

DISCIPLINARY CASES & RED FLAGS

[Excerpts from the 2010-2011 BICAR and 2012-2013 BICAR Course materials.]

Outline:

- ◆ Introduction
- ◆ Case Fact Situations
- ◆ Trust Account Mismanagement - An Ongoing Problem
- ◆ Red Flags & Internal Controls

Learning Objective: After completing this section, brokers-in-charge should have a better understanding of various issues that may arise in brokerage practice and the extent to which licensees, including the broker-in-charge, may bear responsibility for unlawful or inappropriate behavior.

INTRODUCTION

This section describes a number of disciplinary cases the Commission has decided in the recent past. A summary of pertinent facts is presented for each case, followed by questions for discussion regarding what Real Estate License Laws and/or Commission Rules may have been violated. To assist brokers in answering the questions presented in the case fact situations, the relevant portions of the statute specifying conduct that may be subject to disciplinary action are reprinted on the next two pages for reference purposes.

The Commission may initiate an inquiry based upon a complaint filed by a consumer or another licensee, or on its own volition based on information of which it becomes aware. Note too that under **G.S. 93A-6(b)(3)**, a broker is subject to disciplinary action if s/he violates any of the fifteen matters set forth in paragraph (a) while buying, selling or leasing the broker's own property. *A broker engaged in property management is also subject to disciplinary action if any of his/her unlicensed salaried employees violate any of the mandates of subparagraph (a).* Lastly, a broker

who is convicted of certain criminal offenses specified in **(b)(2)** may be reprimanded, or have his/her license suspended or revoked.

§93A-6. Disciplinary action by Commission.

(a) The Commission has power to take disciplinary action. Upon its own initiative, or on the complaint of any person, the Commission may investigate the actions of any person or entity licensed under this Chapter, or any other person or entity who shall assume to act in such capacity. If the Commission finds probable cause that a licensee has violated any of the provisions of this Chapter, the Commission may hold a hearing on the allegations of misconduct. The Commission has power to *suspend or revoke* at any time a license issued under the provisions of this Chapter, or to *reprimand or censure* any licensee, if, following a hearing, the Commission adjudges the licensee to be guilty of:

- (1)** Making any willful or negligent misrepresentation or any willful or negligent omission of material fact.
- (2)** Making any false promises of a character likely to influence, persuade, or induce.
- (3)** Pursuing a course of misrepresentation or making of false promises through agents, advertising or otherwise.
- (4)** Acting for more than one party in a transaction without the knowledge of all parties for whom he or she acts.
- (5)** Accepting a commission or valuable consideration as a real estate broker on provisional status for the performance of any of the acts specified in this Article or Article 4 of this Chapter, from any person except his or her broker-in-charge or licensed broker by whom he or she is employed.
- (6)** Representing or attempting to represent a real estate broker other than the broker by whom he or she is engaged or associated, without the express knowledge and consent of the broker with whom he or she is associated.
- (7)** Failing, within a reasonable time, to account for or to remit any monies coming into his or her possession which belong to others.
- (8)** Being unworthy or incompetent to act as a real estate broker in a manner as to endanger the interest of the public.
- (9)** Paying a commission or valuable consideration to any person for acts or services performed in violation of this Chapter.
- (10)** Any other conduct which constitutes improper, fraudulent or dishonest dealing.
- (11)** Performing or undertaking to perform any legal service, as set forth in G.S. 84-2.1, or any other acts constituting the practice of law.
- (12)** Commingling the money or other property of his or her principals with his or her own or failure to maintain and deposit in a trust or escrow account in a bank as provided by subsection (g) of this section all money received by him or her as a real estate licensee acting in that capacity, or an escrow agent, or the custodian or manager of the funds of another person or entity which relate to or concern that person's or entity's interest or investment in real property, provided, these accounts shall not bear interest unless the principals authorize in writing the deposit be made in an interest bearing account and also provide for the disbursement of the interest accrued.
- (13)** Failing to deliver, within a reasonable time, a completed copy of any purchase agreement or offer to buy and sell real estate to the buyer and to the seller.
- (14)** Failing, at the time a sales transaction is consummated, to deliver to the broker's client a detailed and accurate closing statement showing the receipt and disbursement of all monies relating to the transaction about which the broker knows or reasonably should know. If a closing statement is prepared by an attorney or lawful settlement agent, a broker may rely on the delivery of that

statement, but the broker must review the statement for accuracy and notify all parties to the closing of any errors.

- (15) Violating any rule adopted by the Commission.
- (b) The Commission may suspend or revoke any license issued under the provisions of this Chapter or reprimand or censure any licensee when:
- (1) The licensee has obtained a license by false or fraudulent representation;
 - (2) The licensee has been convicted or has entered a plea of guilty or no contest upon which final judgment is entered by a court of competent jurisdiction in this State, or any other state, of any 3misdemeanor or felony that involves false swearing, misrepresentation, deceit, extortion, theft, bribery, embezzlement, false pretenses, fraud, forgery, larceny, misappropriation of funds or property, perjury, or any other offense showing professional unfitness or involving moral turpitude which would reasonably affect the licensee's performance in the real estate business;
 - (3) The licensee has violated any of the provisions of G.S. 93A-6(a) when selling, leasing, or buying the licensee's own property;
 - (4) The broker's unlicensed employee, who is exempt from the provisions of this Chapter under G.S. 93A-2(c)(6), has committed, in the regular course of business, any act which, if committed by the broker, would constitute a violation of G.S. 93A-6(a) for which the broker could be disciplined; or
 - (5) The licensee, who is also licensed as an appraiser, attorney, home inspector, mortgage broker, general contractor, or member of another licensed profession or occupation, has been disciplined for an offense under any law involving fraud, theft, misrepresentation, breach of trust or fiduciary responsibility, or willful or negligent malpractice.

[*Editor's Note:* The following cases are excerpted from Section 4 of the 2010-2011 BICAR course materials.]

VIOLATIONS OCCURRING IN PERSONAL TRANSACTIONS

The following cases involve disciplinary action against brokers who were not acting in a brokerage capacity. These brokers engaged in conduct in their personal transactions, i.e., transactions in which they were a party, that violated the statute and/or rules and resulted in disciplinary action against the broker. The outcome of each case is given at the end of this Section.

Case 1:

Broker and her husband owned a house and lot that was their primary residence from 1991 through 2001. Water for the property was provided by a well located on adjacent property owned by broker's parents. Broker had attempted to dig two wells on her property in 1991, but neither produced sufficient water to supply the residence, so both wells were abandoned and broker continued using the well on her parents' property. However the water supply from this well was far from ample, necessitating conservation measures by broker and her husband. For example, the couple did not water their yard and broker sold her clothes washing machine early in their residency and washed clothes at a commercial laundry. Occasionally they ran out of water.

In 2001 broker applied to the County Department of Health for permission to sink a new well on her parents' property, which was granted. A new well was dug more than 1000 feet deep, but still yielded no water. Broker then installed a pump on the new well, but never used it as a primary water source. The couple decided to sell the property on their own. Broker and her husband entered into a contract to sell the house and lot for \$178,900.00. Broker gave the buyer a Residential Property

Disclosure Statement on which she indicated that the property recently had been connected to a new well and that the quantity of water had not yet been determined. Buyer specifically asked broker about the water supply and she told him that they had only experienced a water shortage once after a drought and that the new well should produce sufficient water.

Broker failed to disclose to Buyer that she washed her clothes at a commercial laundry, that attempts to install two wells on the subject property had failed, that the old well was running out and the new well had yielded zero water. Prior to closing broker purchased a half acre parcel from her parents that included the new well and conveyed that to the buyer in addition to the subject property. Shortly after the January 2002 closing, both the old and new wells failed. Buyer attempted to correct the problem and to sink a third well without any success. Because the buyer had no water, he was compelled to contract with a private company to truck non-potable water to the house and to purchase bottled drinking water. Buyer informed broker of the developments and sought her assistance which she refused, saying that it was a weather-related problem that occurred after his purchase.

What provisions of GS 93A-6, if any, did the broker violate?

What, if any, disciplinary action do you think is appropriate?

Case 2:

A provisional broker associated with a real estate brokerage company entered into a private agreement with a person to jointly invest in beach property. The individual gave the provisional broker \$68,000.00. The licensee used these funds to purchase two beach properties that he titled in the name of his siblings. Shortly thereafter, the licensee sold one of the properties for a substantial profit. The licensee failed to reimburse the original partner/investor, much less share in the profit.

Understandably, the partner/investor filed a complaint with the Commission. Because the licensee was a provisional broker on active status (i.e., had a BIC), his broker-in-charge also was brought into the investigation to discover the extent to which the BIC was or should have been aware of the situation. The investor/partner and provisional broker both acknowledged that this was entirely a personal business arrangement, that the licensee was not acting as an associated agent of the real estate company and that his BIC knew nothing of the arrangement.

What provisions of GS 93A-6, if any, did the provisional broker violate? The BIC?

What, if any, disciplinary action do you think is appropriate?

Case 3:

A complaint was filed against a broker by a husband and wife who were the broker's neighbors. Apparently the broker had been seen on several occasions by various neighbors walking his dog late at night around the cul-de-sac on which they all lived. One evening, the husband received a telephone call from another neighbor informing husband that broker was leaning on the

side fence outside the couple's house. Husband visually confirmed this, got his camera, went outside and took a photo of broker pressed up against the house peering in through a window. The window was to the bathroom where husband's wife was preparing for bed. Husband immediately retreated to the house after taking the photo and called the police.

The police arrived, took the couple's complaint, and went to broker's house diagonally across the street, where the door was opened by broker's wife with broker standing behind her with a shotgun. The broker was arrested and ultimately pled guilty to the misdemeanor of "secret peeping" which he reported to the Commission within 60 days of the conviction. In attempting to explain his conduct on the criminal conviction reporting form, the broker stated that he had seen a light in the house and, thinking his neighbors were absent, went to investigate. However, he acknowledged: "... I noticed it was the lady of the house. I started to leave but had a compulsion to stay Even though it was not my intention to look in that window for a wrong reason, I did stay and eventually it turned into the wrong reason." The property owners ultimately listed their house for sale, as their feelings of security and privacy had been violated.

What provisions of GS 93A-6, if any, did the broker violate?

What, if any, disciplinary action do you think is appropriate?

Case 4:

Broker had a license on active status and engaged in brokerage as a sole proprietor in the Triangle area. Between 2004 and 2007, broker purchased several coastal properties in his name as investments. Specifically, in August 2007, broker closed two "owner-occupied" mortgage loans, one for \$360,000.00 and the second for \$90,000.00, to purchase a sound-front condominium. On the loan application, broker stated his monthly income was \$30,000.00 as an associated broker with a real estate company on the Crystal Coast and that he owned several other real properties. The loan application was made by telephone. By January 2008 broker was delinquent on these loans and filed for bankruptcy in April 2008. On his bankruptcy petition broker asserted that his income in 2007 had been zero.

What provisions of GS 93A-6, if any, did the broker violate?

What, if any, disciplinary action do you think is appropriate?

Case 5:

This case involved a broker who had moved to North Carolina from Texas who attempted to replicate her Texas business *modus operandi* in North Carolina. She obtained a North Carolina individual broker license, but then attempted to do business as an unlicensed corporation. She would form relationships with various builders who had contracts with consumers to purchase the builders' homes, but the consumers often first had to sell their existing home. Broker, through her unlicensed corporation, would enter into a lease with option to purchase agreement with these buyers and then would search for a prospective tenant/purchaser to whom the corporation could assign the lease-

option agreement. The terms of the lease-option were often left vague until the broker found someone to whom she could assign the contract and typically, broker paid no consideration to the property owner for the alleged lease-option. Instead, broker would charge the buyer/assignees a non-refundable fee of \$3500.00 that was to be applied to the purchase price.

Broker's unlicensed husband also met with builders and their prospective buyers to recruit them into broker's program. He also showed properties on which the corporation held a lease-option agreement to prospective tenant/purchasers and entered into lease-option agreements with them. Broker entered into a one year lease-option agreement with a property owner under which the corporation was to pay the owner \$1,199.00 per month in rent, of which \$600.00 per month was to be credited towards the purchase price if the option was exercised. As was standard in broker's agreements, she had the right to assign the lease-option without the owner-seller's consent and was released from any liability to the owner under the lease-option following assignment.

Broker found a tenant-purchaser to whom she assigned the above lease-option and the tenant paid broker the \$3,500.00 non-refundable fee thinking that it would be held in escrow until tenant decided whether to exercise the option. Ultimately, tenant could not obtain a loan within the one year option period and asked that the \$3,500 assignment fee be applied to rent owed for the remainder of the lease term. Broker refused. The Commission received a complaint from another consumer similar to that outlined above, as well as two complaints from listing agents who had listed properties, only to learn that broker had approached their sellers and persuaded them to enter into agreements for broker to produce lease-option tenants for those sellers. Broker voluntarily placed her license on inactive status during the investigation of this matter.

What provisions of GS 93A-6, if any, did the broker violate?

What, if any, disciplinary action do you think is appropriate?

VIOLATIONS OCCURRING IN BROKERAGE TRANSACTIONS

The following disciplinary cases involve transactions in which the licensee was acting as a broker, rather than as a party to the transaction.

Case 6:

Three individuals owned a limited liability company; two of them were unlicensed and the third had a provisional broker license. They entered into an arrangement with a full broker who was added as a manager of the LLC so he could serve both as the qualifying broker and broker-in-charge of the company. The company then applied for and obtained a firm broker license and proceeded to engage in timeshare sales in Weaverville, NC. The company would take timeshare trade-ins to then sell to purchasers and would also accept purchase money from buyers for a timeshare unit. Apparently, however, many of the owners who sent the company deeds to trade-in their timeshare units never received any money, and many of the buyers who gave purchase money to the company never received a deed for a timeshare. The broker serving as qualifying broker and broker-in-charge

lived in North Wilkesboro and rarely visited the office in Weaverville. When he did visit the office, he apparently was shown a set of false books, which he would review and then leave.

By the summer of 2006, the company and its owners were under criminal investigation. When the provisional broker was arrested, one of the other members absconded to Florida, attempting to remove \$68,000.00 from the company's bank account that had been frozen by the police. It appeared from the criminal investigation that the provisional broker had engaged in such spurious transactions under several different companies in the past. When discovered, he would close that company, move to another area, open a new company and repeat the same scam. The provisional broker had already closed the licensed LLC and let his individual license go inactive, and had opened a new company with one of the two unlicensed owners and was repeating the scam under the new unlicensed company. The Commission's case had 26 complainants. The criminal case involved close to 100 complainants/victims from more than 22 states, including some credit card companies, all of whom had suffered losses totaling in excess of \$300,000.00. When the QB/BIC was contacted as part of the inquiry, he stated that he had no records either as to trust account matters or transaction files, and he did not know where the records were.

What authority does the Real Estate Commission have over the unlicensed actors?

What provisions of GS 93A-6, if any, did the provisional broker violate? The broker-in-charge/qualifying broker? The real estate company?

What, if any, disciplinary action do you think is appropriate, as to the provisional broker? The broker-in-charge? The real estate company?

Case 7:

Husband and wife were both provisional brokers affiliated with the same office of a company and thus under the same broker-in-charge. The husband was also an aspiring builder, but he did not possess a general contractor license. Husband obtained an *owner/builder* permit in May 2007 to build a 4400 square foot two-story home, which permit contained standard language about the owner occupying the residence for at least twelve months following completion. While still constructing the residence, husband entered into a listing agreement in which his wife was the listing agent for the real estate company where both were provisional brokers and the property was advertised in the MLS with a September 15, 2007 completion date.

An offer was received in August 2007 from a buyer who was represented by a buyer agent from another real estate company. The parties negotiated a purchase contract for \$635,500 with a closing date of October 30, 2007. Various issues arose in September, including disputes as to upgrades and other changes, as well as the halting of construction in late September, which aroused buyer's suspicions and caused her to check with the NC General Contractor Board where she learned that husband was not a licensed general contractor. When buyer confronted husband and wife with the information, they indicated that husband had been told that if he passed the general contractor exam prior to closing the permit could be changed to a GC permit, or, alternatively, he could hire a licensed GC to take over the project prior to closing.

The Superintendent of Permits provided conflicting information. He said it was “illegal” to apply for an owner/builder permit if it was the owner’s intention to sell the property upon completion. He also indicated that it is *not* a simple matter to have a licensed general contractor take over a nearly completed project due to tremendous liability issues.

The BIC maintained that both the buyer and buyer agent knew that the husband was acting as his own contractor, that he (the BIC) reviewed all the paperwork and everything seemed in order, that buyer became difficult to work with, and that the sellers could still convey good title to the property, regardless of husband’s GC status. Ultimately, however, the parties entered into a Termination of Contract under which buyer not only received her \$5,000 earnest money deposit, but one-half of expenses she had incurred, for a total payment from sellers of \$10,370.91.

What provisions of GS 93A-6, if any, did the provisional brokers violate? The broker-in-charge? The real estate company?

What, if any, disciplinary action do you think is appropriate as to the provisional brokers? The broker-in-charge? The real estate company?

Case 8:

This case involved a real estate company that operated at least two offices in two different towns separated by more than twenty miles. The office in Town A took a listing. A provisional broker with the company’s office in Town B began working with a couple as a buyer agent. Ultimately, the couple wanted to see the company’s listing held by Office A and the sellers and buyers both signed a dual agency agreement authorizing the company to work as a dual agent. The provisional broker with Office B was not particularly familiar with the town where the property was located, which was thirty miles from her office.

Prior to the buyers making an offer, the sellers told their listing agent that their property lay in the proposed route of a major highway project. The listing agent resided in that area and was aware of the highway project. The listing agent notified the provisional broker about the highway project and told her there was information available on the internet about the project. The listing agent assumed that the provisional broker would share this information with her buyer clients. The provisional broker did not disclose the proposed highway project to the buyers nor did she attempt to learn anything more about the project. The buyers were not from that area and had no knowledge of the proposed project.

Neither the real estate company nor the brokers-in-charge of its various offices had disseminated any information about the highway project to its associated agents, even though the project was going to traverse a large portion of the real estate market where the company operated. The provisional broker’s broker-in-charge failed to ensure that the provisional broker was aware of the impact of the project on the subject property and that the agent had conveyed this material fact to the buyers. The parties entered into a contract to purchase the property for \$185,000.00 and closed a month later. Sometime after the closing, the buyers learned of the proposed highway project.

What provisions of GS 93A-6, if any, did the provisional broker violate? The provisional broker's BIC? The listing agent? The real estate company?

What, if any, disciplinary action do you think is appropriate? Provisional broker? PB's BIC? Listing agent? Real estate company?

Case 9:

A real estate company was contacted by an out-of-state broker concerning one of its listings. The non-resident broker requested a referral fee if friends of his ended up purchasing the property. The non-resident broker indicated that he intended to accompany his friends to North Carolina and assist them in finding a property. The broker-in-charge of the listing company informed the non-resident broker that if he physically entered North Carolina he would forfeit any referral fee as he did not hold a North Carolina broker license. Despite the listing agent's warning, the non-resident broker came to North Carolina with his friends and contacted the sellers directly to show the property, bypassing the listing company. Sellers notified the listing company of the showing, whereupon listing agent twice attempted to contact both the non-resident broker and the broker's out-of-state broker-in-charge to no avail.

Shortly thereafter the listing company received an offer on behalf of these buyers presented by a North Carolina broker who had no record of ever showing the property. The sellers accepted the offer and the transaction closed. Both the NC broker and the non-resident broker attended the settlement meeting. While the listing company paid a \$32,250.00 commission to the real estate company where the NC broker was affiliated, the listing broker-in-charge suspected that the non-resident broker may have shared in the fee, contrary to State law, and filed a complaint. The selling company acknowledged paying the out-of-state real estate company with which the non-resident was affiliated a \$22,000.00 referral fee.

The non-resident broker initially argued that he was acting only as a "financial consultant" for the buyers, not as a broker, yet he had requested a 70% referral fee because he "had done all the work." He later argued that because the fee was paid to the out-of-state real estate company, rather than to him directly, no laws had been violated. In their reply to the inquiry, the NC buyer broker and his BIC both stated that they thought the payment was lawful. The BIC explained: "It is my understanding that an out-of-state broker cannot practice in North Carolina without being actively licensed in our state. It is my understanding that we can not pay a commission to an out-of-state broker, but we may pay a referral fee to an active agent licensed in another state."

Was the selling BIC's understanding of the law correct?

What provisions of GS 93A-6, if any, were violated and by whom?

What, if any, disciplinary action do you think is appropriate?

Case 10:

This case involved two separate complaints against a broker and his company received within two months of each other. The broker was both qualifying broker and broker-in-charge of his company. In one transaction, the non-resident consumer alleged that the broker had contacted him by email about purchasing an investment property for which the broker would find a tenant who would enter into a lease with option to purchase agreement. The consumer expressed interest, the broker found a suitable property and extended an offer on the consumer's behalf as a buyer agent, although there was no written buyer agency agreement nor had the broker provided the consumer with a copy of the "Working with Real Estate Agents" brochure. After the closing, the consumer-owner and the broker discussed a property management agreement, lease terms, amount of rent, etc. and the broker was to forward the appropriate contracts to the owner, but failed to do so.

Owner received a proposed lease, made some changes in the lease and emailed it back to the broker with instructions not to rent to the tenant unless the tenant agreed to the owner's changes. Owner ultimately learned that broker had both leased the property and purchased certain appliances requested by the tenant for the property, both contrary to owner's instructions. Owner filed a complaint against the broker and his company with the Commission. Owner also alleged that broker had received a security deposit and rent monies from the tenant, but failed to forward them to owner. Broker stated in his response that he was *not acting as a property manager, but rather as a tenant/buyer agent only* and that he "agreed to be the property manager ... but only as a part of my client's transaction" by which he meant the tenant. He also stated that the tenant security deposit belonged to the tenant and he had no agreement to provide it to the owner.

On the heels of this complaint, the Commission received a second complaint from a couple who also had purchased a property through broker's "investment program" under which broker locates a property to purchase under market value and then finds a tenant to lease the property for one or two years with an option to purchase. The couple maintained that broker had explained how he screened prospective tenants so the owners would know what they were getting. The couple felt that the broker had misled them in that they had purchased one property believing that broker already had a tenant for the property when he did not, and on a second property they purchased, the tenant the broker found ended up destroying the property, and had a criminal history as well as financial problems.

The investigator asked the couple to provide any documents they had pertaining to the purchase of these properties, as well as any accounting given to them by broker. The accounting revealed that broker had taken a portion of the commission bonus he received from the parties' purchase of the property and credited more than \$1,000 of his bonus to the couple's property management ledger and then used these monies to purchase a refrigerator, garage door opener and blinds for the property. The HUD-1 did not reflect any sharing of broker's commission with his purchasers.

Based on this information, the investigator did an unannounced inspection of broker's transaction files that revealed two recurring practices. One was that broker often received bonuses on his clients' purchase of these investment properties in addition to commission. Broker would retain the commission, but would pay the bonus amount to the purchaser *after closing* without any disclosure to the lenders involved. The other common practice, evidenced by a *written agreement*

between the broker and a corporate builder in the area, was that the builder agreed to take a seller second mortgage equal to ten percent (10%) of the purchase price on any properties purchased by broker's buyer clients. Broker was named as the trustee on these deeds of trust. *However*, if broker sold five of builder's properties within any twelve month period, then the seller second deeds of trust for any of broker's buyers who had purchased within the preceding twelve months would be "forgiven" and marked as canceled or satisfied. (In one instance, the seller second was marked as satisfied the same day it was recorded!) Further, broker's financial projections for these investors never showed the seller second deed of trust as a liability to the investor. An employee of the corporate builder told the investigator that broker had approached them with this idea and provided a copy of their written agreement as well as a list of all transactions involving the broker to the investigator. Additionally, the investigator found the broker's trust account records to be "a mess and the reconciliations are incorrect."

What provisions of GS 93A-6, if any, did the broker violate?

What, if any, disciplinary action do you think is appropriate as to the broker and his real estate company?

[*Editor's Note:* This section excerpted from Section 3 of the 2012-2013 BICAR course materials.]

TRUST ACCOUNT MISMANAGEMENT – AN ONGOING PROBLEM

After refraining from including instruction on Trust Accounts in the BICAR course for several years to avoid criticism from brokers-in-charge taking the course who don't think such instruction is appropriate in the BICAR course, the Commission included a 90-minute segment on "Trust Account Management" in the 2010-11 BICAR course due both to express requests from the Commission and from licensees for training in trust account rules and maintenance and due to the large number of complaints and disciplinary cases involving trust account problems. Despite that fairly recent instruction, *there continues to be an unacceptably large number of instances of noncompliance with trust account rules and good practice guidelines, and much too often such noncompliance results in mismanaged trust accounts and conversion of funds to personal use.*

In order that BICs attending this course might better understand the extent of trust account management problems, presented below is an incomplete list of **32 cases** involving trust account offenses that have resulted in disciplinary action by the Commission in the **nine-month period July 2011 - April 2012 alone**. For more information on these cases, see the October 2011, February 2012 and May 2012 editions of the *Real Estate Bulletin*, which may be viewed on the Commission's website at www.ncrec.gov.

July 2011 - April 2012 Disciplinary Cases Involving Trust Account Violations

1. Qualifying broker/BIC of firm converted trust monies for personal use and failed to maintain proper trust account records.

2. BIC converted \$15,000 of a buyer-principal's money that was entrusted to him; broker also created false agency documents and, in another transaction, converted a buyer-principal's \$1,000 earnest money deposit for personal use.
3. Broker engaged in sales and property management through an unlicensed firm, failed to maintain trust account records according to Commission rules, and deposited rents and security deposits belonging to others into her personal savings account.
4. BIC's trust account was found in a Commission spot audit to be lacking in many details required by Commission rules.
5. Firm owner/BIC failed to supervise bookkeeper who was to account for deposits and rent payments; \$10,000 in cash receipts were not deposited (taken by bookkeeper); BIC failed to review account reconciliations.
6. Firm qualifying broker/BIC failed to maintain trust account according to Commission rules. Trust account held earned commissions, showed "deficit spending," had unrecorded cash withdrawals and a \$14,000 shortage as well as generally poor records.
7. Firm BIC permitted a former broker with an expired license to engage in brokerage and maintain the firm's banking and trust accounts. BIC failed to properly supervise the broker in maintaining appropriate records and failed to safeguard trust funds.
8. Firm qualifying broker/BIC engaged in loan fraud by secretly providing earnest money for a buyer of two investment properties and not disclosing this to the buyer's lender. The BIC failed to provide promised tenants for the properties, leading to foreclosure. The BIC's trust account records were also found to be incomplete.
9. Property management firm partner/qualifying broker/BIC failed to deposit \$2,300 of tenant security deposits from his old firm's trust account to his new firm's trust account. BIC also misappropriated \$1,500 of trust monies for his personal use.
10. Property management firm BIC failed to account for monies received and failed to make trust account records available to the Commission for inspection.
11. Firm BIC converted trust funds by writing checks to himself to pay for office expenses, including \$3,195 in checks from the rental account and \$3,900 in checks from the security deposit account.
12. Property management firm qualifying broker/BIC failed to remit rents and security deposits to landlord/client; converted client monies for personal use; failed to deposit client monies in a trust account; and failed to make trust account records available to the Commission for inspection.

13. Broker failed to turn over an \$8,000 earnest money deposit to his BIC, failed to deposit the earnest money in a trust account, and failed to return the earnest money to the buyer when the purchase failed.
14. Broker acting as property management firm bookkeeper embezzled \$500 from firm's rental trust account.
15. Sole proprietor BIC failed to maintain trust account records according to Commission rules and periodically had shortages.
16. Firm BIC deposited \$1,000 in earnest money in her operating account rather than her trust account, spent a portion of the money and did not refund the EM as required for one year.
17. Firm BIC failed to keep complete trust account records and failed to reconcile records to bank statements over a 12-year period.
18. Firm BIC failed to maintain trust account records in accordance with Commission rules, failed to deposit all received rents in a trust account and engaged in "deficit spending" from the trust account.
19. Firm owner/BIC failed to maintain trust account records in accordance with Commission rules, including not maintaining a journal or ledgers, not performing monthly reconciliations, not accurately disbursing maintenance fees, and retaining personal funds (earned commissions) in trust account resulting in a \$13,000 overage.
20. Firm owner/BIC placed rents, security deposits and other trust monies in an account not designated as a trust account, failed to maintain ledgers, failed to perform monthly reconciliations or trial balances, resulting in both overages and shortages in various client accounts.
21. Firm owner/BIC failed to supervise the individual assigned to manage the firms' trust accounts, resulting in the individual converting trust monies for personal use, and failed to maintain trust account records according to Commission rules.
22. Firm BIC failed to maintain trust account records according to Commission rules and failed to perform monthly reconciliations, resulting in a shortage of \$112,000.
23. Firm BIC failed to keep complete trust account records sufficient to establish a clear audit trail and failed to perform monthly reconciliations over a seven-year period.
24. Broker acting as manager of a homeowners' association collected homeowner dues but did not deposit the money into a trust account within three days of receipt, did not report accurately to the homeowners' association in a timely manner and allowed homeowner dues to accumulate for months before making appropriate disposition of the monies.

25. Firm qualifying broker/BIC disbursed rental proceeds to a landlord-client before verifying that the rent checks had cleared, resulting in the proceeds checks to the owner being returned for insufficient funds.
26. Firm qualifying broker/BIC (licensed since 1979) employed a bookkeeper with prior record of bankruptcy and credit card fraud charges without performing background check. BIC failed to supervise the firm bookkeeper (not licensed) and failed to review or perform monthly reconciliations, thus allowing the bookkeeper to embezzle approximately \$18,000 in trust money. Bookkeeper bought a car with trust funds and wrote checks to her roommate, among other things. The BIC refused to fire bookkeeper despite requests from her affiliated licensees to do so. When finally challenged by BIC, bookkeeper took all books, records and old files from office and refused to return them, but BIC kept her employed for another four months hoping to get the records. The records were never returned, reconstruction based on later acquired bank records was inadequate, and BIC had to repay money owed to clients based on whatever amounts the clients claimed they were owed.
27. BIC of brokerage and property management firm managing a homeowners' association charged unauthorized fees to home purchasers, failed to maintain HOA monies in a properly designated trust account, and failed to keep accurate and complete records of trust monies. Also, when acting as a broker for homebuyers and sellers, BIC failed to keep accurate and complete trust account records in accordance with Commission rules.
28. BIC of a property management firm failed to maintain trust account records in accordance with Commission rules, resulting in a shortage of \$87,000.
29. Qualifying broker/BIC of a property management firm failed to maintain trust account records in accordance with Commission rules. Among other things, BIC operated the firm's tenant security deposit account on a shortage of \$33,580 that had existed for several years and dated to before BIC became BIC of firm.
30. BIC of firm acting as rental agent deducted monies from security deposits of successive tenants for damages for which the tenants were not responsible or which did not exist; charged tenants for repairs which were not made or which did not cost as much as the amount charged to the tenants; and failed to maintain complete records of rental transactions and trust funds. No documents could be provided for deductions from security deposits.
31. Broker operated firm without a firm license, failed to enter into written property management agreements with clients, and failed to maintain rental records and trust accounts for rental proceeds or security deposits, instead depositing these funds into his personal bank account and converting the funds for personal use.
32. Broker engaged in property management business through a firm not registered with the Secretary of State's office or licensed by the Commission and without a designated BIC. Broker maintained incomplete trust account records showing unaccounted for funds in the

account and “deficit spending;” and further cashed rental checks and deposited proceeds into a landlord’s account instead of depositing the rent into his trust account.

Because of the continuing serious problems with trust account mismanagement, often by licensees who have held a license for many years, the following reminder as to “red flags” and suggested internal controls is included. Major trust account violations are occurring in every part of the state and involve brokers-in-charge who are both experienced and inexperienced. The Commission hopes that brokers-in-charge will take note of the ongoing problems that are occurring, frequently right under the noses of otherwise competent and well-intentioned BICs, and will strive to improve their trust account management practices.

It should also be noted that trust account spot inspections by the Commission’s Auditors during the July 2011-June 2012 period showed that of the spot inspections performed, trial balances had not been performed in 44% of the accounts inspected, monthly bank reconciliations were unsatisfactory in 17% of the accounts inspected, and disciplinary hearings resulted from 14% of the inspections.

RED FLAGS & INTERNAL CONTROLS

Red Flags

A **red flag** is a set of circumstances that are unusual in nature or vary from the normal activity. It is a warning sign that something is out of the ordinary and *should be further investigated*.

Common red flags in real estate trust accounts

(A) Checks can be a source of many different red flags, including:

- NSF notices on checks drawn on the trust account.
- Canceled checks missing from bank statements.
- Excessive voided checks or entries to correct errors (a.k.a. “cooking the books.”)
- Checks (and deposits) for large, round figures.
- Checks written to the bookkeeper. (S/he is paid from the operating account!)
- Checks written to an unknown vendor. (Do they really exist?)
- Checks held and not mailed. (Why write the check, but not mail it?)

(B) Likewise, missing trust account records are a red flag. If any of the following are missing, follow-up is a must, both to avoid record-keeping violations and to find out what someone might be trying to hide:

- Cash receipts
- Bank statements, including canceled checks and deposit tickets
- Trust account reconciliations

(C) Similarly, discrepancies between different types of trust account records constitute red flags. Look for:

- Discrepancies between cash receipts and deposit amounts, e.g., cash receipts show \$2,250, yet the deposit ticket from the following day is for only \$2,000.
- Discrepancies between amounts on bank statements and amounts on trust account records, e.g., journal shows 3 voided checks, yet 2 cleared the bank.

The broker-in-charge must discover the explanation for the discrepancies and document it.

(D) Also, look for vendors with P.O. boxes and no physical address. This may be a red flag that the vendor is not real and is simply a conduit through which a bookkeeper, associate or employee is passing money to him/herself or for his/her benefit.

(E) If you see large transfers of funds between various trust accounts, you may also have a problem. Why is the transfer being made? Does it make sense? Do your files include the proper documentation?

So long as each trust account has check writing privileges, there really is no reason to have transfers between trust accounts. However, if for example, the tenant security deposit account is an interest bearing money market account with no check-writing ability, then when the time comes to disburse the tenant security deposit, the broker must transfer the deposit from the money market account into the general trust checking account and then disburse the funds. Other than that, transfers between trust accounts may indicate a shortage; someone is stealing from the more active account and is trying to subsidize it by borrowing funds from the more stable, unused trust account.

(F) Property owner complaints of late rent proceeds or no rent proceeds or insufficient or low proceeds should be a *huge* red flag for brokers-in-charge. If the rent was received by the broker, then why is it that the owner hasn't received the net rent proceeds two months later? It's amazing how patient some owners are, waiting 4-6 months before contacting the Real Estate Commission. Such complaints garner the attention of the Commission's auditors *quickly*.

(G) Finally, employees themselves can be red flags. Look for:

- Employee lifestyle changes. (New car/jewelry/trips - a.k.a. "why is your bookkeeper living better than you?")
- Bookkeeper/employee who is obsessed with the mail. (Seeks to intercept and "screen" the mail to remove NSF notices, owner complaints, etc.)
- Bookkeeper/employee who never takes time off. (Why not?)

A broker-in-charge may authorize a secretary, bookkeeper or other employee to collect trust money, make deposits, sign trust account checks, make bookkeeping entries and reconcile trust account bank statements to the journal and ledgers. However, it is the responsibility of the broker-in-charge to make sure the trust account and related records are properly maintained. If an employee misappropriates trust funds, the broker-in-charge may well be held responsible.

In many cases, after it is discovered that an employee has misappropriated trust funds, it becomes clear that red flags were present. Had the broker-in-charge recognized these red flags, the loss might not have occurred or at least would have been substantially reduced. ***A broker-in-charge should be able to discover most trust account abuses quickly (no later than a month or two) if he or she reviews the records regularly and watches for the red flags described above.*** If a broker-in-

charge realizes in relatively short order that there may be a problem with the trust account and investigates it and documents what happened and makes it right, then chances are s/he may not be disciplined. The longer the embezzlement persists and the larger the sum of misappropriated funds grows, the more likely the broker-in-charge may lose his/her license for some period, because s/he was not fulfilling his/her supervisory duties to monitor the trust account.

Internal Controls

Internal controls are policies and procedures designed to safeguard the assets of a business and ensure the accuracy of its financial records.

Recommended Internal Controls

- Separate the handling of cash from bookkeeping. This helps avoid a situation where a bookkeeper is hiding cash receipts. If someone else knows monies were received and makes a record of receipt, the bookkeeper is less able to take the cash.
- Each employee handling cash should have his or her own cash drawer and account for cash daily.
- Use sequentially numbered cash receipts and compare cash receipts to deposit tickets daily.
- Employees handling cash should be bonded. A bond is like insurance. If an employee does take money improperly, the bond provides coverage. Understand that E&O coverage will not pay one cent for trust account misappropriation as that is an intentional act. Thus, absent bonding, the owners of the company and/or the broker-in-charge may be obligated to personally restore all missing trust funds if the company wants to continue in business.
- Any mail bearing the bank's return address is delivered to the broker-in-charge's desk unopened and is opened first by the broker-in-charge. Compare this month's balance to last, and to prior months' balances. Is the balance significantly lower or steadily declining? Should it be? Have "voided" checks cleared the bank?
- Review checks for unusual amounts or unknown payees. Consider requiring at least two signatures on every trust account check with only two or three people having authority to sign.
- Examine monthly reconciliations and the entire trial balance for accuracy, even if it is pages long.
- Maintain an approved vendor list. The bookkeeper may write checks to anyone on the list, but if a vendor is used who is not on the list, then only the broker-in-charge may sign that check.

- Adequately screen job applicants who will have access to cash, e.g., criminal record check, contact previous employers, etc.
- Actively supervise the bookkeeper and others handling cash.
- Have the books audited periodically by a C. P. A., particularly one experienced in detecting fraud, rather than one who primarily prepares tax returns, or occasionally hire a certified fraud examiner (CFE) to review your records.

In evaluating internal controls, focus on the areas in your practice that are most susceptible to fraud and abuse. Identify what procedures should be in place and then actively supervise the employees to make sure those procedures are being followed on a regular basis.

ANSWERS TO DISCIPLINARY CASE OUTCOMES

Case 1: Broker violated G.S. 93A-6(a)(1), (8), (10) and (b)(3). Order following hearing before the Commission: *6 month license suspension*.

Case 2: Broker appeared to have violated G.S. 93A-6(a)(2), (7), (8), (10) and (b)(3). However, because broker agreed to voluntarily surrender his license for five years pursuant to G.S. 93A-6(e), a consent order was entered that did not specify the violations and noted that broker neither admitted nor denied any misconduct and the case was dismissed without prejudice in light of the voluntary *five year surrender* of his license effective August 1, 2009.

Case 3: Broker violated G.S. 93A-6(a)(10) & (15) and (b)(2). Broker consented to the *revocation* of his license without a hearing.

Case 4: Broker violated G.S. 93A-6(a)(1), (3), (8) & (10). Broker consented to the *revocation* of his license without a hearing.

Case 5: Broker appeared to have violated G.S. 93A-6(a)(1), (8), (10), & (15) and (b)(3). Prior to hearing, broker, without admitting or denying the allegations, consented to the *permanent surrender* of her broker license effective October 1, 2009 and Orders were entered accordingly.

Case 6: The provisional broker and company were found to have violated G.S. 93A-6(a)(1), (2), (8) & (10). Prior to hearing, both consented to the *revocation* of their respective licenses effective April 2009 without admitting or denying the allegations. The BIC violated G.S. 93A-6(a)(15) and Rule A.0110(a) by failing to supervise the day to day operation of the company and failing to keep accurate transaction or trust account records. Prior to hearing and without admitting or denying the allegations, the BIC agreed to a *two year suspension* of his license effective November 2008.

Case 7: Both of the provisional brokers violated G.S. 93A-6(a)(1), (3), (8) & (10). Each consented to an 18 month *suspension* of their respective licenses effective September 1, 2008 of which 3 months was to be active, but each had the option of being placed on probation for the remaining 15

months if each took one CE course on License Law and Commission rules and one course on real estate ethics prior to December 1, 2008. Wife completed the CE and had her license restored as of December 1, 2008, but has been on inactive status since then. Husband endured the full 18 month suspension, as he did not complete the required CE. His license was restored in April 2010 but it is on inactive status.

Their BIC violated G.S.93A-6(a)(15) and Rule A.0110(a). He consented to a one year suspension of his license which was to be reduced to a reprimand if he too completed one CE course on License Law and Commission rules and one course on real estate ethics by January 1, 2009. He completed the required CE and thus received a *reprimand*.

The real estate company violated G.S. 93A-6(a)(1) and consented to a *reprimand*.

Case 8: The provisional broker violated G.S. 93A-6(a)(1). Prior to hearing and without admitting or denying the allegations, she consented to a 90 day *suspension* of her license, of which 30 days was active and the remaining 60 days was stayed. The provisional broker's BIC violated G.S. 93A-6(a)(1), (2), & (15) and Rule A.0110(a). She consented to a 90 day suspension of her license, which suspension was stayed and the BIC placed on probation for one year on condition that she not violate License Law or rules and if she did, then the disciplinary action stayed in this case would be imposed. The case against the real estate company was dismissed, influenced in part by its remedial efforts to make the buyers whole.

Case 9: Both the broker and BIC violated G.S. 93A-6(a)(8), (9), (10) & (15) and Rule A.0109(d) [now Rule A.0109(g).] The broker consented to a one year *suspension* of his license, which suspension was to be *stayed* and the broker placed on *probation for two years* if he completed 4 courses on License Law and Commission rules by a specified date and he did. The broker's BIC agreed to a consent order under which he was to be reprimanded, but if he completed one course on License Law and Commission rules by a specified date, then the case against him would be dismissed. The BIC timely completed the CE and the case against him was dismissed.

Case 10: The broker violated G.S.93A-6(a)(1), (2) (3), (8), (10), (14) & (15). The real estate company violated the same provisions except for 93A-6(a)(14). Both the broker and the company entered into Consent Orders *permanently revoking* their respective licenses. (Broker had been licensed since 1997.)