After reading this chapter, you will be able to:

- identify the general laws and regulations governing broker-held trust funds;
- manage, receive, deposit, hold, and disburse trust funds; and
- understand trust fund recordkeeping and accounting procedures.

**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 generally include:**

- rents and security deposits collected under a property management agreement [See *first tuesday* Form 550];
- good faith deposits tendered by a buyer with an offer to purchase;
- fees and costs handed to the broker in advance of his performance of agreed-to services;
- loan payments and funds on contract collection and loan 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 loan 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;
- associated brokers;
- resident property managers; and
- office personnel.

**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.

Must the broker 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.¹

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¹ Calif. Business and Professions Code §10145
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 his license include locating tenants, collecting rent and deposits, and disbursing funds for payment of operating expenses and installments on a trust deed loan encumbering the real estate.

The broker is further authorized to withdraw his 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 he receives into his *general account*. He then enters the amount of each transaction as trust funds on the client’s *subaccount ledger*.

Although sufficient funds are held in the client’s subaccount to meet operating expenses and make the loan payment, the broker first withdraws his fee before making the loan 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 loan payment.

The broker then issues a check to the lender for the loan 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 loan payment.

In this instance, the broker *illegally commingled* the owner’s funds with his 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 loan, known as a *conversion*. The brokerage/management fee is to be paid last, after agreed-to services have been performed, including all authorized disbursements.

Lastly, by writing a check for the loan 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.²

Alternatively, consider a broker who maintains a brokerage trust account. The trust account contains loan payments received by the broker while servicing loans on behalf of trust deed investors.

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² *Apollo Estates, Inc. v. Department of Real Estate* (1985) 174 CA3d 625
The broker pledges the trust account to secure a personal loan from the same bank which holds the trust account.

The broker defaults on the loan, and the bank seizes the trust account funds.

An investor seeks to recover his trust account funds from the bank, claiming the bank’s seizure of the funds is a *conversion* since trust funds cannot be taken to satisfy the broker’s personal debt.

The bank claims the seizure of the trust account is not a conversion since it exercised its right to an offset under the security agreement.

Is the investor entitled to recover his portion of the trust funds?

Yes! The trust funds belong to the investor and must be returned. The bank’s right to an offset for the broker’s personal debt to the bank does not extend to seizure of funds held for others in the broker’s trust account.\(^3\)

**Handling cash and checks**

Funds received in the form of cash or checks made payable to the broker while acting as an agent must 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 he receives them. These nonnegotiable types of trust funds cannot be deposited in a bank account. Thus, the broker should 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 must regularly account to the owner on the status, expenditure and location of the negotiable trust funds, called an **owner’s statement**.

Prior to the end of the *third business day* following the day the broker receives negotiable trust funds, the broker must 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.\(^4\)

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\(^3\) *Chazen v. Centennial Bank* (1998) 61 CA4th 532

\(^4\) *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 must 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.5

For example, when a broker negotiates the purchase or lease of real estate, he usually receives 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, if:

- 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.6

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. [See first tuesday Form 150 §1]

After a buyer’s offer is accepted, the broker may continue to hold the buyer’s check for the good faith money undeposited if 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 must 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; or
- 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, if the broker is the payee and does not want to deposit and disburse the funds from his trust account to escrow.7

A broker must know who owns and controls the funds held in his 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.

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5 Bus & P C §10145(c)
6 Bureau of Real Estate Regulation §2832(c)
7 BRE Reg. §2832
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 his trust account as funds held on behalf of and owned by the buyer.

The buyer is unable to obtain a purchase-assist loan to fund the purchase. The buyer cancels the transaction, consistent with the loan 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 first tuesday 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 his 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.8

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8 Mullen v. Department of Real Estate (1988) 204 CA3d 295

Trust Funds
Chapter 1
Summary

Funds belonging to others which a broker and his agents handle when acting as agents in a transaction are called trust funds. Trust funds include rents, security deposits, good faith deposits, advance fees, loan payments, and any other personal property of value.

The safekeeping of trust funds is ensured by the imposition of recordkeeping and accounting requirements on brokers when they receive, transfer or disburse trust funds.
Trust funds come in many forms, including checks, precious metals/stones, stocks/bonds, collectibles, promissory notes and any other item or evidence of value handed to the broker or the broker’s employee while acting as an agent in a real estate transaction.

Trust funds are illegally commingled when a broker deposits the funds into an account other than a dedicated trust fund account. A broker’s use of trust funds for any reason other than those expressly authorized by the owner of the funds constitutes a conversion of the client’s funds to the broker’s own use.

Cash and checks held as trust funds must be deposited into the broker’s trust account, held undeposited as instructed, or endorsed and handed to others entitled to the funds.

A broker must regularly account to the owner on the status, expenditure and location of the negotiable trust funds held by the broker. Similarly, brokers must know who owns and controls the funds held in his trust account, identified through the use of subaccount ledgers.

**Key Terms**

- conversion ................................................................. pg. 109
- general account ....................................................... pg. 109
- owner’s statement .................................................... pg. 110
- subaccount ledger ..................................................... pg. 109
- trust funds ................................................................. pg. 107
Notes:
After reading this chapter, you will be able to:

- properly handle the receipt of advance fees;
- adhere to accounting procedures for advance fees prescribed by the Bureau of Real Estate (BRE); and
- understand how to obtain BRE approval for advance fees.

Consider a seller's broker employed under an exclusive right-to-sell listing agreement. The listing states the broker will receive a fee set as a percentage of the purchase price and contingent on locating a buyer. The fee is earned and payable on delivery of a signed offer to purchase the property on the price and terms of payment stated in the listing agreement or accepted by the seller. [See first tuesday Form 102]

The broker locates a buyer. The buy makes an offer to buy the real estate. However, the purchase agreement fee provision calls for the seller's payment of the broker’s fee at the close of escrow, not on acceptance as provided in the listing agreement.

The buyer’s check for the good faith deposit is made payable to the seller’s broker to apply toward the purchase price. On acceptance, the funds are deposited into the broker’s trust account.

The broker’s fee on the transaction is less than the amount of the buyer’s good faith deposit held in the broker’s trust account. The broker, without authorization from the buyer and the seller, withdraws the amount of their

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**Key Terms**

- **advance fee**:
- **good faith deposit**: A deposit or partial payment made by a buyer in evidence of good faith for their offer. Also known as earnest money.
brokerage fee prior to closing the transaction. The broker claims the funds are the seller’s and withdrawal is permitted under the terms of the seller’s listing agreement.

Can the broker advance themselves the fee by a withdrawal from the buyer’s deposit held in their trust account prior to closing?

No! The broker is not entitled to their brokerage fee until the sale closes, as stated in the purchase agreement. The funds the broker withdrew from the trust account in advance of closing were still the buyer’s funds. The buyer’s funds were thus controlled by the terms of the buyer’s purchase agreement, not the seller’s listing agreement with the broker.

On withdrawal of the buyer’s funds, the broker unlawfully commingled trust funds with their separate funds.¹

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.

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. [See Trust Funds Chapter 1]

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.²

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.³

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

• a copy of the advertisement;

¹ Bell v. Watson (1957) 148 CA2d 684
² Bureau of Real Estate Regulation §2972
³ BRE Reg. §2972(f)
• the name of the publication in which the advertisement appeared; and
• the number of ads published and the dates they appeared.4

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 loan requirements was submitted, and the dates the information was submitted.5

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.6

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 Bureau of Real Estate (BRE) for approval at least 10 calendar days prior to use.7

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.8

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.9

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.10

Approval of advance fee agreements

4 BRE Reg. §2972(g)
5 BRE Reg. §2972(h)
6 Calif. Business and Professions Code §10146
7 BRE Reg. §2970
8 Bus & P C §10085
9 BRE Reg. §2970(b)
10 BRE Reg. §§2970(b)(4), 2970(b)(5)
Advance fees are funds received from a client for the payment of broker fees before they are earned. Advance fees are to be handled as trust funds and deposited into the broker’s trust account. The broker may not withdraw their fee from the funds before the conditions for having earned the fee has been fully performed.

Statutorily-mandated accounting and reporting procedures apply to advance fees received by brokers and their agents. Advance fee accounting includes a description of services to be rendered, amounts allocated to providing services, fees, overhead costs and profits, and any advertising to be paid for by the advanced funds.

Any solicitations, advertising, and agreements used by a broker to collect an advance fee will be submitted to the Commissioner of the Bureau of Real Estate (BRE) a minimum of 10 days prior to use.
After reading this chapter, you will be able to:

- properly handle funds advanced by a client to cover the cost of marketing a property;
- correctly account for and report the disbursement of advance funds to cover marketing costs;
- analyze a listing package advance cost sheet; and
- prepare a Listing Package Advance Cost Sheet Addendum.

**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.

An advance cost sheet, also referred to as a listing 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 listing package as an attachment to the listing agreement. [See Form 107 accompanying this chapter]

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.

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1 Calif. Business and Professions Code §10146
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. Again, if any funds remain, they will be returned to the client with the final accounting.²

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

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² Bus & P C §10146
3. PAYMENT OF COSTS:

3.1 ☐ Seller agrees to pay, on presentation of a billing, those costs estimated above and incurred by Broker.

3.2 ☐ Broker agrees to incur the expenses of the estimated costs set out and authorized in §2.3 during the first 21 days of the employment and to timely pay the charges. Seller agrees to reimburse Broker for the costs Broker incurs, IF:
   a. Seller closes a transaction which is the subject of the employment agreement;
   b. Seller terminates the employment agreement by cancellation or by conduct before it expires; or
   c. Seller retains another Broker on the expiration of the employment agreement to pursue a transaction which is the subject of the employment agreement with Broker.

3.3 ☐ Costs paid by Seller under this addendum shall be credited toward any contingency fee earned by Broker upon closing a transaction which is the subject of the employment agreement.

3.4 Seller herewith hands Broker a deposit of $_____________ as an advance for the payment of costs incurred by Broker as estimated above.

4. TRUST ACCOUNT: (To be filled out only if a deposit is entered at §3.4 above.)

4.1 Broker will place the advance cost deposit received under §3.4 above into his trust account maintained with __________________________________________________________________________________ at their ________________________________________ branch.

4.2 Broker is authorized and instructed to disburse from the trust account those amounts required to pay and satisfy the obligations incurred as agreed.

4.3 Within 10 days after each calendar month, or ☐ quarter, and upon termination of this agreement, Broker will deliver to Seller a statement of account for all funds withdrawn from the advance cost deposit handed Broker under §3.4 above.

4.4 Each statement of account delivered by Broker shall include no less than the following information:
   a. The amount of the advance cost deposit received.
   b. The amount of funds disbursed from the advance cost deposit.
   c. An itemization and description of the obligation paid on each disbursement.
   d. The current remaining balance of the advance cost deposit.
   e. An attached copy of any advertisements paid from the advance cost deposit since the last recorded accounting.

4.5 On termination of this agreement, Broker will return to Seller all remaining trust funds.

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The broker is to keep all accounting records for at least three years. Further, the records will be made available to the Bureau of Real Estate (BRE) upon request.3

3 Bus & PC §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.4

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

The listing agreement states the broker will receive a broker fee when the loan is funded by the lender the broker locates. [See first tuesday 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 loan. These costs cover such items as the appraisal of the property securing the loan 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 loan.

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.5

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

The costs listed, if 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.

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

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4 Burch v. Argus Properties, Inc. (1979) 92 CA3d 128
5 Bus & P.C §10145
The client may agree to pay the charges directly to third-party vendors when billed, in which 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.

A seller of real estate will frequently need to incur costs to assist the broker to obtain reports and properly market the property. To cover these costs, sellers may advance funds directly to the broker for the broker’s further disbursement. Advanced funds received by a broker or their agents are classified as trust funds, subject to accounting and reporting requirements.

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 fees the client might owe to the broker. A broker will also keep all accounting records for a minimum of three years.

Itemized advance cost sheets are used to provide clients with a detailed list of all costs the broker incurs. These costs are related primarily to documenting the integrity of the client’s property, not to pay for broker services.
Notes:
After reading this chapter, you will be able to:

- manage trust funds in an interest-bearing account on behalf of the owner of the funds;
- properly authorize agents to make withdrawals from a trust account on behalf of the broker-trustee;
- differentiate between proper and improper commingling of trust funds and personal or business funds; and
- prepare an interest-bearing trust agreement.

### Key Terms

- improper commingling
- signer
- trust account

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.

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.¹

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

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¹ Calif. Business and Professions Code §10145
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.²

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 first tuesday Form 505]; or
- an unlicensed employee of the named broker, provided the unlicensed employee is bonded for the total amount of the trust funds the employee can access.³

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.

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.⁴

The authorization from the corporation is made as part of the employment agreement with each signatory. [See first tuesday 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.⁵

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.

Interest-bearing 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.

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.⁶

² Bus & P C §10145(a)(1)
³ Bureau of Real Estate Regulation §2834(a)
⁴ BRE Reg §2834(b)
⁵ BRE Reg §2834(c)
⁶ 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.\(^7\)

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.\(^8\) [See Form 535 accompanying this chapter]

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.\(^9\)

Except to the limited extent authorized by the Bureau of Real Estate (BRE), 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.\(^10\)

The improper commingling of trust funds exposes the broker to a complaint and revocation or suspension of their license.\(^11\)

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 first tuesday Form 150 through 159]

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\(^7\) Bus & P C §10145(d)

\(^8\) Bus & P C §10145(d)(4)

\(^9\) Stillman Pond, Inc. v. Watson (1953) 115 CA2d 440

\(^10\) BRE Reg. §6835

\(^11\) Bus & P C §10176(e)
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 his 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 his personal account. From his 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 his 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 his own use. Both violations are separate grounds for revocation or suspension of the broker's license.\(^\text{12}\)

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.\(^\text{13}\)

Occasionally, it is unfeasible for the broker to personally enter and maintain each accounting transaction and conduct the reconciliation required by the BRE. 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

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\(^\text{12}\) Brown v. Gordon (1966) 240 CA2d 659
\(^\text{13}\) BRE Reg. 52834(c)
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.\textsuperscript{14}

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.

\textsuperscript{14} Calif. Commercial Code §4406
Funds a broker receives from a client in trust during the course of a transaction will be deposited into a non-interest bearing trust account at a bank or other state-recognized depository. Once trust funds are placed in a trust account, they may only be withdrawn or disbursed as authorized by the owner or any third party who has an interest in them. Trust funds may be placed in an interest-bearing trust account on the owner’s request and at the broker’s discretion. The broker cannot receive any of the earned interest.

A broker may authorize another licensed broker, sales agent or adequately bonded unlicensed employee to withdraw or disburse funds. However, this delegation does not relieve the broker from liability for any loss or misuse of the trust funds.

A broker has improperly commingled funds when they mix the client’s funds held in trust with their own personal or business account. Converting trust funds is grounds for revocation or suspension of the broker’s license.

**Key Terms**

- **improper commingling** .................................................. pg. 127
- **signer** ............................................................................... pg. 126
- **trust account** ................................................................. pg. 125
After reading this chapter, you will be able to:

• maintain trust fund records as required by law; and
• regularly confirm and reconcile trust account balances.

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.¹

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.²

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.

¹ Bureau of Real Estate Regulation §2831(a)
² BRE Reg. §2831(c)
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.3

Separate handling rules apply to funds not deposited in a trust account. The broker is to maintain a trust fund ledger separate from the trust account identifying:

- the location of any trust funds received but not deposited in the trust account; and
- the date the funds were returned or forwarded, such as a check, cashier’s check, cash or promissory note that is not deposited in the broker’s trust account.

For example, a broker receives a good faith deposit check from a buyer. The check is made payable to escrow. As the check is not made payable to the broker, the broker cannot deposit the check into their trust account. Thus, the broker makes no entry in their trust account record regarding the check made payable to escrow. However, the broker makes an entry in their trust funds ledger on the date the check is received.

For safekeeping, the broker places the check in the transaction file with all the other documents regarding the transaction.

The offer is timely accepted and the broker delivers the check to escrow. The broker again makes an entry in the trust funds ledger on the date the check is delivered to escrow.

Does the broker need to keep a record of their handling of a check made payable to escrow?

Yes! The check represents trust funds temporarily entrusted to the broker by the buyer who signed and handed the offer to the broker. Thus, as trust funds, the check will be accounted for by the broker in their trust fund ledger, not their trust account records.4

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3 BRE Reg. §2831.1
4 BRE Reg. §2831(a)(6)
A broker is not required to keep records of checks made payable to others for services, such as escrow, credit reports and appraisal services, if the total amount of all such checks for any one transaction does not exceed $1,000.\(^5\)

However, on request from the Bureau of Real Estate (BRE), or the maker of the check exempt from entry in the trust fund ledger, the broker is to account for the receipt and distribution of the checks.\(^6\)

All records of trust funds are retained by the broker for three years after the closing or cancellation of the transaction involving the trust funds.\(^7\)

Lack of proper accounting records is grounds for suspension or revocation of the broker’s license.\(^8\)

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.\(^9\)

Occasionally due to error, the amount of all funds held in a trust account exceeds the amount of trust funds held in all the subaccounts for individuals. This condition is known as an overage.

An overage occurs when the broker cannot determine the owner of the excess funds. The excess, however, is not the result of the broker’s commingled funds.

The overage generally arises due to mathematical errors. These math errors typically occur in the entry of deposits or withdrawals, bank records, or failure to identify the owner of the funds when deposited or withdrawn and entered in the trust account records.

Unexplained excess funds in a trust account are still trust funds, even though the ownership of the funds cannot be determined.

\(^{5\text{ BRE Reg. §2831(e)}}\)
\(^{6\text{ BRE Reg. §2831(e)}}\)
\(^{7\text{ Calif. Business and Professions Code §10148(a)}}\)
\(^{8\text{ Apollo Estates, Inc. v. Department of Real Estate (1985) 174 CA3d 625}}}\)
\(^{9\text{ BRE Reg. §2831.2}}}\)
An unexplained overage may not be withdrawn for the broker’s business or personal use. Further, an unexplained overage may not be used to offset shortages on individual subaccounts in the trust account.

Excess funds are not the broker’s funds as the broker cannot demonstrate they have instructions to withdraw them. Unexplained trust account overages remain in the trust account, or may be placed in a separate trust fund account established to hold unexplained overages.

<table>
<thead>
<tr>
<th>Date Rec.</th>
<th>Chk./Dep. Date</th>
<th>Chk. No.</th>
<th>Deposit/Pay to</th>
<th>Client</th>
<th>Source</th>
<th>Clear</th>
<th>Amount</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/13</td>
<td>10/1/13</td>
<td>N/A</td>
<td>Initial Deposit</td>
<td>Broker</td>
<td>Broker</td>
<td>Yes</td>
<td>$100.00</td>
<td>$100.00</td>
</tr>
<tr>
<td>10/1/13</td>
<td>10/1/13</td>
<td>N/A</td>
<td>Appraisal, credit report fee for loan</td>
<td>BR 1</td>
<td>BR 1</td>
<td>Yes</td>
<td>$300.00</td>
<td>$400.00</td>
</tr>
<tr>
<td>10/1/13</td>
<td>10/1/13</td>
<td>N/A</td>
<td>Advance costs</td>
<td>SE 1</td>
<td>SE 1</td>
<td>Yes</td>
<td>$500.00</td>
<td>$900.00</td>
</tr>
<tr>
<td>10/3/13</td>
<td>10/1/13</td>
<td>N/A</td>
<td>Appraisal, credit report and property inspection</td>
<td>BY 1</td>
<td>BY 1</td>
<td>Yes</td>
<td>$500.00</td>
<td>$1,400.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/3/13</td>
<td>1173</td>
<td>TRW Credit Reporting Service</td>
<td>BR 1</td>
<td>N/A</td>
<td>No</td>
<td>$25.00</td>
<td>$1,375.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/3/13</td>
<td>1174</td>
<td>Appraiser service</td>
<td>BR 1</td>
<td>N/A</td>
<td>No</td>
<td>- $275.00</td>
<td>$1,100.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/5/13</td>
<td>1175</td>
<td>Appraiser service</td>
<td>BY 1</td>
<td>N/A</td>
<td>No</td>
<td>- $275.00</td>
<td>$825.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/5/13</td>
<td>1176</td>
<td>Home inspection service</td>
<td>BY 1</td>
<td>N/A</td>
<td>No</td>
<td>- $200.00</td>
<td>$625.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/5/13</td>
<td>1177</td>
<td>TRW Credit Reporting Service</td>
<td>BY 1</td>
<td>N/A</td>
<td>No</td>
<td>- $25.00</td>
<td>$600.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/5/13</td>
<td>1178</td>
<td>Local paper</td>
<td>SE 1</td>
<td>N/A</td>
<td>No</td>
<td>- $250.00</td>
<td>$350.00</td>
</tr>
<tr>
<td>N/A</td>
<td>10/5/13</td>
<td>1179</td>
<td>Local caterer</td>
<td>SE 1</td>
<td>N/A</td>
<td>No</td>
<td>- $100.00</td>
<td>$250.00</td>
</tr>
</tbody>
</table>
Ultimately, the excess funds escheat to the state, unless the ownership of the unexplained overage is determined within three years of the discovery of the overage.10

Consider a broker who opens their trust account with a maximum $100 deposit from their own funds to cover bank service charges. This deposit is

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10 Calif. Code of Civil Procedure §§1500 et seq.

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<table>
<thead>
<tr>
<th>Subaccount 1</th>
<th>Client: BROKER – Broker</th>
<th>&gt; &gt; &gt; Client Balance</th>
<th>As Of . . .</th>
<th>Source</th>
<th>Amount</th>
<th>Running Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/13</td>
<td>N/A</td>
<td>Initial Deposit</td>
<td>10/1/2013</td>
<td>Yes</td>
<td>$ 100.00</td>
<td>$ 100.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subaccount 2</th>
<th>Client: Borrower 1 – BR1</th>
<th>&gt; &gt; &gt; Client Balance</th>
<th>As Of . . .</th>
<th>Source</th>
<th>Amount</th>
<th>Running Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/13</td>
<td>N/A</td>
<td>Appraisal and credit report fee for loan on 124 University, Riverside</td>
<td>10/1/2013</td>
<td>Yes</td>
<td>$ 300.00</td>
<td>$ 300.00</td>
</tr>
<tr>
<td>10/3/13</td>
<td>N/A</td>
<td>TRW Credit Reporting Service Statement 10/2/01</td>
<td>N/A</td>
<td>No</td>
<td>$ (25.00)</td>
<td>$ 275.00</td>
</tr>
<tr>
<td>10/3/13</td>
<td>N/A</td>
<td>Appraiser Service Invoice #7654</td>
<td>N/A</td>
<td>No</td>
<td>$ (275.00)</td>
<td>$ 0.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subaccount 3</th>
<th>Client No: Seller 1 – SE1</th>
<th>&gt; &gt; &gt; Client Balance</th>
<th>As Of . . .</th>
<th>Source</th>
<th>Amount</th>
<th>Running Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/13</td>
<td>N/A</td>
<td>Advance costs to sell property 125 Main Street, Riverside</td>
<td>10/1/2013</td>
<td>Yes</td>
<td>$ 500.00</td>
<td>$ 500.00</td>
</tr>
<tr>
<td>10/5/13</td>
<td>N/A</td>
<td>Local paper statement dated 10/3/13</td>
<td>N/A</td>
<td>No</td>
<td>$ (250.00)</td>
<td>$ 250.00</td>
</tr>
<tr>
<td>10/5/13</td>
<td>N/A</td>
<td>Local caterer statement dated 10/3/13</td>
<td>N/A</td>
<td>No</td>
<td>$ (100.00)</td>
<td>$ 150.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subaccount 4</th>
<th>Client: Buyer 1 – BY1</th>
<th>&gt; &gt; &gt; Client Balance</th>
<th>As Of . . .</th>
<th>Source</th>
<th>Amount</th>
<th>Running Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/3/13</td>
<td>N/A</td>
<td>Advance costs for purchase of property located at 123 university, Riverside</td>
<td>10/1/2013</td>
<td>No</td>
<td>$ 500.00</td>
<td>$ 500.00</td>
</tr>
<tr>
<td>10/5/13</td>
<td>N/A</td>
<td>Appraiser Service for property located at 123 university, Riverside</td>
<td>N/A</td>
<td>No</td>
<td>$ (275.00)</td>
<td>$ 225.00</td>
</tr>
<tr>
<td>10/5/13</td>
<td>N/A</td>
<td>Home inspector Service Invoice #7654</td>
<td>N/A</td>
<td>No</td>
<td>$ (200.00)</td>
<td>$ 25.00</td>
</tr>
<tr>
<td>10/5/13</td>
<td>N/A</td>
<td>TRW Credit Reporting Service Invoice #1123</td>
<td>N/A</td>
<td>No</td>
<td>$ (25.00)</td>
<td>$ 0.00</td>
</tr>
</tbody>
</table>
entered by the broker on their overall trust account general ledger and on the broker's subaccount as appropriately commingled funds. [See Figures 1 and 2]

The broker has three clients: **Borrower One (BR1), Seller One (SE1) and Buyer One (BY1).**

Borrower One retains the broker to arrange financing. The broker receives $300 from Borrower One to cover costs incurred for:

- placing the loan;
- appraisal costs; and
- credit report costs.

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**Figure 3**

**Form 536**

**Record of All Trust Funds Received**
These funds are deposited in the broker’s trust account. The broker enters information on the deposit to Borrower One’s subaccount under an account number assigned to Borrower One by the broker. [See Figure 4]

The entry is also recorded in the general ledger for the trust account. The general ledger is the balance of all the individual subaccounts.

Seller One enters into an exclusive seller’s listing agreement with the broker and advances the broker $500 to cover costs to be incurred by the broker to obtain reports for better marketing the seller's real estate. The broker deposits the $500 in their trust account. The information is then entered in a subaccount ledger under an account number assigned to Seller One by the broker. The balance is then entered in the general ledger.

Buyer One makes a purchase offer, and hands the broker a $1,000 check for a good faith deposit. Buyer One also advances the broker $500 to cover the cost of a property inspection, credit report and appraisal required by the lender to finance the purchase.

The broker is instructed by Buyer One not to negotiate the $1,000 good faith deposit check until the offer is accepted. The $1,000 check is held undeposited, but is entered on the broker’s ledger for undeposited trust funds. [See Figure 3, Form 536]

The $500 is deposited in the broker’s trust account and entered in a subaccount ledger under an account number assigned to Buyer One by the broker, and entered on the trust account general ledger.

<table>
<thead>
<tr>
<th>Date Rec.</th>
<th>Check No.</th>
<th>Deposit/Pay to Additional Description</th>
<th>Source Cleared</th>
<th>Amount</th>
<th>Amount Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/1/13</td>
<td>N/A</td>
<td>Appraisal and credit report loan fee for 124 University, Riverside</td>
<td>BR 1 Yes</td>
<td>$300.00</td>
<td>$300.00</td>
</tr>
<tr>
<td>10/1/13</td>
<td>1173</td>
<td>TRW Credit Reporting Service Statement 10/2/13</td>
<td>N/A No</td>
<td>$25.00</td>
<td>$275.00</td>
</tr>
<tr>
<td>10/3/13</td>
<td>1174</td>
<td>Appraiser service Invoice #7654</td>
<td>N/A No</td>
<td>$(275.00)</td>
<td>$0.00</td>
</tr>
</tbody>
</table>
The overall balance of the broker’s trust account is now $1,400. The balances of the subaccounts within the trust account are:

- $100 in Account 1, representing the broker’s initial deposit in the account to cover account fees;
- $300 in Account 2, representing the funds received by the broker from Borrower One;
- $500 in Account 3, representing the funds received by the broker from Seller One; and
- $500 in Account 4, representing the $500 received by the broker from Buyer One (the $1,000 check held undeposited by the broker as instructed by Buyer One is not part of the balance of the broker’s trust account).

The broker then pays out $25 for a credit report and $275 for an appraisal for Borrower One in Subaccount 2.

These disbursements are entered on both Borrower One’s subaccount ledger and the general ledger.

The information from the subaccount ledger for Account 2 will be used to generate Borrower One’s monthly statement from the broker. [See Figure 3]

**Acceptance**

Buyer One’s purchase offer is accepted by the owner of the real estate. The broker delivers Buyer One’s check for the $1,000 good faith deposit to escrow (as payee or by endorsement). The broker records the transfer of the check on the broker’s separate ledger for undeposited trust funds. [See Figure 3, Form 536]

From the trust account, the broker also disburses $275 for an appraisal of the property, $200 for an inspection of the property and $25 for a credit report on Buyer One.

These disbursements are entered by the broker on Buyer One’s subaccount ledger, and the trust account general ledger.

On behalf of Seller One, the broker disburses $250 for advertising and $100 for catering at an open house. These disbursements are also entered on the subaccount ledger and the general ledger.

All three transactions close without further disbursements.

**Trust account balances**

A $350 balance now exists in the broker’s trust account. The balances of the subaccounts are:

- $100 in Subaccount 1, the broker’s initial deposit of their own funds to open the trust account;
- $0 in Subaccount 2, as the funds received from Borrower One were completely exhausted;
For every trust account a broker maintains, the broker maintains a general ledger for the overall trust account. The broker also maintains a separate subaccount ledger for each owner of the trust funds.

Further, the broker maintains a separate trust fund record with a ledger of any trust funds the broker receives which are not deposited in the trust account. All records of trust funds are retained by the broker for three years.

Brokers are to reconcile the general ledger for the trust account against the separate subaccount ledgers each month when deposits or withdrawals are made.

Unexplained excess funds called overages are still trust funds. Excess funds are to remain in the trust account or be placed in a separate trust account specifically for unexplained excesses, and escheat to the state if they are unclaimed after three years.
After reading this chapter, you will be able to:

- interpret the penalties of misusing trust funds; and
- understand when individuals can satisfy a judgment against a broker through the Real Estate Recovery Account.

### Key Terms

- **Embezzlement**
- **Punitive Damages**
- **Restitution**

### Trust Funds

Chapter 6: Penalties for misuse of trust funds

Real estate brokers who handle trust funds must 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 penalties, including:

- **Civil liability** for money wrongfully converted;
- **Disciplinary action** by the Bureau of Real Estate (BRE);
- **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. [See *Trust Funds* Chapter 2]

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**.\(^1\)

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\(^1\) Calif. Business and Professions Code §10146
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.

If the BRE Commissioner determines a broker violated trust fund accounting rules, the Commissioner may obtain an injunction against the broker to stop or prevent the violation.²

The Commissioner may also include a claim for restitution on behalf of clients injured by the broker’s misuse of trust funds.³

If the BRE 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.⁴

Commingling of trust funds is grounds for suspension or revocation of the broker’s license.⁵

A broker who misuses trust funds must reimburse the owner of the funds the amount wrongfully used.⁶

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.⁷

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.

² Bus & P C §10081.5
³ Bus & P C §10081(b)
⁴ Bus & P C §10081.5
⁵ Bus & P C §10176(e)
⁶ Calif. Civil Code §3281
⁷ Savage v. Mayer (1949) 33 Cal.2d 548
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.\(^8\)

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.\(^9\)

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**.\(^10\)

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.\(^11\)

In instances where actual money losses are small, punitive money awards are occasionally awarded as a **deterrent** against future fraudulent activity.\(^12\)

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8. Ward v. Taggart (1959) 51 C2d 736
9. CC 51294
10. CC 51573
11. Haigler v. Donnelly (1941) 18 C2d 674
The Real Estate Recovery Account

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:

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

The client’s recovery is limited to $20,000 per transaction. The recovery is further limited to the actual losses on the transaction which resulted from the broker’s fraud.\(^\text{13}\)

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 if 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 $20,000. Thus, the owner’s recovery is limited both by the $20,000 ceiling and the actual amount

\(^{13}\) Bus & P C §§10471 et seq.
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.¹⁴

Also, no attorney fees award can be recovered from the Recovery Account since attorney fees are not direct losses.¹⁵

However, the owner can recover the interest and court costs awarded in the judgment from the Recovery Account as part of the $20,000 maximum recovery.¹⁶

Income taxes to the extent due are paid on all income, from whatever source. This includes income derived from illegal activities such as embezzlement.¹⁷

Thus, brokers who convert trust funds expose themselves to tax penalties if they fail to report the converted funds as income and pay the appropriate taxes on the illegal income.¹⁸

Further, embezzled money must be reported as income even if 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.¹⁹

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.²⁰

A broker who uses funds in any way not authorized by the owner may be held guilty of embezzlement.²¹

Whether the broker is merely “borrowing” the funds and intends to return them is of no import. The broker is still guilty of embezzlement.²²

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.

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¹⁴ Circle Oaks Sales Co. v. Real Estate Commissioner (1971) 16 CA3d 682
¹⁶ Nordahl v. Franzalia (1975) 48 CA3d 657
¹⁸ Calif. Revenue and Taxation Code §19701
¹⁹ Buff v. Commissioner of Internal Revenue (1974) 496 F2d 847
²⁰ Rev & T C §1282
²¹ Calif. Penal Code §506
²² Pen C §513
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.\textsuperscript{23}

\textsuperscript{23} \textit{People v. Parker} (1965) 235 CA2d 100