [Bus & P C §10146]

The **statement of account** for the trust funds will include the following information:

- the amount of the deposit toward advance costs;
- the amount of each disbursement of funds from the trust account;
- an itemized description of the cost obligation paid on each disbursement;
- the current remaining balance of the advance cost deposit; and
- an attached copy of any advertisements paid from the advance cost deposit.

Lastly, the broker is to keep all accounting records for at least *three years*. Further, the records will be made available to the California Department of Real Estate (DRE) upon request. [Bus & P C §10148]

A broker who fails to place advance cost deposits in their trust account, or who later fails to deliver proper trust account statements, is presumed guilty of **embezzlement**. [**Burch v. Argus Properties, Inc.** (1979) 92 CA3d 128]

embezzlement

The dishonest act of converting a client's assets for personal use.

For example, a borrower retains a mortgage broker to locate a lender to make a mortgage to fund the acquisition of real estate. The borrower and mortgage broker enter into an *exclusive right-to-borrow listing agreement*.

The listing agreement states the broker will receive a broker fee when the mortgage is funded by the lender the broker locates. [See **RPI** Form 104]

The broker includes an *advance cost sheet* as an attachment to the listing. The advance cost sheet calls for the borrower to advance funds to cover itemized costs which will be incurred by the broker while arranging a mortgage. These costs cover such items as the appraisal of the property securing the mortgage and credit reports. The advance costs are separate and unrelated to the payment of

the broker fee.

The borrower issues a check payable to the broker for the amount of the costs to be incurred by the broker while arranging the mortgage.

Can the broker deposit part or all of the funds advanced by the borrower into the broker's *general business account* to cover the costs the broker is to pay on behalf of the borrower?

No! Funds received by the broker to hold and use to pay costs to be incurred in the future on behalf of the borrower are *trust funds*.

Trust funds are deposited by the broker in a *trust account* in the name of the broker as trustee. They are separate from general accounts established to hold the broker's personal or business funds. [Bus & P C §10145]



1. A(n) _____ refers to an itemization of the costs incurred to properly market a property for sale which are to be paid by the owner.
 - a. advance cost sheet
 - b. advance fee sheet
 - c. balance sheet
2. A broker who fails to place advance cost deposits in their trust account is presumed guilty of:
 - a. blockbusting.
 - b. embezzlement.
 - c. eminent domain



when
how

Analyzing the Marketing Package Cost Sheet

Itemized costs the seller can expect to incur

The items listed on the *marketing package cost sheet* are not costs of the broker's overhead incurred to maintain their brokerage office.

The costs listed, when incurred, relate primarily to the condition of the property listed, marketed and sold. The costs are incurred to document the integrity of the client's property, not to pay for services of the broker.

Thus, the costs rightly are to be paid by the client who owns the property, not borne by the broker. [See **RPI** Form 107]

When filling out the sheet, the client is given choices as to *when* and *how* they will pay the stated costs.

The client may agree to pay the charges directly to third-party vendors when billed. In this case, the broker coordinates the arrangements for payment with the vendors as an agent of the client. When the client's check is payable to the vendor, not the broker, it is handed to a seller's agent for delivery to the vendor. The check still constitutes trust funds received by the broker, and requires an entry in the trust fund ledger maintained by the broker.

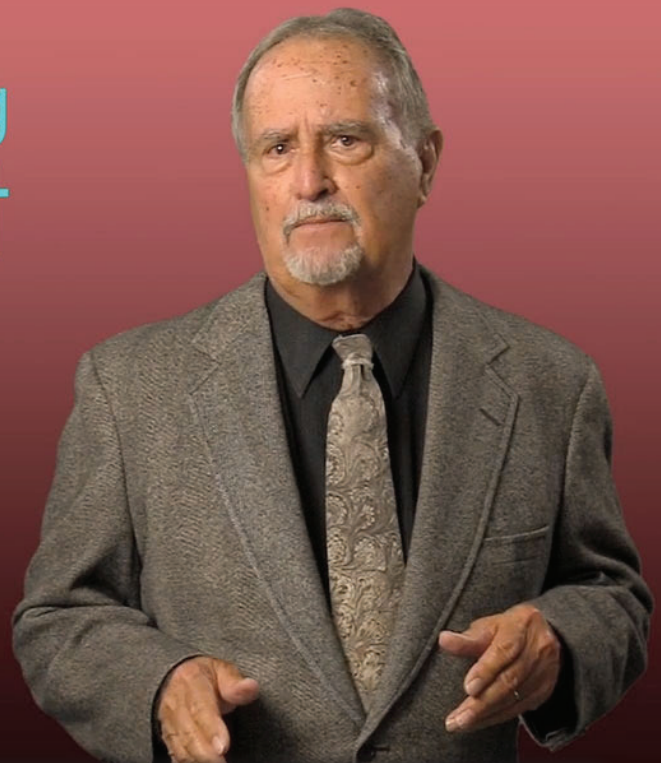
Alternatively, the client may deposit the estimated costs with the broker, making the check payable to the broker, thus classifying the payment as **advance costs**. The broker will then pay the charges from the funds held on deposit when billed by the vendor.



QUIZ

1. Costs listed on a marketing package cost sheet which relate to the condition of the property listed, marketed and sold are paid:
 - a. by the client who owns the property.
 - b. by the broker.
 - c. by the buyer.

non-interest bearing trust account



Trust Account Management

The withdrawal of trust funds

Checks or cash are frequently made payable and handed to a real estate broker during a transaction. These items are *trust funds* since they do not belong to the broker. Rather, checks payable to the broker and cash are received “in trust” by the broker and held on behalf of the client. These funds will be deposited by the broker into a **non-interest bearing trust account**, unless endorsed and handed to others as instructed by the client.

trust account

An account separate and physically segregated from a broker's own funds, in which the broker is required by law to deposit all funds received for clients.

The *trust account* opened for the deposit of cash and items payable to the broker will be in the name of the broker, as **trustee**, at a bank or a state-recognized depository, such as a *thrift*. [Calif. Business and Professions Code §10145]

Once deposited, the trust funds may only be withdrawn or disbursed as authorized and instructed by the owner of the trust funds. A third party who has an interest in the funds may also be necessary to authorize disbursement, such as a seller who acquires an interest in the buyer's good faith deposit on acceptance of a purchase agreement offer. [Bus & P C §10145(a)(1)]

Withdrawals or disbursements from the trust account in the name of an individual

broker will be made under the signature of:

- the broker named as *trustee* on the account;
- a licensed broker or sales agent employed by the named broker under a broker-agent employment agreement [See **RPI** Form 505]; or
- an unlicensed employee of the named broker, provided the unlicensed employee is **bonded or insured** for the total amount of the trust funds the employee can access, and the bond or insurance protects the broker from intentional wrongful acts committed by the employee. [Department of Real Estate Regulation §2834(a); Bus & P C §10145(a)(2)(c)]

A **signer** is an employee other than the broker who has written authorization from the broker to withdraw or disburse funds from the trust account. This authority is either included in an addendum to the employment agreement or is provided in the agreement itself.

signer

An employee who has written authorization from the broker to withdraw or disburse funds from the trust account.

When the trust account is in the name of a **corporate broker** as trustee, withdrawals are made by:

- the **designated officer (DO)** who qualified the corporation as a licensed broker; or
- a licensed or unlicensed employee with the written authorization of the designated officer. [DRE Reg. §2834(b)]

The authorization from the corporation is made as part of the employment agreement with each signatory. [See **RPI** Form 505, 510 or 511]

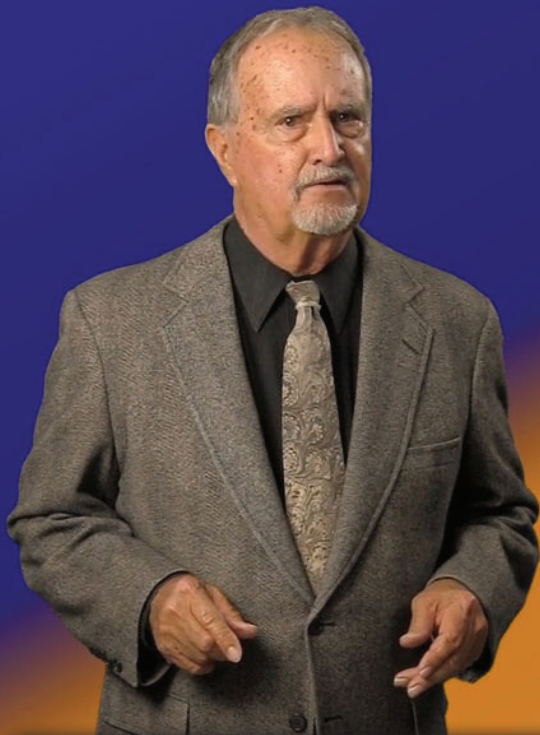
However, a broker's written delegation to others who are signers on the trust account does not relieve the individual broker or the designated officer of a corporate broker from liability for any loss or misuse of trust funds. [DRE Reg. §2834(c)]

To help prevent an improper withdrawal by an individual signer, the broker may require two signatures on trust account withdrawals. An *insurance policy* for the brokerage business needs to include coverage for theft by employees who have direct or indirect access to trust funds.



1. A trust account opened for the deposit of cash and valuable items payable to the broker will be in the name of the broker as the:
 - a. signer.
 - b. trustor.
 - c. trustee.

2. A _____ is an employee other than the broker who has written authorization to disburse funds from a trust account.
 - a. signer
 - b. substitute
 - c. dual agent



interest bearing account

Interest-Bearing Accounts

A broker's proper handling of interest-bearing trust accounts

Trust funds may be placed in an **interest-bearing account** if requested by the owner of the funds and agreed to by the broker. [See RPI Form 535]

However, the broker is under no obligation to comply with the owner's request if they notify the owner they will not place the trust funds in an interest-bearing account. [Bus & P C §10145(e)]

If the broker agrees to place the owner's trust funds in an interest-bearing trust account:

- a separate trust account will be established solely to hold the owner's trust funds;
- the trust account will be in the name of the broker as trustee, with the owner named as the specified *beneficiary*;
- the trust account will be insured by the Federal Deposit Insurance Corporation (FDIC); and
- the broker and their agents may not receive any interest earned by the trust account, even if agreed to by the owner of the trust funds. [Bus & P C §10145(d)]

Also, if trust funds are to be placed in an interest-bearing account, the broker is to first disclose:

- how interest is calculated on the account;
- who will receive the interest;
- who will pay bank service charges; and
- any penalties or notice requirements for withdrawal. [Bus & P C §10145(d) (4); see **RPI** Form 535]



1. Trust funds are generally kept in a(n):
 - a. interest-bearing account.
 - b. non-interest-bearing account.
 - c. off-shore account.



Maintaining Trust Account Integrity

Improper commingling

If a broker deposits trust funds into an account used to receive and disburse personal or business funds, the broker has **improperly commingled** the funds. Similarly, *improper commingling* occurs when the broker places or leaves personal funds in a trust account. [**Stillman Pond, Inc. v. Watson** (1953) 115 CA2d 440]

commingling

The mixing of personal funds with client or third-party funds held in trust.

Except to the limited extent authorized by the California Department of Real Estate (DRE), commingling is always improper.

A broker is only permitted to commingle personal or business funds with trust funds in the following two authorized situations:

1. The broker may maintain a deposit of up to \$200 of *their own funds* in the trust account to cover bank service charges on the account; and
2. Fees or reimbursement for costs *due the broker* from the trust funds may remain in the trust account for up to 25 days before being disbursed to the broker. [DRE Reg. §2835]

The improper commingling of trust funds exposes the broker to a complaint and

revocation or suspension of their license. [Bus & P C §10176(e)]

For example, a broker prepares a purchase agreement for a buyer. The offer includes the broker's receipt of a check for the buyer's *good faith deposit*. Instructions are not included in the purchase agreement authorizing the broker to hold the check undeposited until acceptance of the offer. [See **RPI** Form 150 through 159]

The buyer signs the offer and issues a check payable to the broker for the good faith deposit. The broker deposits the buyer's check into their trust account.

The offer is not accepted by the seller. The broker then withdraws the buyer's good faith deposit from the trust account and deposits the funds in their personal account. From their personal account, the broker writes checks using the buyer's funds to pay personal expenses.

Is the broker's personal use of the buyer's funds cause for revocation or suspension of their license?

Yes! Not only has the broker violated the rule against commingling trust funds and personal funds, the broker also *converted* the buyer's funds to their own use. Both violations are separate grounds for revocation or suspension of the broker's license. [**Brown v. Gordon** (1966) 240 CA2d 659]

Proper recordkeeping

Records maintained by the broker for their trust accounts document and track the broker's **receipt and disbursement** of trust funds. However, recordkeeping alone will not protect the broker against dishonest employees.

The assurance all trust funds are correctly deposited, credited and disbursed is best accomplished by maintaining a *written journal or digital accounting system*. However, even the best of accounting procedures do not protect against deliberate diversion of trust funds by others.

The broker named as trustee on a trust fund account is responsible for funds held in the account. The broker is liable even if others sign on the account with authorization to make withdrawals from the account. [DRE Reg. §2834(c)]

Occasionally, it is unfeasible for the broker to personally enter and maintain each accounting transaction and conduct the reconciliation required by the DRE. Banks and other depositories send a monthly statement of the account to each account holder for the purpose of verifying the validity of the deposits, withdrawals and charges on the account. The broker can best protect the trust funds from unauthorized withdrawals by personally receiving and reviewing bank statements before anyone else.

The broker, to maintain the integrity of the trust account, is to make sure the statement is:

- mailed to the broker's office and handed to them unopened;
- held by the bank and personally picked up by the broker; or
- sent to the broker's residence instead of the office.

If unauthorized withdrawals occur, the broker will discover them by reviewing the bank statement and the accompanying deposit tickets and paid checks before anyone else has access to the statement.

In the event the broker discovers an unauthorized withdrawal due to forgeries or improper endorsements, the broker is to notify the bank within 30 days of receiving the statement. The notice of improper payment of checks by the bank will enable the broker to recover the amount of the unauthorized payment. [Calif. Commercial Code §4406]

Any loss from the trust account not covered by the bank will be covered by the broker. Thus, to protect the broker from unrecoverable losses, business insurance is to include coverage for *employee theft*.

Trust account bookkeeping and monthly reconciliation

The broker's bookkeeping for each trust account maintained at a bank or thrift includes entries regarding:

- the amount, date of receipt and source of all trust funds received;
- the date the trust funds were deposited in the broker's trust account;
- the date and check number for each disbursement of trust funds previously deposited in the trust account; and
- the daily balance of the trust account. [Department of Real Estate Regulation §2831(a)]

Entries in the **general ledger** for the overall trust account are to be in chronological order of occurrences and formatted in columns. The ledgers may be maintained in either a computer program or a written journal. [DRE Reg. §2831(c)]

Editor's note – Computer programs have been developed that allow the broker to make a single entry for the receipt and disbursement of

trust funds from the trust account under an account number given to the owner of the funds, called a beneficiary. On completing the entry, the program automatically generates reports for the overall trust account, each owner's subaccount, and the statements to be sent to each owner of trust funds.

In addition to the *general ledger* of the entire trust account, the broker also maintains a separate **subaccount ledger** for each owner of the trust funds. The *subaccount ledger* lists each deposit and disbursement from the broker's trust account on behalf of each owner of the trust funds.

The subaccount ledger identifies:

- the date and amount of trust funds *deposited*;
- the date, check number and amount of each *disbursement* from the trust account;
- the date and amount of any *interest earned* on funds in the trust fund account; and
- the total amount of trust *funds remaining* after each deposit or disbursement from the trust account. [DRE Reg. §2831.1]

Brokers maintaining bank trust accounts are to **reconcile** the general ledger for the entire trust account against the separate subaccount ledger of each person and each transaction in the subaccounts. Brokers are to reconcile these accounts at least once each calendar month deposits or withdrawals occur.

The monthly reconciliation of the bank trust account contains:

- the name of the bank or thrift where the trust account is located and the account number;
- the date of the reconciliation;
- the account number of each subaccount in the trust account documenting the deposits, withdrawals and disbursement for each person; and
- the amount of funds remaining held in trust on behalf of each (DRE Reg. §2831.2).



QUIZ

1. _____ occurs when a broker deposits trust funds into an account used to receive and disburse personal or business funds.
 - a. Dual agency
 - b. Improper commingling
 - c. A kickback

2. A broker is permitted to keep up to _____ of their own funds in a client's trust account.
 - a. \$200
 - b. \$1,000
 - c. \$5,000

restitution

injunction

Penalties for Misuse of Trust Funds

Commingling, conversion and restitution

Real estate brokers who handle trust funds need to deposit the funds as instructed by their owner.

Trust fund handling is regulated by a variety of *penalties and consequences*. A broker who misuses trust funds is subject to:

- *civil liability* for money wrongfully converted;
- *disciplinary action* by the California Department of Real Estate (DRE);
- *income tax liability*; and
- *criminal sanctions* for embezzlement.

The penalty depends on the nature of the funds which the broker misuses. For example, penalties for a broker's misuse of **advance fees** held in trust accounts are specifically fixed by statute.

If the broker misuses advance fees, the owner of the funds may recover treble damages plus attorney fees from the broker. A broker who fails to account for advance fees is presumed to be guilty of **embezzlement**. [Calif. Business and Professions Code §10146]]

embezzlement

The dishonest act of converting a client's assets for personal use.

However, the existence of specific statutory provisions relating to the misuse of advance fees does not mean the misuse of other types of trust funds will go unpunished. Penalties for the misuse of trust funds for other purposes fall under more general statutory schemes.

Violations subject to DRE discipline

If the DRE Commissioner determines a broker violated trust fund accounting rules, the Commissioner may obtain an injunction against the broker to stop or prevent the violation. [Bus & P C §10081.5]

The Commissioner may also include a claim for **restitution** on behalf of clients injured by the broker's misuse of trust funds. [Bus & P C §10081(b)]

restitution

Money award given to restore an injured party to the condition they held before being damaged.

If the DRE conducts an audit of the broker's trust account and discovers the broker has **commingled** or **converted** more than \$10,000 of trust funds, the broker's license may be suspended pending a formal hearing.

After the hearing, a receiver may be appointed to oversee the broker's business. The receiver is allowed to exercise any power of the broker and may file for bankruptcy on behalf of the broker. [Bus & P C §10081.5]

Commingling of trust funds is grounds for suspension or revocation of the broker's license. [Bus & P C §10176(e)]

Civil liability

A broker who misuses trust funds needs to **reimburse** the owner of the funds the amount wrongfully used. [Calif. Civil Code §3281]

However, a client's right to recover money from a broker is not limited to the amount or value of the funds the broker wrongfully converted. In addition to money losses, the client may be awarded *punitive penalties* based on a breach of the broker's agency relationship with the client.

Also, when a broker uses the client's money for their own benefit, any profits earned by the broker's misuse belong to the client.

Thus, the client is entitled to recover the funds wrongfully converted, *plus any gain* the broker derived from their use. [**Savage v. Mayer** (1949) 33 C2d 548]

For example, a seller's broker presents the listed property to a buyer at a price exceeding the seller's listing price. The buyer signs an offer to purchase at the price solicited by the broker and gives the broker a **good faith deposit**.

The broker never communicates the buyer's offer to the seller. Instead, the broker purchases the property from the seller at the seller's lower listed price, then deeds the property to the buyer. The broker keeps the difference between the listed price and the purchase price as a profit.

The buyer seeks to recover from the broker the difference between the prices paid for the property. The broker claims the buyer is not entitled to recover the difference since the property acquired was worth at least what the buyer paid for it.

Is the buyer entitled to the difference in price?

Yes! Further, the buyer's recovery is not limited to actual money losses for overpayment on the price. Since the broker used the buyer's deposit to secretly profit, the buyer is also entitled to recover the profits and fees received by the broker. [**Ward v. Taggart** (1959) 51 C2d 736]

Punitive damages

A broker who wrongfully converts trust funds may be liable for **punitive damages**. *Punitive damages*, also called **exemplary damages**, is a money award given to a client when the broker wrongfully obtained assets, such as trust funds, from the client by fraud or with malice. [CC §3294]

punitive damages

Monies awarded in excess of actual money losses in order to deter unlawful actions.

Any wrongful use of trust funds is automatically considered *fraudulent*. The broker's breach of their agency duty is defined by statute as *constructive fraud*. [CC §1573]

Thus, any broker misusing trust funds is potentially liable to the principal for punitive damages as well as reimbursement of the trust funds taken or misused. Whether punitive damages will be awarded depends on:

- the severity of the broker's misconduct; and
- the agency relationship undertaken by the broker.

For example, a seller and broker enter into a *listing agreement*. Under the terms of the listing, the broker's fee will be any amount paid by a buyer in excess of the net sales price sought by the seller.

After the seller signs the listing agreement, the broker alters the fee provision to provide for a brokerage fee of one third of the sales proceeds.

The broker accepts cash from a buyer for the full sales price of the property. The broker handles the closing and retains one third of the sales proceeds as their brokerage fee. The balance handed to the seller is an amount less than the net amount agreed to in the listing agreement.

Here, the seller is entitled to *punitive damages*. The punitive damages are based not only on the wrongful conversion of gross sales proceeds held in trust for the seller, but also on the broker's fraudulent conduct. The broker could not have honestly believed they were entitled to a fee equal to one third of the sales proceeds. [**Haigler v. Donnelly** (1941) 18 C2d 674]

In instances where actual money losses are small, punitive money awards are occasionally awarded as a *deterrent* against future fraudulent activity. [**Esparza v. Specht** (1976) 55 CA3d 1]

Income tax

Income taxes to the extent due are paid on all income, from whatever source. This includes income derived from illegal activities such as *embezzlement*. [**James v. United States** (1961) 366 US 213]

Thus, brokers who convert trust funds expose themselves to tax penalties when they fail to report the converted funds as income and pay the appropriate taxes on the *illegal income*. [Calif. Revenue and Taxation Code §19701]

Further, embezzled money needs to be reported as income even when it is paid back. Thus, a broker embezzling trust funds cannot escape income tax liability by returning the funds and characterizing the embezzlement as an *unauthorized loan*. [**Buff v. Commissioner of Internal Revenue** (1974) 496 F2d 847]

In addition, no deductions of any kind are allowed to offset income derived from illegal activities. The broker is responsible for reporting the full amount of the income they have derived from converting trust funds, undiminished by their related expenses, costs and reimbursements. [Rev & T C §17282]

Embezzlement

A broker who uses funds in any way not authorized by the owner is guilty of **embezzlement**. [Calif. Penal Code §506]

Whether the broker is merely "borrowing" the funds and intends to return them is of no import. The broker is still guilty of embezzlement. [Pen C §513]

For instance, a developer accepts down payments from buyers for homes in a subdivision. The purchase agreements state the down payments will be held in escrow until title to the homes is conveyed to the buyers.

The developer fails to deposit any of the funds received into an escrow or trust account. Instead, the developer uses the funds for their own business expenses.

The developer gives the buyers credit for the down payments and later conveys title to the buyers. Thus, the buyers are not harmed by the developer's conversion of the down payments funds.

Even though the down payments would ultimately go to the developer and the buyers received what they paid for, the developer is guilty of embezzlement. The developer had no right under the purchase agreements to use the funds until title was conveyed to the buyers. [**People v. Parker** (1965) 235 CA2d 100]



1. Money damages awarded in excess of actual money losses that are levied in order to deter unlawful actions are known as:
 - a. legal fees.
 - b. reimbursement.
 - c. punitive damages.

2. _____ refers to the dishonest act of converting a client's assets for personal use.
 - a. Embezzlement
 - b. Civil liability
 - c. Restitution

Court Judgment

- Fraud, misrepresentation, or deceit
- Conversion of trust funds
- Criminal restitution

The Real Estate Recovery Account

Recovery from an insolvent broker

If a client sues a broker for trust account violations and receives a money judgment, the client may satisfy the judgment through the state **Real Estate Recovery Account** if:

Real Estate Recovery Account

Funds available to individuals who have obtained a final-court judgment against a licensee and are unable to recover the judgment from the licensee. This account is also referred to as the Real Estate Recovery Fund and Consumer Recovery Account. All refer to the same thing.

- the broker is *insolvent*; and
- the losses are *directly related* to the broker's conduct.

This account is also referred to as the *Real Estate Recovery Fund* and *Consumer Recovery Account*. All refer to the same thing.

The client's recovery is limited to:

- **\$50,000** for one transaction; or
- **\$250,000** for any one licensee.

The recovery is further limited to the actual losses on the transaction which resulted

from the broker's fraud. [Bus & P C §§10471 et seq.]

For example, an owner of income-producing real estate enters into a property management agreement with a broker. Under the property management agreement, the broker collects rents from tenants and arranges for maintenance of the real estate.

The owner gives the broker a cash advance to cover maintenance expenses. The broker deposits the cash advance into their **personal account**.

Tenants pay their rents to the broker in cash, which the broker deposits into their personal checking account. The broker then issues a check from their personal account payable to the owner for all funds due the owner.

The check is rejected by the broker's bank due to insufficient funds. The owner demands the broker to either pay the rents collected and return the cash advanced for maintenance, or account for the funds when they have been disbursed. The broker refuses to account to the owner.

The owner sues the broker and is awarded a judgment for:

- three times the amount of *rents collected* by the broker and not paid to the owner;
- three times the amount of the *cash advanced* for maintenance, as no evidence exists showing the broker expended the funds for the benefit of the owner;
- *pre-judgment interest* at the legal rate of 10% on the rents and cash advanced from the date they were received by the broker;
- *post-judgment interest* at 10% until the judgment is satisfied;
- costs; and
- attorney fees.

The owner attempts to collect on the judgment but the broker is insolvent.

Can the owner collect all of their money judgment amounts due from the broker for the misuse of trust funds from the *Real Estate Recovery Account*?

No! The owner can only recover their *actual and direct losses* on the transaction from the Recovery Account, up to the sum of \$50,000. Thus, the owner's recovery is limited both by the \$50,000 ceiling and the actual amount of their lost rents and the cash advanced for maintenance. The tripled amount cannot be recovered from the Recovery Account since the amount exceeds the actual loss inflicted by the broker. [**Circle Oaks Sales Co. v. Real Estate Commissioner** (1971) 16 CA3d 682]

Also, no attorney fees award can be recovered from the Recovery Account since attorney fees are not direct losses. [**Acebo v. Real Estate Education, Research and Recovery Fund** (1984) 155 CA3d 907]

However, the owner can recover the interest and court costs awarded in the judgment from the Recovery Account as part of the \$50,000 maximum recovery. [**Nordahl v. Franzalia** (1975) 48 CA3d 657]



1. When an individual obtains a final-court judgment against a licensee and is unable to recover the judgment from the licensee, the individual may be able to recover the funds through the:
 - a. broker's errors and omissions (E&O) insurance policy.
 - b. real estate recovery account.
 - c. Department of Housing and Urban Development (HUD) embezzlement fund.

2. An individual seeking funds from the real estate recovery account is limited to:
 - a. \$50,000 for one transaction.
 - b. \$250,000 for any one licensee.
 - c. Both a. and b.

Trust Funds: Glossary

A

advance cost sheet..... 15

An itemization of the costs incurred to properly market a property for sale which are to be paid by the owner.

advance fee..... 12

A fee paid in advance of any services rendered.

C

commingling..... 25

The mixing of personal funds with client or third-party funds held in trust.

conversion..... 6

The unlawful appropriation of another's property, as in the conversion of trust funds.

E

embezzlement..... 16, 30

The dishonest act of converting a client's assets for personal use.

G

general account..... 5

A broker or agent's personal or business account, not to be commingled with trust funds.

O

owner's statement..... 6

An accounting on the status, expenditure and location of negotiable trust funds provided to the owner of those funds.

P

punitive damages.....32

Monies awarded in excess of actual money losses in order to deter unlawful actions.

R

Real Estate Recovery Account35

Funds available to individuals who have obtained a final-court judgment against a licensee and are unable to recover the judgment from the licensee. This account is also referred to as the Real Estate Recovery Fund and Consumer Recovery Account. All refer to the same thing.

restitution31

Money award given to restore an injured party to the condition they held before being damaged.

S

signer.....21

An employee who has written authorization from the broker to withdraw or disburse funds from the trust account.

subaccount ledger.....5

An accounting document or file identifying the owner of trust funds and the amount held for the owner.

T

trust account.....20

An account separate and physically segregated from a broker's

own funds, in which the broker is required by law to deposit all funds received for clients.

trust funds..... 1

Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.