

Broker Trust and Escrow Accounts

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Background

Broker trust or escrow accounts are usually separate accounts required to be maintained by brokers for the purpose of depositing certain funds received in trust on behalf of the client. They are widely used in many real estate transactions and fiduciary arrangements. State laws governing trust and escrow accounts vary. Common areas addressed by the laws include banking procedures, signatory requirements, and restrictions on interest or the control of interest payments. Laws usually also provide for some type of auditing of trust accounts.

Issue Analysis

For property managers, problems arise when interpretation of the laws and regulations governing trust or escrow accounts conflict with fiduciary responsibilities and agreements with clients. The underlying factor of many problems associated with trust accounts is that legislation regarding this issue is often drafted with the general brokerage business in mind, not property management. A broker-client relationship can be relatively short-lived and ends when escrow closes; however, the relationship between property manager and client is usually long-term, at times extending for the life of the asset.

Many states make no distinction between property management and brokerage because the two activities can involve similar transactions. Also, states tend to regulate types of transactions and relationships rather than job titles. In fact, many states require property managers to be licensed as brokers, thus bringing managers under the jurisdiction of the states' real estate commissions charged with regulating occupational licensing.

Property management is much greater in scope than general brokerage and consequently involves more operating accounts. Operating accounts are established according to a management agreement and are not intended to be treated as broker trust accounts or subject to such regulations. Nonetheless, states often apply broker trust and escrow account regulations to operating accounts. For example, an efficient property manager might want to ensure that a client's funds are kept in interest bearing accounts; however, in their state, operating accounts are considered the same as broker trust and escrow accounts that are not allowed to earn interest. Besides making an owner/client's wishes impossible to fulfill, this application of the law has resulted in civil penalties being imposed on sound, profitable, and mutually agreeable fiduciary arrangements.

Application of broker trust account laws to all property management client accounts can sometimes place fee managers at a great disadvantage. Large clients sometimes demand that funds not be placed in broker trust accounts, preferring instead an account in which the owner and manager are signatories. This allows the owners more control of the funds and provides for better monitoring of the management's performance. If fee managers are legally prohibited from such an arrangement, the client may turn to in-house management as a means of circumventing the legal restraint.

Problems resulting from the inappropriate application of accounting requirements will continue to grow for property managers unless state regulators begin to recognize differences between general brokerage and property management. From a practical business point of view, application of broker trust regulation to all operating accounts can have a devastating effect on property owners and managers, as well as the property management industry. State regulatory agencies must be made aware of the difference between brokerage and property management. Otherwise, laws and regulations designed to protect clients and consumers can have a potentially harmful effect. Unfortunately, in some cases, legal action may be required to force changes in regulations.

Case Study

In Michigan, a routine random audit of a property management company's broker trust account by state authorities found no discrepancies or inconsistencies; however, when the auditor asked to review all of the property management accounts, the company questioned the auditor's authority to do so. Following discussion with the auditor's supervisor, it was agreed that an additional account would be examined. The account selected was not a broker trust account but rather an operating account. The auditor applied the broker trust account requirements and although he did not find any accounting discrepancies, he noted several "problems" with the management company's accounting procedures. Specifically, the account was not a demand account and was interest bearing. The broker did not sign all checks written on the account and the account was not labeled as a trust account. As a result of the audit, the Department of Licensing and Regulation filed a formal complaint against the property management company. Although the state Attorney General stated in an opinion that escrow and trust requirements pertain only to transactional accounts (thus excluding operating accounts such as the type that the audit found fault with), the Michigan Department of Licensing and Regulation indicated that it would continue audit operating accounts.

Sources for Information on Broker Trust Accounts

Association of Real Estate License Law Officials
<http://www.arello.com/site/main.jsp>