

## ***Trust Accounts: Does It Really Matter?***

### ***By Chris Burand***

An agency valuation I completed a few weeks ago was considerably less than the agency owners expected. The reason? Their balance sheet was very poor and they were materially out of trust (meaning (Accounts Receivable + Cash)/Accounts Payable was less than 1.0). They were quite upset that I would decrease their value for this reason. They retorted, "We always pay our companies on time, our companies have never been hurt by this, our customers have never been hurt by this, and our CPA has never found fault with this practice. You are the only one that thinks it matters!"

As it happened, this particular agency was also located in a state that legally required agents maintain a trust fund. Even so, this is an issue for all agencies regardless of their state law because, remember, Michael Segal, principal of Near North Insurance, was convicted in FEDERAL COURT of fraud and racketeering charges in June 2004 for violating his brokerage's trust account. As the U.S. Attorney's office for the Northern District of Illinois stated, "We think it sends an important message to those who are trusted with the fiduciary duty of holding other people's money that there are serious consequences to violating that trust and duty." (*Business Insurance*, June 28, 2004)

Mr. Segal's defense "contended that Mr. Segal was a victim of bad accounting at the brokerage and that no insurer or customer was ever harmed." (*Business Insurance*) Doesn't this latter part of the rebuttal sound familiar? In fact, I have heard the very same argument from very many agencies. I have not seen any evidence suggesting that Mr. Segal's companies were not paid or that his customers were harmed, and yet, he was convicted. The point is not whether the companies or customers were harmed but rather, the money was misused. When customers pay for their insurance, that money should not be used for any other purpose, whether that purpose is to buy other agencies, make payroll, or improve one's lifestyle. Even if the agency owners must pay higher taxes by leaving money in the agency so the agency's trust ratio remains above 1.0, the money should remain and the taxes paid.

I have seen several articles written by other consultants estimating 40%-50% of all agencies are out of trust. My experience suggests they are correct. Why should an agency that has obviously misspent its clients' money be valued as highly as one that has not? One way or another, the agency will have to pay the money back. If not before the sale, then every halfway intelligent agency buyer is going to deduct enough from the price to get the agency into trust upon acquiring the agency.

I strongly encourage every agency in every state to get into trust as soon as possible. There are several ways to do this. The fastest is to get a long-term loan equal to the deficit and put the cash in the bank and leave it. Then pay off the loan.

An alternative is to budget \$x per year to the agency's capital account until it is in trust. For example, suppose an agency determines it should leave \$50,000 cash in the agency every year until it gets into trust. To leave \$50,000, the agency must record profits of approximately

\$87,000 at a 34% tax rate. Therefore, it must adjust its budget accordingly so that its profit at year-end will be at least \$87,000 after every single other expense, including all owner compensation. Sometimes this means owners must take pay cuts which is always hard to swallow. However, another way to think of it in some situations is that the owners would not have made as much in past years if they had not paid themselves from the trust funds anyway, so this is just repaying the loan.

My clients noted their CPA had never advised them about being out of trust, and in fact when their CPA called me to learn about trust ratios, he advised that he did not think they were that important. And indeed, I can see his point since insurance agency trust fund questions do not appear on the CPA exam. Since he had also not read state insurance laws, insurance company contracts, insurance agency ethics, or any recent editions of major insurance industry trade press, he could claim ignorance.

Agency owners beware! Unless you ask your accountant very specifically for advice on these issues, they will not advise you on them. They will just focus on minimizing your taxes which in turn, will almost inevitably put you further out of trust!

Many agency owners have advised that since their states do not mandate they maintain separate trust accounts, being in trust is meaningless to them. I am not an attorney so I cannot offer a legal opinion. However, I do know the following: the insurance company contracts often require being in trust, ethically it is the right thing to do, and Mr. Segal was convicted in FEDERAL COURT! Nearly everyone reading this probably lives in the United States and does business across state lines (since your companies are located in states other than yours). Maybe it is time to reconsider whether being in trust applies to you.

**Chris Burand** is president of Burand & Associates, LLC, an insurance agency consulting firm. Readers may contact Chris at (719) 485-3868 or by e-mail at [chris@burand-associates.com](mailto:chris@burand-associates.com).

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