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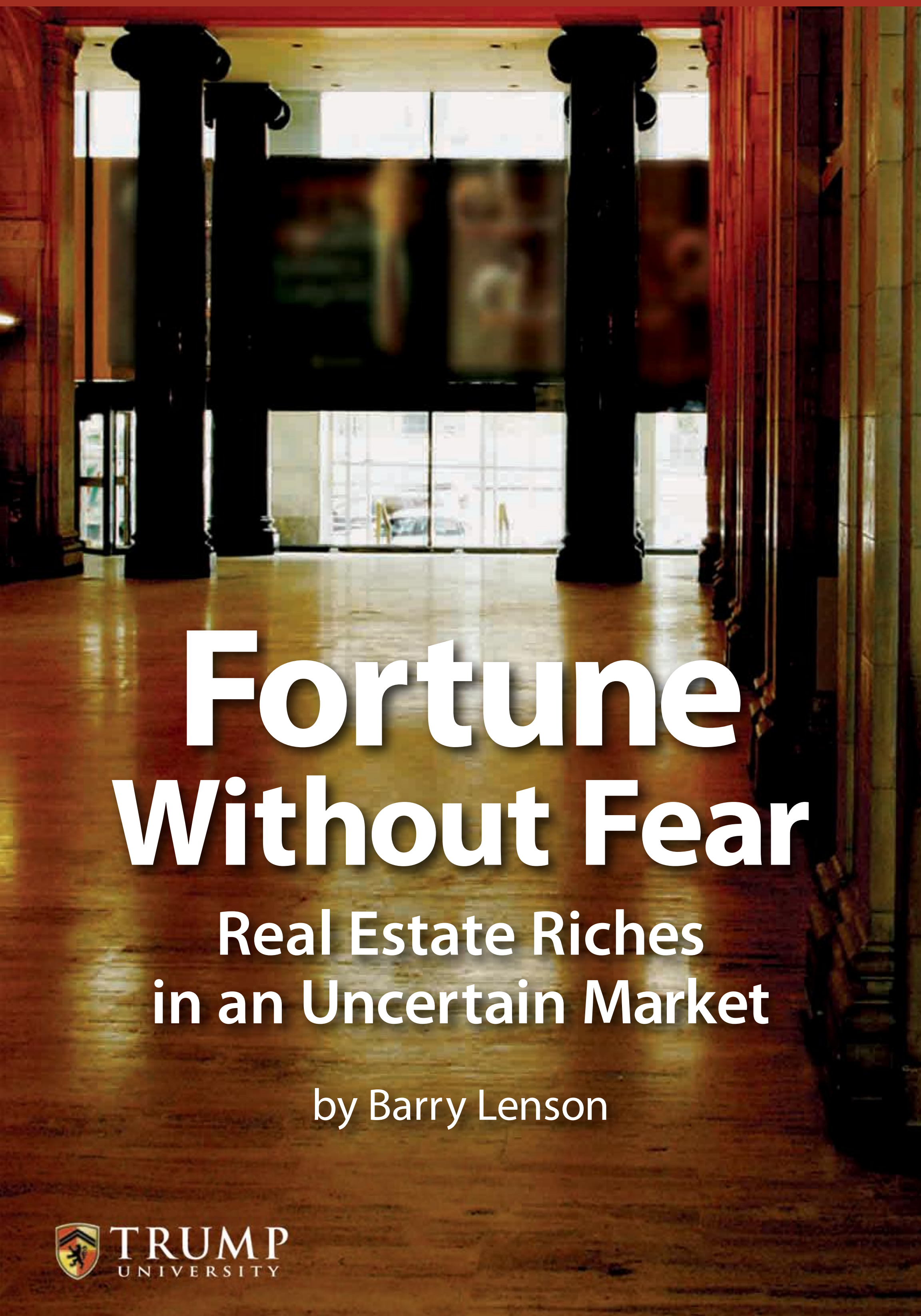
Book two in the series, Make Your Fortune in Real Estate



Fortune Without Fear

Real Estate Riches in an Uncertain Market

by Barry Lenson

TRUMP UNIVERSITY

Contents

Introduction

Welcome to *Fortune without Fear,* the second book in the *Make Your Fortune in Real Estate* self-education books on real estate from Trump University.

Catch the Wave, the first book in the series, showed you a simple approach to building a fortune in real estate by timing your investments against trends in the marketplace, in society, and in your life.

Fortune without Fear teaches another set of critical skills that will help you build a fortune in real estate:

The Ability to Handle Risk

Why write a book about risk? Because risk is part of any real estate activity. You can analyze it, you can minimize it, but you cannot avoid risk entirely. Ultimately, your ability to handle risk will determine how successful you are in real estate.

A Story from the Early Career of Donald J. Trump

When Donald J. Trump was starting his career in real estate, he could have chosen a safer path than the one he ultimately took. His father's real estate company had already developed impressive properties in Queens, New York. He could have built an enviable real estate empire there without ever crossing the river to become a major force in Manhattan real estate and beyond.

Nobody made him try his hand at in the real estate "big leagues." Nevertheless, he was determined to take his enterprise to that next level. To do that, he had to face risk.

It is important to note, however, that Donald J. Trump was not reckless. He applied wise and prudent techniques to control risk, and then he acted decisively. That is the approach that builds success.

Bravery, Recklessness, and Cowardice

All three of these traits can be defined in their relationship to risk:

- **Brave** people understand risks, take steps to minimize them, and then act despite the presence of those risks. In other words, they take *calculated* risks. They are the people who make things happen.
- **Reckless** people charge ahead without stopping to consider the risks they are facing. Many of them score an occasional win, but few keep on winning indefinitely. They are relying on dumb luck.
- **Cowardly** people are paralyzed by fear. They never act. They remain immobilized in most all areas of life, avoiding anything as risky as real estate. You won't hear them mentioned again in this book.

A Rock-Solid Way to Minimize Risk

People who succeed in real estate are brave, but not reckless. They have developed some very effective strategies for analyzing a problem and taking action:

- **First,** they accept the reality that real estate investments are risky. In other words, they are realistic.
- **Second,** they invest the time to understand the risks that surround what they want to achieve.

- **Third,** they take *considered* actions, despite the risks that they have identified and analyzed. By understanding and minimizing risk, they reduce it to an acceptable level.

- **Fourth,** they learn a lot from every risk they face. Then they apply their learning, and build success on success.

Those are the skills you will learn in *Fortune Without Fear*. Let's get started.

Chapter One:
Today's Most Risk-Resistant Business Structures

"When I'm talking to a contractor, examining a site, or planning a new development, no detail is too small to consider. I even try to sign as many checks as possible. For me, there's nothing worse than a computer signing checks. When you sign a check yourself, you're seeing what's really going on inside your business, and if people see your signature at the bottom of the check, they know you're watching them, and they screw you less because they have proof that you care about the details.

I learned how to think like a billionaire by watching my father, Fred Trump. He was the greatest man I'll ever know, and the biggest influence on my life."

— From *Think like a Billionaire* by Donald J. Trump
with Meredith McIver (Random House, 2004).

What is the most risk-free business structure for you as you build your real estate empire? Should you be a sole proprietor and simply treat your investment properties as personal possessions? Should you take a partner and divide the risk with another individual? Or should you incorporate from day one and minimize your risk even further?

Those are important questions. Try to answer them as early as possible in your real estate career so you can avoid costly mistakes later on.

A Case Study You Can Profit From . . .

Joan Reynolds, a new real estate investor, stood at a gate in Boston's Logan Airport, waiting to meet her mother's flight from Seattle. When her mother arrived, Joan said to her, "Mom, on the way home, let me show you the apartment building I just bought!"

Joan drove to the block where the apartment house stood. From the corner of the block, Joan could see that something funny was happening. A large truck stood in front of her building. Men were unloading dozens of shrink-wrapped kitchen cabinets into the lobby — enough to renovate all the kitchens in the building.

Joan pulled up to the curb and went in to investigate. "Guys, what's going on?" she asked them. They showed Joan an invoice for the cabinets worth nearly $18,000 that had been signed by her partner. Joan was furious. This was hardly the way to start her career in real estate or to start out her partnership — and hardly the way to show her mom that she was now on the road to real estate riches.

"I never should have taken a partner!" Joan told her mother. "I would have been better off doing it all on my own."

What you can learn from this story . . .

- Partnerships are a great way to lower the risk of investing in real estate and an excellent way to share investment costs. But they can bring unpleasant surprises and losses, too. Tread carefully when entering into a partnership.

Forming a partnership can be an excellent option for certain investors. Other investors may prefer to be the sole proprietor or to incorporate

Let's take a closer look at your options so you can decide the optimal structure for your new real estate business.

Sole Proprietorships

When you acquire buildings without a partner, a corporation, or any other business entity behind you, you are functioning as a sole proprietor. You are in the driver's seat, making the decisions, taking the profits, but also incurring the risks.

Being a sole proprietorship offers the following advantages:

- **You make all the decisions yourself**. No one can show up at your door with a load of kitchen cabinets that you didn't order. No one can rent an apartment to a tenant you wouldn't approve, or undersell your property.
- **Your business is relatively easy to run.** Keeping records is not complicated. If you track your expenses, profits, depreciation, and other basic statistics, you can probably manage your business with only the help of an attorney and a tax accountant. You also enjoy one of the basic freedoms we have in the United States: the right to conduct business as an individual.
- **You can treat your holdings the same way you treat all your personal property.** If you want to give some of your buildings to your children or set them aside in a trust for them to inherit after you die, you can.

Yet, sole proprietorships pose some disadvantages too:

- **You are personally liable for expenses, penalties, and legal liabilities.** If your building sits vacant for a year and no one rents it, you will be the only person who suffers the damage of negative cash flow. If someone slips on a patch of ice in the driveway of your building and gets hurt, you are the person who gets sued.

- **You don't enjoy certain tax advantages.** All income and expenses are reported on your personal tax return. If you die, your spouse and heirs may have to pay a lot of inheritance tax instead of inheriting all of the money you worked so hard to accrue.

- **The rising value of your properties can become a liability**. If you divorce, for example, the "on paper" value of your holdings can become a real asset to which your former spouse can lay claim. If you decide to sell properties for a great deal more than you paid for them, you will probably pay capital gains taxes. (You can get around paying capital gains taxes by like rolling your profits through investing in other properties. Consult with your attorney or tax advisor.)

These advantages and disadvantages should be balanced against other options for structuring your business.

Partnerships

In a real estate partnership, two or more individuals form a shared business enterprise to buy, manage, and sell properties.

A partnership lets you leverage your way into properties that are larger, more expensive, and potentially more profitable than you could afford as a sole proprietor. Partnerships promise other benefits, too. If you are not well informed about certain areas of real estate investing, you can partner with people from whom you can learn. Your partners will benefit from your expertise, too. This is one reason why real estate partnerships are often made up of people with complementary experience, such as a construction professional, a lending expert, and a skilled property manager.

Of course, there are dangers in partnerships. If one partner wants to sell a building and the other partners do not agree, frictions arise. If one partner wants to invest money to fix up a building or invest in additional properties, conflicts can start. Finally, if one partner decides to leave the business, difficult negotiations often take place about how he or she should be compensated.

The best prevention is to know a great deal about your partners before entering into a partnership and to hire an attorney to spell out your partnership agreement. This legal agreement should cover how one partner can buy his or her way out of the partnership since that is the time when conflict often arises.

DO THIS!

Have a frank and open conversation with any potential partners. Talk about:

- how much they intend to invest each year in new properties and in fixing up those you already own.
- what their long-term plans for real estate activity are.

Does their agenda match yours?

Another area of potential conflict concerns the terms under which you and your partners will sell your business if that becomes a possibility in the future. Suppose, for example, that your partner wants to sell her half of your business to a big real estate development firm and you want to keep your half. How would such a deal be structured? How would each of your halves be given a dollar value? Such questions point up the necessity of structuring a partnership with the help of a smart attorney.

Beyond the legal issues of partnership, it is also important to know your partners' long-term goals for their real estate investments. Do they intend to hold buildings for years, or sell them quickly after their values increase by a small percentage? Do they want to fix up rental units in your properties or invest as little as possible? The more you discuss such questions with potential partners, the more you minimize the possibility of significant friction later.

In addition to the legal considerations, you should be familiar with the two most common types of business partnerships:

- **Limited partnerships**: These are often comprised of a group of one or more *general partners* (which can be individuals or a corporation) who handle property management and operations, and another group of *limited* partners, who invest money, but are involved in the details of property management. General partners claim a larger share of the profits (as negotiated and agreed upon), almost like salaried employees. Limited partners are more like investors in the company. They can invest even small sums of money and can remain separated from the hassles of ownership. In addition, limited partnerships enjoy some of the risk-minimizing advantages of corporations. If one partner dies or files for bankruptcy, for example, the other partners can enjoy some protection from loss. (Consult an attorney in your state for more detailed information about how a limited partnership can protect you from such losses.)

- **General partnerships:** These are the smaller "mom and pop" arrangements that most of us think about when we think about partnerships. General partnerships are made up of two or more partners who fully share in the management and buying of property. In addition, all partners share responsibility for legal liabilities, debts, and business losses. As previously noted, frictions can arise over operations and other business issues, such as the departure of partners.

What about taxes? All real estate partnerships prepare a 1065 form for the Internal Revenue Service, outlining profits and losses incurred by the partnership. Partners then file this form with their individual returns on which profits and losses are also reported.

Limited Liability Companies

A Limited Liability Company (LLC) combines some of the features of a partnership and a corporation. They are now the most common way for a group of investors to share ownership of properties.

Here are some of the reasons that LLCs have become so popular today:

- **They offer protection.** LLCs function as legally separate entities from their owners and offer some protection from legal liabilities and other losses. (Consult your attorney for advice.)
- **They are flexible.** LLCs can be established so that different investors own different percentages of the organization's holdings. One individual can own 75 percent of an LLC, for example, while another can hold the remaining 25 percent.

What about taxes? LLCs can be set up so that profits are shared among investors, who report them on their individual returns. There are other tax options with an LLC as well such as the opportunity to take limited profits from the LLC for tax purposes while setting aside some of the income to improve properties or to put toward other business purposes. (Again, consult your attorney and/or accountant for complete information.)

Be aware, however, that there are downsides to establishing an LLC such as attorney and state fees.

In general, partners report profits from the LLC on their individual tax returns. You should consult with your attorney about additional requirements that may apply to an LLC doing business in your state. In many cases, LLCs must also file specialized tax forms and reports and sometimes pay taxes in the states where they do business.

Tenancy in Common

What is Tenancy in Common? Chances are that you have not heard of its advantages for real estate investors. In certain circumstances, Tenancy in Common offers smaller real estate investors an innovative way to structure their investment activities.

Tenancy in Common is a partnership in which different owners can own stated portions of a property; if multiple properties are owned, one partner can own only certain properties that are held in common. Here are some examples:

- In a ten-unit apartment building, one partner owns three units, and the other partner owns seven.
- In a partnership that owns ten buildings, each partner owns five buildings.

Each partner can sell his or her holdings at any time, and manage them as he or she desires. Tenancy in Common offers many of the same advantages and disadvantages of simple partnerships. On the plus side, they are a cost-effec-

REMEMBER!

Tenancy in Common offers many of the same advantages — and disadvantages — of simple partnerships. On the plus side, they can afford a cost-effective way to get started small in real estate investing.

tive way to get started in real estate investing. You could, for example, buy three apartments in a larger building and establish a Tenancy in Common agreement with the owner of the building. Those apartments will be yours to manage, and the profits from them will be yours. On the negative side, you will also have to live with many of the disadvantages of partnerships. If you or your partner decides to sell holdings, for example, negotiations between you can become quite sticky. As in all partnership agreements, discuss your plans and priorities in detail ahead of time.

What about taxes? Income is reported on the individual partners' tax returns. Be sure to consult your attorney and tax advisor before entering into a Tenancy in Common partnership.

Corporations

The advantages of incorporating are well known to real estate investors. A corporation is a legal entity, separate from you and your partners (if any), that can offer significant benefits:

- **Legal protection:** If you become a corporation that owns property instead of a sole proprietor, you enjoy some legal protections that you would not otherwise have. If someone is injured on your property, for example, it will be the corporation, not you, that will be sued. Your home and property may also be protected from seizure in any settlements because they are not legal holdings of your corporation.

- **Tax advantages:** You can pay yourself a salary and pay income tax on that figure and not on the larger profits earned by your corporation. This can be a significant advantage. If you sell a building for $500,000, for example, you can work with your accountant to find appropriate measures to reinvest that money in new properties or other endeavors without encountering the risk of paying immediate capital gains or income tax. (Consult with your attorney and tax advisor for advice.)

- **The ability to sell stock:** At some point, you can issue stock and sell it to individual investors to raise monies you need to expand your holdings and your business. Issuing stock offers other benefits such as the ability to give stock to your family or heirs or to employees as compensation. (Please consult with your attorney and/or accountant before taking this option since many laws limit corporations' selling and distributing shares.)

REMEMBER!

Becoming a corporation offers protection from personal liability, but it is also expensive. It is not a step to be taken lightly, even though there are plenty of places on the Internet where you can incorporate quickly and easily.

Talk to your attorney, and discuss your needs before making the decision that is right for you.

There is one significant disadvantage to becoming a corporation:

- **The expense:** It costs a lot of money to have an attorney draft and file the paperwork to incorporate. The cost of filing state and federal quarterly tax reports and returns can also add up quickly.

What about taxes? The tax situation of corporations depends on whether your corporation will be an *S Corporation*, which can pass profits directly to individual shareholders who must then pay taxes on them, or a C Corporation, which pays taxes on profits before distributing the remainder to shareholders. These are complex issues, so consult with your attorney and accountant to be certain that you are making the best decisions.

Action Steps for Chapter One

Talk with your tax advisor and attorney before deciding which type of business structure is best for you. There is no "right" or "wrong" business structure. It all depends on your needs, priorities, and current investment level.

Never enter into a real estate partnership without first talking in detail with your prospective partner about differences that may surface later. Do you both want to acquire properties at about the same rate? Do you want to invest similar amounts in fixing up the properties you share? The more differences you can put "on the table" before entering into a partnership, the lower the chances that significant frictions will upset your partnership later.

Talk with your attorney and tax advisor before incorporating. It is not a decision to be made with incomplete information.

Develop a strategy for how you will sell properties that have appreciated significantly in value. Of course, you want your properties to appreciate, but unless you structure your business appropriately, you will end up paying high taxes on properties you sell or end up holding onto properties you *don't* want in order to avoid paying taxes. Be sure to speak with legal and financial advisors about how structure your company in the most advantageous way possible.

Chapter Two:
Minimizing Risk with the Right Insurance

"There are a lot of ups and downs, but you can ride them out if you're prepared for them.

"Learning to expect problems saved me from a lot of wasted energy, and it will save you from unexpected surprises. It's like Wall Street; it's like life. The ups and downs are inevitable, so simply try to be prepared for them.

"Sometimes I'll ask myself why I want to take on some new, big challenge. A substantial loss is always a possibility. Can I handle it if it doesn't go well? Will I be asking myself later, Why did I ever do that? What was I thinking? I'm actually a very cautious person, which is different from being a pessimistic person. Call it positive thinking with a lot of reality checks."

— Donald Trump in *Trump: How to Get Rich* by Donald J. Trump with Meredith McIver (Random House, 2004).

Insurance can be a real estate investor's best friend. If your building burns down or is swept away in a flood, insurance will protect your investment. If a visitor falls down and gets hurt on one of your properties, insurance will prevent you from paying the high costs of any legal judgments against you.

While insurance *is* your friend, it is also a very costly companion. The safer you want to be, the more you have to pay.

To further complicate matters, a property investor needs to know about the many different kinds of insurance on the market. In this chapter, we'll cover what you need to know.

What is Private Mortgage Insurance?

There was a time when most mortgage lenders required Private Mortgage Insurance (PMI) only for buyers who were obtaining loans with little money down. Now, most banks require PMI from all mortgage-holders.

PMI compensates the mortgage lender if you default on the mortgage. It generally costs about $500 a year.

Although you pay, you do not have to shop for it. It is provided by your lender and covered in closing costs and/or your monthly mortgage payments.

Title Insurance

Do you really own the building you just bought? That might sound like a silly question to ask, but as the following case study shows, it might be the smartest question of all.

A case study you can profit from . . .

Three months after Carla Jacobs bought an apartment house and began to fix it up, her attorney called her and gave her some disturbing news. A former partner of the man who sold her the property had just made a claim against her ownership of the property. He said that he had been co-owner of the property. "This guy claims that he owned half the building you bought," her attorney said.

What will happen to Carla? Granted, the man will probably sue his former partner, not Carla, to recover some the value of the property he claims to own. That could take a long time, however. In the meantime, Carla has to put her renovations on hold and wait until the dispute is resolved. The clock is ticking: she has bills to pay and her property is not generating a cent of income.

What we can learn from this case study . . .

You need to buy title insurance even if a title search determines that the ownership of a property you are acquiring is not in question. Fortunately, most lenders require borrowers to purchase title insurance. If your lender doesn't, consult with your attorney about acquiring title insurance independently.

What Title Insurance Does

Title insurance protects you from title defects that were unknown to you at the time you purchased the property. "Title defect" means that your clear ownership of the property can be challenged by someone else who claims to own all or part of it.

"Title" refers to the collected ownership records of a piece of real estate, including the transfer of any property rights and any loans that might exist in which your property was used as collateral. A clear line of title makes you much less vulnerable to ownership claims from other parties and to outstanding debts of previous property owners. Before writing a policy, a title company will check for defects in your title by examining public records, including deeds, mortgages, wills, divorce decrees, court judgments, tax records, liens, and maps. The company will then defend

What a Title Policy Covers

If someone claims an interest in your property, a title company will defend your title in court and pay for any actual loss under circumstances like these:

- A lien against your title exists because a previous owner failed to pay a mortgage or had a judgment against him or her and is attempting to satisfy it using your property. Remember to contact your title company immediately if you receive notice of such problems. Failure to do so could result in many problems, including the loss of property.
- A lien exists for labor and materials furnished by a previous owner's contractor.
- Leases, contracts, or options on your property were not disclosed to you.
- The seller did not disclose legal restrictions about how you can use your property.
- An easement exists that isn't in public records and that you don't know about. *Example:* There is another property behind yours that has no direct access to the street. The owner has, therefore, been granted the right to use your driveway. This may prevent you from building on or expanding your property. Your title insurance can help by compensating you for such unknown easements.
- A deed or other document in your chain of title is invalid as a result of forgery or fraud. *Example:* Two or three owners ago, a document was forged saying that a lien against the property had been satisfied.

in court any claims to the property covered by your policy, subject to certain limitations. If the company loses, it will pay you for covered losses (like the renovation expenses that Carla has already incurred), up to the amount specified in your policy.

Although they appear similar, there are two types of title insurance policies you should know about:

- **Mortgagee policies** remain in effect until your loan is repaid and you own the property outright. If you refinance, most lenders will require a new mortgagee title policy.
- **Owner polices** remain in effect as long as you or your heirs own a property or are liable for any title warranties made when you sell the property. Because claims can sometimes be made against you when you decide to sell a property you own outright, owner policies provide greater protection.

DO THIS!

Check your title policy's description of your property survey to be sure the policy covers your property accurately.

Be sure to ask which type of insurance your lender provides. If a title dispute arises, you will need to know. It is important to read your policy carefully. Pay special attention to any limitations, exclusions, exceptions, and special conditions. Discuss these exceptions with an attorney before you close on a real estate deal. Also, check a policy's description of the land against your survey to be sure the policy covers your property accurately. Title insurance generally does not protect against boundary disputes with neighbors. You may be able to purchase such coverage for an additional premium.

Ah, That False Sense of Security!

At some point in your real estate career, you are probably going to hear advice that will go something like this . . .

"Don't pay for so much insurance! Just hire a company to manage your property and let their insurance cover you! You'll avoid paying for insurance you don't need."

Of course, there is a grain of wisdom in that advice. The insurance held by a management company you hire does provide coverage—but never enough.

The safest way to be sure you are fully protected is to buy and understand your own policies.

Property Insurance

Property insurance protects you from actual losses, such as buildings that burn down or are destroyed in natural disasters. If you occupy a property that you own, property insurance can also protect you from theft, damage to belongings, and other losses.

Property insurance can protect you in other ways too, serving as a defense against claims made against you as the owner of real estate. If a tenant loses all her furniture because a pipe bursts in a ceiling over her apartment, for example, or if she falls down and breaks an ankle in the lobby of your apartment building, your insurance will pay some or all of any judgments made against you. It also helps cover the costs of mounting your legal defense. Lawyers can be very expensive.

Coverage for Loss of Buildings

You can choose from these two types of policies to protect you from catastrophic loss:

- **Cash value:** In this basic coverage, your policy will repay you for the cost of replacing your property, a value you agree upon with the insurance company, minus depreciation. This is the standard, least expensive kind of policy.

- **Replacement value:** This coverage, which is more expensive than cash value coverage, pays the cost of replacing the property. If you lose your property, you will be compensated with a payment that is closer to the value of the property if you sold it. This coverage, though more expensive, offers better protection from catastrophic loss.

Be aware that some properties can be difficult, if not impossible, to insure. Insurance underwriters might not cover waterfront property that has suffered water damage in the past or an old home in an earthquake zone. Therefore, it is very important to speak with insurance agents, possibly several of them, before moving too far ahead with your plans to purchase a property. The cost of insuring high-risk properties can be prohibitive. Before you buy, you need to weigh the costs and benefits when you calculate your expenses and profits.

Be aware, too, that certain types of renovations, like adding a sprinkler system or a fire alarm to a commercial property, can reduce insurance premiums. The bottom line is knowing your insurance expenses before buying a property — and taking steps to reduce those costs — can make the different between a property that is profitable and one that is not.

When You Have Renters

When you are a landlord of an apartment building, retail location or office building, you are facing greater risks than you do in your own home. There is the danger that a renter or a renter's guest will get injured and sue you, possibly claiming that some physical defect in your building caused the injury. An additional danger is that a fire or a leak will cause damage to rental property, and you will be held liable.

That's why many insurance companies require landlords to carry *coinsurance* ,which you can think of as extra insurance on top of the insurance you already own. Coinsurance is designed to protect the insurance company (and, by extension, you) from large settlements that can result if tenants sue you. You have to pay for this extra coverage even though the insurance company benefits from it as much as you do.

> **ACTION TIP!**
>
> If you own multiple rental properties, speak with an insurance agent about the possibility of obtaining a blanket policy that covers them all. This can save a great deal of money, especially at those critical times when you are adding a second or third rental property to your portfolio.

One way to minimize or reduce insurance costs in rental properties is to require all tenants to have their own renter's insurance policies or business policies, if you own a retail or office building, in place.

You simply stipulate in leases the amount of coverage that you require all tenants to maintain and add a clause stating that they will not hold you liable for loss of belongings. Speak with your attorney about these measures; the fact that renters have agreed to have insurance may not prevent them from suing you if some major problem in your building, such as a flood or fire, damages their property. As has often been noted, we live in a litigious society.

What is the Right Deductible for Your Properties?

When you make an insurance claim, the deductible is the amount of money that you must pay out-of-pocket before your insurance covers the remainder.

How large a deductible should you agree upon? Making this decision is essentially a balancing act in which you weigh your financial resources against the amount of risk you are willing to assume. The higher the deductible you can live with, the lower your insurance premium will be. You need to consider how much cash you will have available to pay out that higher deductible if you should ever have to do so.

Because each property owner's situation is different (different cash on hand, different rental income, different taxes to pay and so on),

DO THIS!

Before you buy a policy from an insurance agent, ask to see copies of the forms that you would have to fill out to file a claim. Then ask the agent to explain the timetable that you would have to follow in order to get paid.

How does that process feel to you? Try to see ahead and imagine what it would be like to go through the claims process.

If you had to pay out $10,000 to pay for a new roof in the aftermath of a hurricane and wait six months to be reimbursed from insurance, what kind of damage would that do to you in other areas of your real estate activity?

Try to see ahead to possible problems and to buy the insurance that can protect you from the "worst case scenarios" that can sometimes do great harm to real estate investors.

weigh all these factors and make the decision that is best for you.

This is a topic to discuss with your insurance company, your attorney and your accountant.

What is the best insurance company for you?

Shop around before buying a policy. Speak with several independent insurance brokers and exclusive company agents (insurance professionals are either independent brokers who write policies for many insurers or exclusive agents who write policies for just one). Make sure that you are getting the coverage you really need at the lowest possible cost.

Remember there is more to picking a good insurer than price alone. You also need to investigate the company's record for paying claims and its overall financial health. All the coverage in the world will not help you if your insurance company goes out of business or takes too long to pay its claims.

Remember, insurance companies do go out of business. Be sure to check out companies using these resources:

- A. M. Best: http://www.ambest.com
- Moody's: http://www.moodys.com
- Insure.com: http://www.insure.com

One more precaution: Examine all policies carefully to be sure they accurately describe the specific coverage that you discussed with the person who sold you the policy. To be protected, you need documentation of your coverage, not verbal assurances.

Action Steps for Chapter Two

Ask whether you can lower your insurance premiums by adding a sprinkler system, a fire alarm, or other improvements to your property.

One way to minimize or reduce insurance costs in rental properties is to require all tenants to have in place their own renter's insurance policies or business policies, if you own a retail or office building. You simply stipulate in leases the amount of coverage that you require all tenants to maintain, and add a clause stating that they will not hold you liable for loss of belongings. Be aware, however, that such clauses in leases may not prevent certain tenants from suing you in the aftermath of a fire or flood.

Before you buy a policy from an insurance agent, ask to see copies of the forms that you would have to fill out to file a claim. Then ask the agent to explain the timetable that you would have to follow in order to get paid. How does that process feel to you? Try to imagine what it would be like to go through the claims process.

Examine all insurance policies to be sure they accurately describe the specific coverage that you discussed with the person who sold you the policy. To be protected, you need documentation of your coverage, not verbal assurances.

Chapter Three:
How to Know Even More about Properties than the Inspectors You Hire

"A knowledgeable, licensed inspector-engineer can detect whether the heating unit is functioning properly, whether the air-conditioning is sufficient, whether a sump pump is needed, and so on. Think of a building inspection as an X ray; the inspector will be able to see through the entire house and identify any systemic problems. If the inspector makes you nervous or you sense that he or she is working too quickly, find someone else. The inspection is too important to be careless about it."

— from *Think like a Billionaire* by Donald J. Trump with Meredith McIver (Random House, 2004).

If you do not know a great deal about the structural elements of buildings — from furnaces to wiring to masonry — you are operating with a higher exposure to risk than you should be.

In this chapter, you will learn what you need to know to avoid buying a property with serious structural or mechanical problems. In a few short pages, you will learn as much as many professional inspectors do.

But before we start rounding that learning curve, let's answer a question that has probably entered your mind as you began to read this chapter:

"Why do I have to learn all that technical information? Can't I just rely on a home inspector to tell me everything that is wrong with a property? Isn't that what home inspectors are for?"

Yes, that is what home inspectors are for. The problem is that there are highly capable building inspectors and there are also completely incompetent ones. Another problem is that even good inspectors sometimes fail to notice a problem that can cost you a lot of money later on. When that happens, your inspector will not call you up and say, “Well, that was my mistake, let me pay for the repair.”

They don’t’ do that because, ultimately, it is your responsibility to know what is wrong with a building that you own, not theirs.

A case study you can profit from . . .

Patricia Davis, a single mother with a young daughter, was about to buy her first house. It was an exciting time for her. She rode the train from Stamford, Connecticut, where she was renting an apartment, to Bridgeport, where a realtor showed her a house that she liked. At $244,000, it was in a price range that she felt she could consider. She made an offer for $240,000 and it was accepted.

Did Patricia have an attorney to represent her, the realtor wanted to know? No, she did not. The realtor recommended a lawyer for her to use. Conveniently, he had an office right around the corner from the realty office. Patricia went to talk to this man. She liked him. He reviewed the copy of the seller’s contract that the realtor had prepared for her to sign and got the process started. Patricia signed the contract, wrote a deposit check, and began to look for financing. But first, the lawyer and realtor both told her, she needed to have a property inspection to be sure that nothing was wrong with the house.

To simplify things, the realtor recommended a property inspector for Patricia to use. The next day, she met the inspector at the property. The first thing that happened was that the inspector walked into the basement of the house and said, “This place is not built the right way.”

He went on to explain that the wooden beams that supported the ground floor were sagging and had been jacked up to keep the floors to level. He then took her out to the street and pointed up at the roof. “Just as I suspected,” he said, “from that sag curve in the roof line, you can see that the whole house is sagging.”

Patricia was relieved. She called the realtor and said that she wanted her deposit back. “No problem,” the realtor said, “as soon as the inspector’s report comes in stating that there is a structural defect in the house, you will get your deposit back as stipulated in the contract, which states that you can cancel the contract if an inspection shows a ‘structural defect.’”

But then something odd happened. When the inspection report came in, it described the house in great detail, but neglected to use the words “structural defect.” So Patricia was still bound by the contract she had signed. In fact, the realtor and the attorney both told her that the owner of the house was entitled to hold onto her deposit money until another buyer made an acceptable offer on the property. Patricia was astonished that she had gotten into such hot water by following instructions. Fortunately, it all turned out well when another buyer came along. But it was a sobering experience for a first-time homebuyer.

REMEMBER!

To be sure you are getting an honest lawyer who is really on your side. Find one who is experienced in real estate and who has, if possible, satisfactorily represented people you know.

Take a digital camera with you

As you visit potential investment properties and later go through them with a home inspector, keep a digital camera in hand, and keep snapping as you go.

Digital cameras are terrific tools for real estate investors who are screening properties. They offer a quick way to document problems. And the pictures provide a way to remember many details about a property that you would otherwise forget. Just what was the condition of the bathroom tiles? What kind of floor was in the entry hall? A digital camera captures it all.

Also: Carry a pencil and paper with you to record room dimension and other details. Low-tech tools are important, too!

What you can learn from this story . . .

- **First, do not hire an attorney who has been recommended to you by your real estate broker or salesperson**. To be sure you are getting a lawyer with no strings attached, find one who is experienced in real estate and who has, if possible, satisfactorily represented people you know.

- **Second, do not utilize a home inspector who has been recommended by your real estate broker or salesperson.** Granted, Patricia's inspector was probably honest and may not have been influenced by the realtor who was trying to complete a sale. But he might also have been acting in collusion with the realtor, or the seller, to make sure the deal happened. Perhaps that is why he omitted the words "structural defect" from his report. Patricia will never know, but the fact is that she ended up unprotected.

Zero in on recent repairs

When inspecting a property, remember that "new" is not necessarily good.

New siding might be hiding a badly damaged exterior. New siding makes it difficult to see whether it was installed properly, with underlayment to limit drafts and reduce heating bills.

New exterior grading and gravel around the foundation could indicate a recent attempt to correct basement flooding.

A new basement floor is often an attempt to hide evidence of flooding.

Exceptions to the rule: New windows, a new roof, new electricity and new plumbing are generally not red flags. These updates show an attempt on the part of the seller to update or correct flaws that potential sellers could use as bargaining issues when making offers on the property.

Bottom line: When you see something new, figure out why sellers have chosen this time to make the change. Ask questions. You might get a song and dance or you might get a satisfactory explanation.

- **Third, amend a sales contact to meet your needs before signing it.** Patricia's attorney should have asked her about the age of the house she was considering and anticipated that she needed the option to terminate the contract based on considerations other than "structural defects." Your attorney needs to protect you. In order to understand how to do that, he or she needs to ask questions to assess your needs rather than present you with an off-the-shelf contract, saying "Sign here."

Protecting Your Assets

When you are buying a building, whether it is a modest single-family home or an apartment complex with hundreds of units, you are making investing a lot of money. Your investment takes on added importance when you stop to consider that you are also investing money to make more money, expecting that the property will generate rental income or appreciate in value.

You are investing important money. And since *your* money is on the line, it is your responsibility to know how buildings work.

This knowledge will help you spot potential problems:

- **You can spot problems** and decide not to buy a building before you call an inspector. That saves both time and money, and heads off legal entanglements ahead of time.
- **You can inspect properties side-by-side** with the inspectors you do hire, making sure that they do not overlook heating, wiring, plumbing, and other critical systems.
- **You can ask** your inspector more informed questions and get deeper insights into the building and its potential problems. If you see signs of a leaky basement, for example, you can ask the inspector what he or she believes the problem is, and how much it would cost to correct it. If you do not recognize a leaky basement when you see one , you may be incurring too much risk.

In short, when you have the knowledge you will gain in this chapter, you can have a well-informed idea of the property's problems and the potential cost to repair it before you make your decision to buy or not to buy.

Ask the City or Local Government to Inspect Buildings That Interest You.

Have previous owners gotten proper permits to perform repairs on a property? Are there conditions that the city will want corrected before it issues a Certificate of Occupancy, which many communities (and some states) require before a property can change hands?

The only way to know is to visit city hall and ask to have a city property inspector visit the building(s) you are considering. Remember that it is the responsibility of the seller to make any updates or renovations that are required—not yours—so there is every reason to ask for an inspection.

"As Is" Properties Are Not For You!

Incredible as it might seem, some sellers try to sell properties "As Is." They offer to sell at a bargain price without permitting buyers to have a professional conduct an inspection. Mortgage lenders will not lend you money to buy properties under such conditions — and you should not want to either.

Even if you have a large quantity of cash on hand and discover a low-cost property that seems like a steal on an "As Is" basis, insist on having it inspected.

There is only one reason anyone would sell a property "As Is," and that it that he or she is hoping to avoid paying for property upgrades

Don't buy properties on an "as is" basis

If a seller refuses to let an inspector into a property, walk away from the deal. Mortgage lenders will not lend you money to buy properties under such conditions — and you should not want to either.

or improvements. Since investment properties are not used cars, beware of sellers who treat them that way.

How to Hire an Inspector

- Again, don't take a referral from a real estate agent. Do consider taking a recommendation from your attorney, who should be completely on your side in the transaction. You don't want to get ripped off by an inspector who is in collusion with the selling agent.

- Ask for referrals from people you know who used inspectors to buy their homes. Did the inspector they used find everything that was wrong? Or did he or she overlook problems that surfaced later on?

- Look for somebody who has real construction experience (an engineer, plumber, construction-company owner or electrician), not a decorator or landscaper. Ask ahead of time about their background. Ask specifically about expertise in plumbing and electrical systems, too. You might not find a former plumber or electrician, but you should at least have an inspector who really knows about those vital systems. *Also:* Those are the

Conflict of interest!

The person you hire to inspect your home is there to inspect your home — period.

If he or she offers to come back to your home as a contractor, plumber, or other professional, that represents an unethical conflict of interest. He or she might be trying to discover "defects" to repair later on, at your expense.

Consider terminating the inspection on the spot, refusing to pay, or filing a complaint with any professional organizations that have certificated the inspector.

two areas where problems are most likely to be missed, since not all problems are visible to the naked eye.

- Make a checklist ahead of time with your specific concerns about the house, based on what you saw (e.g., roof, wet basement, etc.). Ask how the inspector evaluates such problems before you hire him or her.

- Ask whether the inspector does all the required inspections in your area, or that your mortgage lender will require, such as termite inspections or radon inspections. Why hire multiple inspectors to do these extra inspections, when you can probably find just one inspector who can do them all?

Should You Hire a Certified Inspector?

There are a number of professional organizations that certify home inspectors. In most cases, a certified inspector has taken the training that the organization provides, passed certification tests, and agreed to adhere to the certifying organization's code of ethics.

For these reasons, it is a good idea to use a certified inspector when you can. Be aware, however, that certification does not guarantee you are getting an excellent inspector or an ethical one. Sometimes a certified inspector is simply an inspector about whom no one has yet complained.

To check on certification or find a certified home inspector in your area, visit these sites:

- National Association of Home Inspectors Inc.: http://www.nahi.org

- American Society of Home Inspectors: http://www.ashi.org

- National Association of Certified Home Inspectors: http://www.nachi.org

Congratulations! You Are About to Become an Expert!

In the pages that follow you will learn just about everything you need to know to spot potential problems in properties you are considering. There might be more *detailed* information than you think you need.

Please read it anyway. Knowledge is the greatest risk-fighting weapon you have at your side in real estate.

Please note: Some of the advice in the pages that follow may not apply to the properties you are inspecting. An office building will not have laundry facilities or a kitchen, for example. Please read the sections that provide the information you need. Or read it all because one day you may need to know it and knowledge is power in the business of real estate.

Here's what you need to know to inspect buildings like a professional.

Outside the House/Building

- **Grading and drainage.** Examine the land around a building you are inspecting. If the property is largely flat, are there certain low areas without adequate drainage where rainwater is likely to pool which could seep into your foundation or destroy the grass or landscaping? If the lot slopes, is there a clear path for water to follow around your building in the event of heavy rain?

- **Attempts to direct water away from the building.** Have there been recent excavations around the foundation, possibly covered by new gravel? These are signs of a probable leaky basement.

- **The condition of the land.** If the building is set on a lawn, does grass feel firm underfoot? A "squishy" lawn indicates poor drainage or a water problem. Look at adjoining properties with the same considerations in mind since a water problem next door is probably a water problem for your property, too. *Also:* Look at the curb in front of the property. If drainage hoses emerge from holes in it, they were installed to dispose of water coming from somewhere around the building. In all likelihood, they were installed to correct a leaky foundation.

- **Foundation.** Looking from outside the house, does the house appear to be solid, square, and free of cracks? Missing or out-of-place cinder blocks or bricks could be indicators of wider structural problems that disqualify the property from further consideration. Why buy a building with such obvious flaws?

> **REMEMBER!**
>
> Missing or damaged bricks or cinderblocks in a foundation might look like small potatoes, but they could indicate wider structural problems in a building.

- **Exterior lighting.** Is it in good condition? Was it installed to beautify the property? Or was it installed for security purposes like lighting a dangerous alley adjoining the building? While it is not a sure indicator, security lighting can be a tip-off that the building is in a high-crime neighborhood.

- **Sidewalks, driveway and masonry.** Are they in good condition, or cracked and in need of replacing? Are they in such poor condition that passersby or tenants might fall, leading to lawsuits against you later on? Are there low areas where water will pool in cold weather and freeze into treacherous pools? *Remember:* Masonry work is

What You Need to Know about Heating Systems

In general, heating systems can be understood as two separate systems that work together: the heat-generating component and the heat-distributing component. Let's take a closer look:

The Heat-Generating Component creates heat from some source, most often natural gas, oil, or electricity. Oil and gas are burned; electricity is used to heat an electrical coil that creates heat.

Gas and oil heating systems must be connected to chimneys or vents that allow fumes and/or smoke to escape from the building. Electrical systems do not require venting because nothing is burned.

The Heat-Distributing Component is the system that takes the heat from wherever it is generated and transfers it to living areas throughout the house. In general, heat can be transferred in four ways:

1. **By blowing hot air** from a central furnace through pipes or ducts that run through the floors, walls, etc. These ducts do double duty in buildings with central air conditioning by also distributing cooled air through the building.

2. **By creating steam** in a boiler that is part of the furnace, then sending that steam through pipes to radiators located in living areas.

3. **By pumping hot water** through pipes to baseboard heaters or other devices that transfer heat from the water to the surrounding air.

4. **By radiant heating,** in which electrical coils or pipes run beneath floors and transfer heating through the floors into rooms. Radiant heating is a recent offering and will be found only in newer homes.

What You Need to Know about Heating Systems (continued)

How to Spot Problems

Check hot air distribution systems for signs that they may need cleaning. They may be breeding mold. To check the distribution systems, remove one of the grates that covers a heating duct in a room. Perform a visual inspection, looking for dust. Reach in with a rag, wipe the inside wall of a duct, pull out the rag, and inspect it for dirt and signs of mildew. If mold or mildew are present, consider asking sellers to have the ducts professionally cleaned as a precondition of sale.

Check steam systems by visually inspecting all radiators and surrounding visual supply pipes, walls and floors for signs of drips, which often leave white chalky deposits after they have dried. Inspect all steam pipes that run into the boiler, again looking for any evidence of drips. Also inspect the surface of the boiler and the area under it, looking for signs of leaks. Turn the system on high, wait while steam is generated, and inspect the boiler and all radiators for leaks. Hairline cracks in boilers can sometimes be detected in this way.

Check hot water heating systems by scanning all visible pipes, baseboard heating units, and other visible components for signs of leakage. Turn the system on and perform the visual check again. While the system is running, take a close look at the water pumps that move the heated water away from the boiler/furnace to the heaters located in the house. These pumps, which are really electric motors connected to the main furnace, should run quietly and without much vibration. A shaking or banging pump or motor will need replacing soon.

Check hot-water radiant systems by visually scanning all floors or joints underneath them for any drips or signs of leakage. *Example:* if a radiant system is installed in the living room floor on the first floor,

What You Need to Know about Heating Systems (continued)

go to the basement underneath that room and look up, checking for leaks on the basement ceiling or in the beams that support the floor above. Radiant systems rarely leak. But when they do, repairs can be extremely costly, involving replacement of the floor that is installed above the pipes or coils. Note that electrical radiant systems cannot leak, since the heat is generated directly by electrical coils imbedded under the floor.

In all cases . . . turn the heating system on, turn the thermostat up, and watch and listen for problems.

surprisingly expensive. If a property needs it, get cost estimates before you make an offer to buy, and use those estimates to bargain on a selling price. At the very least, budget these expenses into your projected expenses.

- **Plantings.** Since landscapers and landscape architects charge more than you expect, the presence of good plantings can save you money later on. If landscaping is inadequate and you plan to invest in it to fix up a property for sale, budget it into your overall planning.
- **Trees overhanging the house.** The most common way for squirrels, raccoons, and other vermin to enter a house is from trees that are too close to a roof or exterior walls. If such trees exist around the structure you are inspecting, make sure to check the attic and roof for holes or signs that animals have entered.
- **Exterior walls of the building.** If they are brick walls, are there cracks in the bricks themselves, or between them? Is mortar missing?

If walls are made of wooden clapboards, are they in good condition? If wooden exterior walls and paint are in poor condition, what will you do to improve them? Pay special attention to vinyl or aluminum siding. Yes, it looks good, but its presence makes it difficult to assess the condition of the walls underneath. If you can, find a long uninterrupted run of siding on the lowest level of siding on the building. Gently pull its bottom edge away from the building and look underneath. You should see that the building was adequately sealed with plastic sheeting called underlayment before the siding was put on. If you see that siding was installed directly over cracked or rough wooden clapboards, you may be looking at a rushed cosmetic fix-up performed with the aim of making money fast.

- **Exterior of doors and windows.** Unless you are buying a lovingly restored Victorian or other historic house, you should be hoping to find newer, double-paned windows and all-weather doors throughout. If older windows and doors are present, plan on replacing them with modern units. Even damage-free older wooden windows without obvious problems (cracks, missing putty) are best replaced by modern models. Get estimates and budget accordingly — or negotiate for a lower purchase price.

Window Wisdom!

Unless you are buying a historical masterpiece, look for newer double-paned vinyl windows and modern all-weather storm doors. Old windows might be charming, but they waste energy.

- **Roof.** Stand away from the building and perform a visual inspection of the roof, looking for sagging (not straight) roof lines, metal flashing that has pulled away from the places where the roof meets building walls or chimneys and missing shingles. Also look at the overall condition of the surface; even from ground level, it is often possible to quickly assess whether a new roof will be needed or not. (A set of binoculars or field glasses can help with these visual checks.) *Also:* Inspect the roof from windows, exterior fire escapes, and other vantage points that offer you a close view. If you are interested in a building and have any doubts about the condition of the roof, calling in a professional roofer is a necessity, not an option, because the costs of replacing a roof can be quite high. (*Note:* In the section titled "In the Attic" below, you will continue your roof inspection from there.)

REMEMBER!

A sagging roof is a sure sign of structural problems. Unless you are in love with the property, don't even consider it.

- **Gutters and drainpipes.** Are they new and in good condition? Are all drain pipes well secured to the exterior of the building and securely connected to each other? Are they free of leaves and debris? Remember that gutters and drainpipes, if damaged or poorly installed, can cause leaks inside a building. Remember the location of sagging gutters or broken drain pipes and check inside the building to see whether leaks from them have caused damage.

- **Porches, exterior wooden stairs and decks.** Walk heavily on them, bouncing a bit as

Keep on Walking!

Floors that feel soft or spongy underfoot, whether on a porch or inside a house, are a major cause of concern. They indicate water damage or insect damage. If you find them, walk on to the next property you want to consider.

you go. Note any spots that feel soft underfoot. Insofar as you can, examine porches and decks from beneath. Are supporting joists and top lumber solid and free from rot or insect damage? If you discover problems, have a carpenter estimate costs of repair before making an offer on the property. Use those estimates as bargaining points.

- **Termite and insect damage.** Using a screwdriver or penknife, gently probe wooden exterior walls, paying special attention to areas where they meet the foundation, porches, or other structural members. Check any areas where bushes or plantings touch the structure, since termites and carpenter ants often crawl across plants to gain access to a building. You are looking for soft, spongy wood that indicates infestation. *Note:* In addition to wanting a property appraisal and an inspector's report, virtually all banks and mortgage lenders will require you to have a property inspected for termites, carpenter ants, and damage from other insects that are active in your region. That is to your advantage, since the extent of termite damage is difficult for a layperson to determine. Damage that is only slightly visible at foundation level can extend up into a house, reaching structural members. Repairing that kind of damage can cost a great deal of money.

- **Garage.** If you are inspecting a rental property, does the parking garage offer adequate parking for tenants? If you are inspecting a single or multi-family dwelling, what is the condition of the garage? Inspect roof, walls, and floor for overall condition. If you are buying a home with an external garage, be sure to check its roof, walls, floors, windows, and, if applicable, operation of the electrical door opener.

In the Basement

- **Evidence of water intrusion.** Sump pumps and French drains (drains located at a basement's lowest point that collect accumulated water and allow it escape from the basement) almost certainly indicate a history of water gathering in the basement. Also examine the walls of the foundation for signs of water damage or incursion, most often, a white chalky "water line" that is visible running horizontally along a foundation wall. If you see recent paint, be suspicious. The seller may be trying to hide a water problem from prospective buyers.

- **Condition of foundation.** Look for cracks, repairs, and other signs of structural instability. Note that foundations can be made of stone (in older, historic homes), poured cement, or cinder block. The overall determinant of a foundation's health is not which of these varieties you are examining, but the overall condition.

- **Presence of jacks or floor-leveling devices**. If you see tall metal pipes with adjusting screws at top or bottom that run from the basement floor to the ceiling, you have found jack stands that have been used to lift or level floors above. Their presence could indicate a severely sagging house or an attempt to strengthen an older building. If you are interested in the building, have a professional inspection before making an offer or going to contract on it.

Basement Wisdom

If you see tall metal pipes (with adjusting screws at top or bottom) that run from the basement floor to the ceiling, you have found jack stands that have been used to lift or level floors above. Their presence could indicate a severely sagging house, or a simple attempt to strengthen an older building.

- **Basement windows and exits to exterior.** Note the condition of stairs, doors, and metal “flip-up” basement doors. Since this is an area that is especially prone to collecting water, check any wood in the area for rot or insect damage. Examine basement windows for the same problems as well as cracked glass.

- **Hot water heater.** In general, there are two kinds of hot water heating systems: those that utilize the home’s heating furnace to heat water, and those that heat water in a separate, stand-alone unit. If you are not sure which type of system is in place, it is easy to tell. If there is no separate water heater (a large cylindrical tank), then water is heated in immersed coils, which are located in the boiler that is part of your furnace. In either case, cold water will enter the unit in one pipe, and heated water will exit through another. (If you cannot tell which pipes these are, have someone open a hot-water faucet in the building. You will be able to hear and feel the supply pipe that brings cold water into the furnace and be able to identify the hot-water-bearing pipe that leaves the furnace easily because it will get warm.) Inspect these pipes for evidence of leaks seen as white discolorations on the surface of the pipes. If you are inspecting a stand-alone hot water heater, check the pipe, too, but also carefully inspect the tank’s exterior ,as well as the floor beneath it, for evidence of leaks. Pay special attention to any sign of rust or bubbling on the bottom of the tank’s exterior. This indicates a tank that will soon crack and leak.

- **Water supply pipes.** Look for white drip marks or drips on all water pipes. Take special care to look for leaks around any splices in the system such as junctions where copper pipes are connected to plastic PVC pipes. These are the places where leaks are most likely to occur.

- **Stack and sewer pipes.** In older homes, these will be large cast-iron pipes that are between three and five inches in diameter. In newer homes, they will typically be PVC (plastic) pipes. Look for cracks, patches, or other obvious defects. *Also:* Find and inspect the clean-outs that are located in pipes or in a concrete floor. These are the openings, closed with screw-on caps, where plumbers can insert reaming tools to clean out blockages in your sewer lines. They are more prone to leaks than the rest of the drain pipes.

- **Interior gas lines.** These are most commonly black iron pipes that route gas to gas furnaces and water heaters, as well as to vertical pipes that run to any gas appliances in the kitchen or elsewhere in the house. They should be clean and rust-free and all closeout valves (brass valves that allow gas to be closed off to the kitchen, water heater and other locations) should be look new and clean.

- **Circuit breaker boxes and other electrical components.** In general, assessment of a building's electrical service is a job for a professional inspector or electrician. Still, there are telltale signs of problems that a layperson can see with the naked eye, such as circuit-breaker boxes with a maze of unordered wires emerging from them or the presence of multiple circuit-breaker boxes that were added on at different times. Ask your inspector to verify that the power coming into the house is modern, 220-volt service, which is to be expected in modern or updated older structures. Ask your inspector to explain what he sees.

Electrical Expertise

Circuit-breaker boxes with mazes of unordered wires emerging from them indicate a history of slipshod electrical updates. Ask your inspector to investigate.

- **Insect and termite damage.** You looked for it outside the house, and you should look for it in your basement, too. If insects have found their way into the exterior walls of a building, you will notice spongy-looking wood in floor joists and other wooden components, usually next to the exterior walls of the building. You might also see powdered wood, like saw dust, on the floor. This is evidence of insect damage. *Also:* Look for signs that rodents are present in the house, such as the presence of droppings or mousetraps, rodent poison, or glue boards. Rodents are present in many buildings, but a serious infestation can be unhealthy to residents, and serious infestations can be difficult to eliminate.

In the Attic

- **Evidence of leaks or water damage.** If a roof leaks, you will often see signs of it in the attic. Look for water stains overhead, either on the wood that underlies the exterior shingles or on ceilings that have been installed under the roof. Be aware of new ceilings that might have been installed to camouflage a leaking roof.

- **Insulation.** There are many kinds of insulation that you may see in an attic from rolled fiberglass insulation to spray-in insulation that looks like small peanut-sized chunks that lie between joists. Inspect all insulation closely with a flashlight for any signs of wetness. Discuss with your inspector whether the insulation has been installed correctly. In some cases, too much insulation on the floor of an attic causes moisture to build up in the attic. It can even be a hazard in the event of fire.

Pre-Closing Inspection Checklist

Before the sale closes and you own a property, it is essential to do a pre-closing inspection in which you make sure that the condition of the property has not changed since you last inspected it — in all likelihood, some months earlier.

Here's a checklist of things to inspect in your final walk-through. *Remember:* If you discover new problems, you can use them as negotiating points as the deal is concluded.

- Gutters and roof (Look for newly missing shingles.)
- Condition of sidewalk, driveway, fences, outdoor lighting and all exterior components
- Windows (Look for cracks in glass and broken screens.), locks, and doors.
- Operation of heating and cooling systems.
- Operations of all plumbing, including hot water heater, water pressure, sinks, drains, garbage disposal, etc.
- Operation of any appliances that were included in the sale, including stoves, refrigerators, vent hoods, etc.
- Condition of electrical switches, lighting fixtures, outlets.
- Cosmetics, including floors, walls, bathroom, and kitchen tiles, paint, etc.
- Operation of all windows, doors, cabinet doors, etc.

Central Cooling Systems

- **Age and condition of central air units, if present.** Visually inspect exterior units to see if they are clean and free of debris. Inside the house, inspect duct work where it is visible. If the ducts are made of old, galvanized steel, remove a grate from one of the output registers in the house (the registers that blow cooled air into interior rooms). Reach in with a rag, wipe the inside of a duct, and inspect the rag. Some dust is to be expected, but a dark mildew stain indicates the need for a building-wide duct cleaning to remove mold spores.

Kitchen

- **Age and condition of appliances, vents and other devices.** If they are appliances that you might keep for your use or that of tenants, turn them on and be sure they are working. If there is a gas stove, check the operation of all burners. *Tip:* Don't forget to check the operation of garbage disposals. They have a short life expectancy and many property investors forget to check them. If you need to install a dozen disposals in an apartment building, you should know about that expense ahead of time.

- **Age and condition of sinks, faucets and other plumbing.** Check the condition of sinks and other fixtures. Check all pipes, both supply pipes and drains, for signs of leakage. *Also:* Check water pressure and the time it takes for hot water to arrive.

- **Condition of cabinets and counters.** These can be expensive to replace, especially in apartment buildings with multiple units.

Call a professional inspector before making an offer on a building with these problems.

- A roof that is visibly sagging or sloping
- A roof that is structured so you cannot evaluate its age and condition
- Cracks in foundations and/or walls
- Evidence of flooding or water in the basement
- Extra electrical breaker boxes or other "add-on" features that show the electrical system has been expanded
- Renovations or alterations for which the seller is unable to provide permits
- Spongy or sloping floors
- Water leaks whose sources you cannot access, such as pipes behind walls or in crawl spaces
- Windows or doors that are not square or level

Bathrooms

In general, you will need to perform the same inspections that you did in the kitchen. But also be sure to inspect:

- **Condition of flooring.** Any hidden leaks often can be detected in discolored grout between floor or wall tiles. If a new floor has been installed, it could indicate an attempt to conceal water problems.

- **Condition of tiles, tub enclosures.** Tiles should be new looking. Grout should be clean and preferably new. Check the water pressure to shower and tub. *Also:* Run several inches of water into the sink and tub and allow it to drain. Slow-draining basins indicate clogs and the possibility that drainpipes are inadequate or poorly installed Ask for an inspection by a professional plumber.

- **Water pressure.** You checked it in the kitchen, but check the water pressure even more carefully in the bathrooms. Because they are generally more remote from the building's water supply pipes, insufficient water pressure to a building will be more noticeable in upstairs bathrooms than it is on the main floor.

All Interior Rooms

- **Water leaks on ceilings and walls.** Look for stains on ceilings and walls. In addition, bubbles under wallpaper can point to a leak from the roof or an exterior wall.

- **Overall condition**. Inspect windows, doors, locks, trim, flooring, wall coverings, and carpeting.

- **Electrical fixtures.** Check operation and condition of all switch plates, outlet covers, outlets, and lighting fixtures.

Laundry Facilities, Alarms, Lawn Sprinklers, and Other Extras

- **"Kick all the tires".** The things you forgot to inspect can cost you a great deal to repair later on. Ask to have inoperative systems repaired as a condition of sale, or use them as bargaining points to negotiate for a reduced price.

Test for Radon and Lead

- **Radon.** Radon is a radioactive gas that accumulates in buildings in all areas of the United States. It enters through a foundation's floor and walls then becomes distributed throughout a structure. It arises from the natural breakdown of uranium in soil, rock, and water. Any building can have a radon problem, new or old, well-sealed or drafty. Radon gas is listed as a Class One human lung carcinogen. Prolonged exposure to high levels of it can cause lung cancer. As a result, the EPA and the office of the Surgeon General recommend that all homes be tested for the presence of radon. Radon is invisible and odorless, but there is a simple test that you or your inspector can perform for high radon levels. (A quick Internet search for the term "radon test" will lead you to several tests that you can order online.) If your property test reveals a high level of radon, you can invest in a mitigation system that will ventilate the basement to keep radon levels low. However, be aware that buying houses or other properties that test positively for high radon levels is often not a good idea. You don't want your own family or your tenants exposed to it. Its presence can make your building harder to sell and possibly make you the object of lawsuits if your tenants become ill and sue you for renting them an apartment or office in a building where you knew the level of radon to be high.

- **Lead.** Lead, a highly toxic element, was used extensively for many years in residential paint. Because it was not banned until 1978, an estimated 75 percent of American housing contains lead-based paint. Exposure to lead can cause permanent damage to the nervous system, especially in children and pets. Most often, exposure results from breathing lead dust, which can be generated by sanding or scraping of walls where lead is present. If a building has a lead problem, repainting and cleaning with a special HEPA vacuum can generally correct the situation. Many home inspectors will do lead dust testing for you, or you can do it yourself. An Internet search for the term "lead test" will take you to the Web pages of companies that make lead-testing products. One reputable company that manufactures them can be found at http://www.leadtestkits.com.

Establishing Escrow to Pay for Repairs

When you are buying a property, chances are that your contract of sale requires the seller to deliver the property with all of its major operating systems (heating, electrical) in operating order. There is also the possibility that your inspection will reveal the need for costly repairs, such as insect damage that the seller will agree to correct as a condition of the sale.

It is often desirable to correct these problems after the sale. Under those circumstances, the buyer and seller will agree that the most efficient way to handle these after-the-fact repairs is for the seller to place a mutually agreed-upon sum of money in a specialized account called an escrow account. The buyer will have a specified amount of time to utilize that money to make the specified repairs using his or her own methods and preferred contractors. It is important to know that an escrow is established for a specific purchase like repairing a furnace or a roof. It is illegal for a buyer to use the money for some purpose other than the one for which the escrow was established.

The greatest difficulty can be negotiating how much money the escrow should contain. The buyer may want to set up an escrow account to pay for a new furnace in a houseHe or she asks for $4,000; the seller offers $3,000. Conflicts can also arise over the amount of time that the buyer will need to complete the repairs since the escrow can only be terminated when the repairs are completed. *Example:* The buyer completes the repairs in only a week, but is in no hurry to close the escrow account. The seller, however, wants to close the account at once so the sale is truly completed and final papers can be filed.

Despite the potential frictions and conflicts between buyer and seller, a well-intentioned and well-administered escrow can lend needed flexibility to the rigid timelines that apply to most real estate transactions.

Knowing these basics about establishing an escrow account for repairs adds to your ability to move ahead decisively to acquire or sell properties without undue delays.

Action Steps for Chapter Three

Don't hire a home inspector based on just one recommendation, especially from your real estate broker or a salesperson. Instead, ask for referrals from people who used inspectors to buy their homes. Did the inspector find everything that was wrong? Or did he or she overlook problems that surfaced later on?

Go into property inspections with a checklist of your specific concerns about the property based on problems you already saw –(e.g., roof or wet basement).

Carry a digital camera when you visit potential investment properties and later go through the properties with a home inspector. Keep snapping as you go.

Turn on faucets in every location of a building you are considering to check water pressure. The pressure might be great in the kitchen on the first floor. Will it also be great in the bathroom two stories up?

"Kick all the tires" during your inspection by testing the sprinkler system, garbage disposals, garage door openers, and everything else. The things you forget to inspect can cost you a great deal to repair later on.

If a seller refuses to let an inspector onto a property, walk away from the deal. Mortgage lenders will not lend you money to buy properties under such conditions, and you should not want to either.

Chapter Four:
Mold, Bugs, Floods, Earthquakes . . . Unpleasant Risks You Need to Understand

"Many small investors get into trouble because they try to do everything themselves, right down to their own legal and tax work. To be successful with your real estate project, you need to get the best people in the field to help you."

— from *Trump Strategies for Real Estate: Billionaire Lessons for the Small Investor* by George Ross, (Wiley, 2004).

In this chapter, we will take a close look at mold, insect infestations, flooding, and earthquakes. From bugs to earth tremors, all in one chapter? That might seem like an odd range of topics. But there is a good reason. Each of problem, in its own way, can dramatically reduce the value of the properties you own. Let's see how to protect your properties and your money from these threats that can imperil your real estate fortunes.

All About Mold

A case study you can profit from . . .

On a cold February day back in 2003, a pipe burst in Christopher Reilly's ranch house in Michigan. "It must have been two or three days before I was aware of the problem," he recalls. "I was pulling the car out of my garage one day and noticed a pool of ice on the floor. I looked up and saw that water was dripping down from the ceiling."

He called a plumber, who had to break through the bathroom wall to fix the leak. Christopher had a tile installer come and repair the wall and the problem seemed to he over. But the following June, Chris smelled a musty odor in his garage. He looked up and saw a bunch of fuzzy black spots on his garage ceiling. "Oh, hell, I have some mold up there," Christopher thought. He called Jack, a handyman he had used in the past, to repair the problem. Jack opened the garage ceiling and was greeted by a mildew-like stench. He removed a two-foot-square section of sheetrock, but counseled Christopher against replacing it right away. "Leave the ceiling open for a few months to let everything dry out," he advised. Christopher did, but noticed a week later that the mold spots seemed to be spreading across his garage ceiling. He was beginning to wonder just how big a problem he really had. One thing that didn't help was the way Christopher's work colleagues reacted when he told them he had a mold problem in his house. They didn't seem to know much about the problem, but they didn't hesitate to tell him that if the mold had spread far through his house, his property would be worthless on the marketplace.

What you can learn from this case study . . .

Most of us don't know much about mold. At the same time, it is a hot topic that has been widely covered in the media. Protect yourself from mold by educating yourself about it. This education should serve two purposes. First, it should prevent you from buying a mold-infested property. Second, it should help you understand how serious mold can be if you already own a property where it has appeared.

How Serious a Problem is Mold?

Mold, which is really a fungus, has been around virtually forever. Why has it suddenly shot up high on people's radar as a problem in buildings? Mold existed in buildings a few decades ago and nobody seemed to care about it. Why has it become such a hot topic now?

One reason that mold has made the news is the fact that it has now been proven to cause serious health problems. Asthma, skin problems, and even heart attacks have all been blamed on mold. For this reason, mold exerts a growing strain on the real estate and construction industries. Why is the construction industry affected? Because there is evidence that buildings need good ventilation to be mold-resistant. Many modern windowless buildings that rely on ventilation systems seem to breed mold more quickly than older buildings.

The bottom line is you really don't want mold in your building, not if you live there, and not if you have tenants. According to the *New York Times,* about 10,000 mold-related lawsuits are now filed in America each year. And according to the Insurance Information Institute, insurance companies pay $2.5 billion in mold-related claims per year, most of them in Florida, Texas, and California.

Here are some effective ways to reduce the chances that mold has found its way into a property that you are considering:

- **Avoid buildings** in low-lying, flood-prone areas or buildings with prior moisture-related problems such as basement flooding, leaking roofs, or burst pipes. If water has gotten in, mold could be breeding.
- **Ask your building inspector** how he or she will test for mold. A thorough inspection should include an assessment of the building for both visible and hidden signs of water damage and mold growth. If

What about Asbestos?

For many years asbestos, a natural mineral, was routinely added to other materials to provide insulation or fire resistance. Most commonly, it is found in a cement-like coating on heating pipes.

Breathing in asbestos fibers causes emphysema, lung cancer, and other problems. However, as long as asbestos is "static," meaning that it is not shredding or flaking off, it generally poses no immediate threat.

What is essential, however, is to avoid prodding or touching the fibers on your own. You need a professional environmental testing firm to test suspicious-looking insulation and if it is asbestos, to remove it according to procedures that conform to the requirements of federal and state laws.

In some states, it is permissible to encapsulate asbestos (wrap it in a plastic-like compound) so that it will not escape. In addition to federal and state laws, you may also encounter asbestos-abatement laws that are in effect on the local level. If your community requires a C of A (certificate of occupancy) to be issued after inspection by a city official, it may well be that a building can fail that inspection if asbestos is present.

If you suspect there is asbestos in a building you are considering, be sure to have a qualified inspector inspect the property before you move along too far into the buying negotiations. Removing asbestos in accordance with environmental guidelines is very expensive; removing it from the heating system of just one heating system in a small home can cost thousands of dollars.

walls are discolored, an inspector can inspect their hidden interior surfaces by inserting a fiber-optic viewer through a small hole that has been drilled in them. The inspector should also collect air samples in all rooms (basement, crawl spaces, attic, garage) and send them to a lab for testing.

- **Remember that buildings with forced-air heating** or central air conditioning (or both) are more vulnerable to mold because spores can be spread through the ducts that carry warm or cold air. The inspector should test for the presence of spores in each heating/cooling duct and in the air outflow from registers.

- **Mold and mildew** can be scrubbed from non-porous surfaces, such as metal or plastic. Mold is difficult to eradicate, however, on porous surfaces such as sheetrock, plywood, fiberglass insulation or concrete.

- **If during a home inspection you discover fresh paint** in an area that is moisture-prone, such as on sheetrock that covers a crawl space, investigate further. The paint may be an attempt to conceal the stains and discolorations of mold.

- **When buying an apartment house or condominium,** have your attorney investigate whether residents of the property have filed any mold-related lawsuits or insurance claims. You don't want to buy a property with a documented history of breeding mold.

Above all, don't minimize the danger that mold can pose to your investments. Mold might look like a small problem to you in a building you are considering, something you can clean up with some ammonia. But even if the problem appears small, it might not appear so inconsequential to potential buyers, who might run from the prospect of buying a

Ten Things
The Environmental Protection Agency Says
You Should Know About Mold

1. Potential health effects and symptoms associated with mold exposures include allergic reactions, asthma, and other respiratory complaints.

2. There is no practical way to eliminate all mold and mold spores in the indoor environment; the way to control indoor mold growth is to control moisture.

3. If mold is a problem in your home or school, you must clean up the mold and eliminate sources of moisture.

4. Fix the source of the water problem or leak to prevent mold growth.

5. Reduce indoor humidity (to 30-60%) to decrease mold growth by: venting bathrooms, dryers, and other moisture-generating sources to the outside; using air conditioners and de-humidifiers; increasing ventilation; and using exhaust fans whenever cooking, dishwashing, and cleaning.

6. Clean and dry any damp or wet building materials and furnishings within 24-48 hours to prevent mold growth.

7. Clean mold off hard surfaces with water and detergent, and dry completely. Absorbent materials such as ceiling tiles, that are moldy, may need to be replaced.

8. Prevent condensation: Reduce the potential for condensation on cold surfaces (i.e., windows, piping, exterior walls, roof, or floors) by adding insulation.

9. In areas where there is a perpetual moisture problem, do not install carpeting (i.e., by drinking fountains, by classroom sinks, or on concrete floors with leaks or frequent condensation).

Ten Things The Environmental Protection Agency Says **You Should Know About Mold** (continued)

10. Molds can be found almost anywhere; they can grow on virtually any substance, providing moisture is present. There are molds that can grow on wood, paper, carpet, and foods.

building with even a trace of mold. And then there is always the chance that they are right to be cautious. After all, there are hundreds of thousands of mold species that have not yet been studied for possible toxic properties to humans. As in all things connected to real estate, it is better to be safe than sorry.

To Learn More

For more information about mold inspection and remediation, check out these resources:

The National Association of Industrial and Office Properties: http://www.naiop.org/index.cfm

The Environmental Protection Agency's Indoor Air Quality resource page: http://www.epa.gov/mold

A publication called *A Brief Guide to Mold, Moisture and Your Home* can be downloaded from the Environmental Protection Agency's Web site at: http://www.epa.gov/mold/moldguide.html

Do You Need Flood Insurance for Your Properties?

The answer to that question, more often than most of us expect, is *yes,* and for one very simple reason:

Most homeowners' policies don't cover flood damage.

If you are acquiring a property where floods have occurred in the past, it is foolhardy not to get flood insurance, especially in light of the fact that it is relatively easy to buy (more than 100 insurance companies offer it) and relatively inexpensive (government subsidies keep policy prices low).

To make it even easier, chances are that flood insurance will be available as part of the policy or policies you are already planning to buy.

The cost of a flood insurance policy for a single-family home averages about $475 a year. If you live in a low-to-moderate risk zone that is not near a lake, an ocean or a river, premiums might be even lower.

Two case studies you can profit from . . .

- **The little house on the marsh.** Paul and Rhonda bought a beautiful, brand new beach house on New Hampshire's coast. It was located far away from the ocean, facing an inland marsh. "The marsh is not a tidal marsh," the builder told them, "Why would I be crazy enough to build all these new houses if they would flood? You can ask your insurance company, this is not a flood zone." They did talk to their insurance agent, but decided to avoid the extra cost of flood insurance. The next year there was an especially rainy spring season — a "monsoon" according to the local papers. Paul and Rhonda stood in their back yard, watching the water advance steadily across their new sod toward their

Why It is Foolish Not to Get Flood Insurance

Although flood insurance is relatively inexpensive, most Americans don't purchase protection.

- Only about one-quarter of the homes in areas most vulnerable are insured against flood loss, according to the Federal Insurance Administration (FIA). Yet in those areas, flooding is 26 times more likely to occur than a fire during the course of a typical 30-year mortgage.
- Even in areas where flooding is rare, most homes are still at some risk. According to the Federal Insurance Administration, 25 percent of all flood claims occur in area that have been classified as having low to moderate risk of flooding.
- Residents of about 20,000 communities with higher-than-average risk of flooding have been entitled by the government and the Federal Emergency Management Agency (FEMA) to purchase flood insurance at low cost through the National Flood Insurance Program (NFIP), a program FEMA oversees.

house. The advancing tide got within about six feet of their basement, which was already flooded. They got lucky. The rain stopped and the water receded, but they had learned an important lesson. They had flood coverage in effect within days, at considerable cost.

- **Miles from a river.** Jack and Ted, real estate partners, invested in a small shopping center in a town in West Virginia. The town had experienced destructive floods in the 1920s, but has had no significant floods since. Furthermore, the shopping center was located uphill from the river that ran through the center of town. There was no conceivable way that the river would rise high enough to flood the location even if it rained heavily for days on end. But then in 1999, it did rain for days on end as a hurricane passed through. Water coursed downhill from above the location, swamping the shopping center and damaging the stores and their inventories. Most of the merchants had their own insurance policies that covered their losses. A sporting goods store however, had not taken out flood insurance, and the owners threatened to take Jack and Ted to court. Suddenly they had a new and unexpected problem on their hands, one that threatened to damage the value of their property, make it harder to find tenants, and inflate their insurance costs at the same time.

What you can learn from these case studies . . .

- **The time to anticipate flood damage is ahead of time** before you buy a property, not after flood damage occurs. If water comes at the wrong time and in the wrong way, it can sweep away a lot of the value of your investment.

One way to assess the potential damage to a property is to determine whether it is located in a designated flood zone. While no one can predict precisely where floods will strike, the Federal Emergency Management Agency (FEMA) does maintain maps of areas in the United States that are especially prone to flooding. To find out whether a property you are considering is located in a high-risk area, call the Flood Map Service Center at (800) 358-9616 or write:

Federal Emergency Management Agency
Flood Map Service Center
P.O. Box 1038
Jessup, MD 20794-1038

Or for faster information, visit FEMA's Flood Map Center at http://store.msc.fema.gov/webapp/wcs/stores/servlet/FemaWelcomeView?storeId=10001&catalogId=10001&langId=-1

Picking Flood Insurance

Buying flood insurance is complicated. If you are insuring an apartment house, for example, you might want to buy a policy that protects you from tenants' lawsuits if their property is lost or they are injured in a flood. If you are buying flood insurance for your own residence, do you want to cover the replacement value of the house or to cover furnishings in the house? Do you want a policy with a deductible that would be applied to your losses, or one in which you pay more and are fully covered?

In making such decisions, look closely at your general property insurance policies and ask whether they already cover flood damage. Read all the fine print and buy additional riders to cover flood damage only if needed.

When comparing insurers ask how quickly claims are resolved. A company in robust financial health will pay claims more quickly than a company that is in trouble. One way to tell is to visit Insure.com's Insurance Company Guide online at http://www.insure.com.

Be aware that some companies cater to specific regions of the country, such as Unisun, which serves homeowners from Virginia to Texas. Allstate, Mutual of Omaha, State Farm, and Travelers write policies nationally.

To Learn More

For more information about flood insurance, check out these resources:

The Federal Emergency Management Agency (FEMA) National Flood insurance Program: http://www.fema.gov/nfip/whonfip.shtmat

The Federal Emergency Management Agency (FEMA) FloodSmart information page: http://www.floodsmart.gov/floodsmart/pages/index.jsp

Insure.com: http://insure.com

Earthquakes and Earthquake Insurance

A case study you can profit from . . .

When the Puget Sound area of Washington State experienced a significant earthquake in early 2001, many property owners learned the hard way that their standard insurance policies did not cover the losses they had suffered. The phone lines lit up at insurance companies as property holders scrambled to buy new policies or new riders for old policies that had fallen short on providing adequate coverage. In many cases, the property holders were turned away, at least for a time. That is not uncommon in the aftermath of a quake. Insurance companies can stop issuing policies while their analysts and underwriters look at what the company has been required to pay its current policyholders. Often, prices increase.

What you can learn from this case study . . .

Don't wait for an unpleasant surprise. Learn all you can now about earthquake insurance to assess your current coverage.

California, Oregon, and Washington are especially prone to earthquakes. These states are also more prone to mudslides and forest fires than other states, so buying property in them should prompt any real estate buyer to carefully investigate appropriate insurance protection.

What Policies Cover

Unlike more general policies, earthquake insurance covers major losses. It is usually sold with deductibles equaling 10 to 25 percent of the structure's policy limit. (On a $400,000 building, for example, deductibles could be in the range of $40,000-$100,000.) The more you pay in policy premiums, the lower the deductible.

You are probably familiar with deductibles on your auto insurance policies, and earthquake insurance deductibles work in essentially the same way. Insurance pays only for damages that exceed the deductible.

But there are some additional factors to consider. Unlike car insurance, which has just one deductible, many earthquake policies treat contents and structure separately. Different deductible amounts or percentages may be applied separately to distinct loss areas such as:

- Contents of the property
- Loss of the structure
- Loss of garages, sheds, driveways, or retaining walls
- Automobile damages incurred during an earthquake

Not all policies are alike. Shop around to get the coverage that best meets your needs.

Note that insurance companies are now applying increasingly tough requirements when writing policies. Most will require an inspection of your property before they will agree to issue a policy.

Buying Your Earthquake Policy from A Company That is Not Your Primary Insurer

A brochure arrives in the mail offering you the opportunity to buy earthquake insurance from a company that is not your primary insurer for a property.

Such policies are called "stand-alone," meaning they are offered by specialty insurance companies who do not require you to purchase your primary homeowners insurance from them, too.

Sometimes these policies are a good value because they are offered by companies specializing in quake insurance that are willing to lower costs and take higher risks than bigger companies.

If you are tempted by such a policy, review its listing on http://www.insure.com to make sure the company behind it is reputable and solvent. Also, be sure to compare what it offers against the riders you can add to policies you already have in place. In many cases, it is more economical to expand your current policies than to add a new one.

A case study you can profit from . . .

California Earthquake Coverage. A policy to protect a single-family home and its contents from earthquake damage is expensive, typically on the order of $1,300-1,400 per year. Coverage for apartment buildings, office buildings, and retail complexes is even more costly.

In California, insurance companies are required to offer earthquake insurance to homeowners that covers the dwelling, personal property (valued at not less than $5,000 or 10% of the covered dwelling loss), and additional living expenses (ALE) of at least $1,500.

ALE covers living expenses for homeowners who have to live in hotels or other temporary quarters in the aftermath of a quake. It may also cover such expenses as restaurant meals while you are unable to live in your residence. Accordingly, ALE coverage is probably not necessary if you or your family will not occupy the property that you wish to insure.

Another Earthquake Hazard

Fires in the aftermath of an earthquake can often pose just as much of a threat to property value as the earthquake itself.

If you have property insurance, but not earthquake insurance (either as a rider in your main policy through as a separate "stand alone" policy), make sure that you are covered in the event that an earthquake causes a fire.

Save Money on Earthquake Insurance

Some simple measures can reduce the extent of potential damage from earthquakes and reduce your earthquake insurance premium, too. Such repairs are called "retrofitting" and can include:

- Anchoring a dwelling more securely to its foundation
- Installing automatic gas shut-off valves
- Installing wall bracing
- Reinforcing chimneys
- Securing and bracing the water heater

States like California offer tax rebates and other incentives to pay for these modifications, which will in turn reduce your insurance bills.

Action Steps for Chapter Four

Avoid buildings in low-lying, flood-prone areas or buildings with a history of moisture-related problems, such as basement flooding or leaking roofs.

Ask your building inspector how he or she will test for mold. A thorough inspection should include an assessment of the building for both visible and hidden signs of water damage and mold growth. If a wall looks discolored, the inspector should inspect its interior surfaces by inserting a fiber-optic viewer through a small hole that has been drilled in the wall. The inspector should also collect air samples in all rooms (basement, crawl spaces, attic, and garage) and send them to a lab for testing.

If you suspect there is asbestos in a building you are considering, have a qualified inspector look over the property before you get too far along in negotiations. Removing asbestos in accordance with environmental guidelines is very expensive.

If you are acquiring a property where floods have occurred in the past, it is foolhardy not to get flood insurance, especially in light of the fact that it is relatively easy to buy (more than 100 insurance companies offer it) and relatively inexpensive (government subsidies keep policy prices low).

Anticipate flood-caused damage ahead of time, not after flood damage occurs. If water comes at the wrong time and in the wrong way, it can sweep away the value of your investment.

Some simple measures, such as bolting a frame house to its foundation, can reduce the extent of potential damage from earthquakes and reduce your earthquake insurance premium. Talk with your insurance agent to learn what to do.

Chapter Five: **Avoid the Perils of Risky Financing**

"Did you know that the most expensive thing you'll likely ever buy is not your home: it's the cost of financing required to purchase that home."

— from *Trump Strategies for Real Estate: Billionaire Lessons for the Small Investor* by George Ross, (Wiley, 2004).

In this chapter, you'll learn how to protect yourself from risky mortgage financing, including owner financing.

Notice, we did not say we will advise you *against* these forms of financing because there are times when you might want to consider them. The key is to reduce your exposure to the risks they present. Let's learn how.

Balloon Mortgages

Balloon mortgages start out with interest rates that are lower than the norm for fixed-rate mortgages. You make regular monthly payments that do not change for a predetermined period of time, usually 15 or 30 years. At the end of the period, a large percentage of the money you owe or *all* of the money you owe becomes immediately due.

Balloon loans were invented in times of high interest rates as a way to help first-time homebuyers get started without making onerous monthly mortgage payments. They are generally regarded as high-risk loans.

Still, if you are buying a property that you definitely plan to sell before the balloon payment comes due — preferably a property you are certain will appreciate a great deal — a balloon mortgage might be worth considering.

Balloon Wisdom

Consider a balloon mortgage if you want to minimize monthly payments on a property you will hold for 15, 30 years — definitely less than the amount of time before your final payment is due.

Consider a balloon mortgage if you want to minimize monthly payments on a property you will hold for 15 to 30 years, less than the amount of time before your final payment is due. You might consider one of these mortgages if you expect to refinance the loan well before the balloon payment comes due. That scenario works best if you are reasonably certain that your property will appreciate rapidly. If its market value increases 50 percent over five or ten years, for example, you will then be in a good position to refinance your loan and get a more predictable fixed-rate loan.

Interest-Only Mortgages

Interest-only loans are a new product, created for buyers eager to obtain mortgages in high-cost housing markets.

Interest-Only Loans

Consider an interest-only mortgage if you are willing to assume a lot of risk to buy a property you will keep only a short time and "flip" for a quick profit.

In the early years of an interest-only loan, monthly payments go towards paying back only the interest that is owed on the loan. Payments are low compared to a fixed-rate loan for the same amount. But after a predetermined period of time, monthly payments increase dramatically as the loan-holder begins to repay the principal of the loan. Interest-only loans, like balloon loans, are generally regarded as risky. There might be times to consider one, such as when you are certain you will hold a property for only a short time before selling it for a quick profit.

Consider an interest-only mortgage if you are willing to assume a lot of risk to buy a property you will keep only a short time and "flip" for a quick profit. However, many financial experts warn against interest-only loans because of the problems they can cause in the future.

Owner Financing

Owner financing is an agreement between the seller of a property and its buyer in which the seller agrees to finance a portion of the purchase price.

In rare cases, an owner financing agreement might be struck in which the seller agrees to finance 100 percent of the value of the property that he or she is selling. A contract is drafted that stipulates the terms of the loan, including an interest rate, term of the loan, monthly payments due, and other terms like those found in a mortgage agreement made between a buyer and a bank or other lending institution.

It is rare, however, for a seller to offer to finance 100 percent of the purchase price. Usually an agreement is made in which the seller agrees to "hold a note" for an agreed-upon portion of the selling price as a loan that the buyer will repay over a stipulated period of time.

A case study you can profit from . . .

John and Cynthia Cobb, a young couple, wanted very badly to buy a house that was down the street from Cynthia's parents' suburban home. They had recently graduated from college. Though they both had jobs, they owed student loans and felt that they could not expect to obtain a mortgage for the full asking price of the house, which was $355,000. Their parents agreed to help them by giving them about half of the asking price in cash, a casual loan that they would be free to repay in future years. That left them with the need to borrow about $175,000. They approached Tom, the home's seller, to discuss whether he would finance that amount for them, in effect "holding a note" on the house, which they would repay in regular monthly payments, much like a conventional mortgage.

From Tom's point of view, it was an attractive proposition. He liked John and Cynthia, knew Cynthia's family, and was willing to bet that the young couple would repay a loan on schedule. Tom had another reason for finding the notion of owner financing attractive. In the first few weeks that the house was on the market, it had become clear to him that he would have to lower his asking price considerably in order to sell it. John and Cynthia were not even haggling on the price — they wanted to buy the house for his full asking price, provided that he would finance part of their loan. Tom agreed to finance $175,000 of the loan, repayable over 15 years at an annual percentage rate of six percent. In real dollars, that meant that Tom would be selling his house for even *more* than his asking price.

Owner Financing

Benefits the buyer by. . .

- Cutting closing costs
- Obtaining a loan with less scrutiny of credit history and other qualifying factors
- Letting the buyer qualify for a more expensive property

Benefits the seller by. . .

- Generating an ongoing income stream from a property after it is sold.
- Increasing the odds of selling for higher prices.

Another case study you can profit from . . .

Michael Farris secured owner financing from the owner of the first property he bought, an automobile repair shop with a rental apartment above it. He really leveraged himself a great deal to put the deal together with very little money out of pocket. But six months into his ownership, the auto shop closed its doors and defaulted on its lease, leaving him with a large, unrentable space. Even though he was protected by the lease that the shop's owners had signed, Michael quickly saw that taking them to court to collect unpaid rent would not solve his cash-flow problem, nor his inability to repay his combined owner financing and bank mortgage. He defaulted on his loan and was back to square one. "Actually," he summarizes, "I am not back on square one because I defaulted on a loan and now have a black mark on my creditworthiness."

What you can learn from these case studies. . .

- **With careful planning** and in the right circumstances, owner financing can benefit both buyer and the seller. The buyer can afford a more expensive property. The seller can often get his or her full asking price. That is what is called a *win/win* situation.

- **It can be exciting** to use owner financing to leverage your way into a building you could not otherwise afford. But doing so without sound planning and foresight is an invitation to disaster.

Rent to Buy

A "rent to buy" arrangement is a form of owner financing in which a landlord agrees to set aside part of a tenant's monthly rent as a down payment toward the purchase of the apartment or property.

As in any owner-financing arrangement, the agreement can be structured in any way the landlord and tenant agree upon.

For the tenant, the advantages can be . . .

- **The ability to put a portion of rent to good use,** the purchase of the property.

- **The chance to leverage ownership** of a property with a small down payment or no down payment or, at the very least, with a reduced outlay.

- **The opportunity to get to know a neighborhood** or property before a full commitment to buy is made.

For the landlord, the advantages can be . . .

- **A chance to sell a property** for a higher price than might be commanded if the property were simply put on the market.

- **The opportunity to generate greater monthly cash flow** than might be possible from a simple lease.

But there are risks as these two statements show:

- "I was delighted when I entered into a rent-to-buy arrangement with a couple who had really fallen in love with the little house they rented from me, a house I had been unable to sell for quite some time," says Bruce. "But then they got divorced, the husband left, and I had just one tenant who was barely able to make rent. She left, and six months later I was right back where I started — with a house to sell. Actually, I lost money because I had to give the place a fresh coat of paint and other cosmetic fix-ups before I could list it again."

- "We signed on to spend more per month on our rent-to-buy deal than we would have spent just renting a similar apartment," says Juan, "and then we didn't like the neighborhood. When we moved out, we had spent more money fixing the place up than we should have. Of course, we were better off in the long run because we had avoided purchasing a home in an area that would have disappointed us. But overall, it was a disappointing experience."

In summary . . .

Alternative forms of financing can help buyers, especially first-time buyers, acquire properties with less cash. But before entering into a high-risk financing arrangement like those described in this chapter, be sure to weigh the potential risks. It is most important to consider potential events that could affect your ability to make monthly payments. In real estate, cash flow is often the factor that determines whether a particular property investment succeeds or fails.

Action Steps for Chapter Five

Consider a balloon mortgage if you want to minimize monthly mortgage payments on a property you will hold for 15 or 30 years – definitely less than the amount of time before your final balloon payment is due.

Consider an interest-only mortgage if you are willing to assume a lot of risk buying a property you will keep only a short time and "flip" for a quick profit.

It can be exciting to use owner financing to leverage your way into a building you could not otherwise afford. But doing so without sound planning and foresight is an invitation to disaster.

If you are a landlord, consider offering rent-to-buy to potential tenants. You can even advertise the fact that you are offering to rent your properties on a rent-to-buy basis. It's an attractive option that can help attract worthy renters to fill your vacant properties.

Special Bonus Chapter: **Four Wealth-Preserving Secrets of Real Estate Masters**

This is a book about risks: the risks of not having enough insurance, of buying a building with structural problems, and of not choosing the best financing option.

Those risks are troubling, to be sure. But there is a bigger risk we should also mention: the risk that, after you spend years of your life amassing a fortune in real estate, you are going to lose it all because of some unfortunate event that is largely beyond your control. We are talking about the kind of disasters that insurance cannot protect you against.

But with the right kind of outlook, you can protect yourself. Let's take a closer look.

Risk #1: A Partner's Bad Judgment Sinks You

It does happen. You spend years building a good name and amassing a fortune, then the actions of an associate bring you down.

Here's a quick case study that illustrates the point:

Sarah and her partner, Jeanne, bought and renovated an apartment building ten years ago. When they were buying it, an inspector found asbestos covering many of the pipes in the old heating plant in the basement and said that it needed to be removed. Jeanne met with an asbestos-removal company, which said it would cost $25,000 to remove the asbestos and file all the appropriate paperwork and permits. When Jeanne turned pale after hearing that estimate, the abatement company offered an alternative; they could simply remove the asbestos for less than half that amount of money and nobody would be the wiser. Jeanne agreed without telling Sarah. But now one of their tenants has developed lung cancer and is asking questions about whether she might have been exposed to asbestos. Spurred by that, Jeanne has finally leveled with Sarah about her lapse of judgment about getting the asbestos removed. It could become the kind of problem that costs them both a fortune and destroys their reputations as developers – not to mention the remorse that comes from an unwise decision that might have harmed an innocent person.

Sobering story, isn't it? Everyone stands to lose so much over a lapse of judgment. How can you protect yourself from such problems?

- Avoid partnerships. Now, partners can be great assets. They pool their investment money with you and enable you to acquire more property. Their skills augment yours. But doing business with a partner is always risky. And let's face it, "Only do business with a partner you trust" is not intelligent advice. (You are certainly not going to do business with a partner you don't trust.) You cannot predict everything a partner might do that could land you in trouble. Generally, it is safer to go it alone.

- Talk about this issue with an attorney before entering into a partnership. Ask about strategies you can implement to insulate yourself from unwise or dishonest partners.

- If you are already in a partnership, consider converting it into a corporation instead. A corporation, as we discussed in Chapter One, can protect your personal assets from business losses and liability.

Risk #2:
A Loophole in Your Insurance Coverage Will Cause You to Lose Everything

This is many real estate investors' worst nightmare. Somehow, the specific event that damages or destroys a building is somehow not covered by a policy. To protect yourself:

- Make appointments with several real estate agents. Have them review your policies and tell you where you are not covered. Of course, they will try to sell you all kinds of new coverage and new policies, but that might be a good thing. In their efforts to sell something to you, they might uncover areas where your coverage is weak.

- Make a list of worst-case scenarios. If a tornado struck, would you be covered not only for the loss of the building, but for loss of life, too? If a flood destroyed your tenants' cars in the underground garage beneath your building, can you be sued for their replacement value? Do some doomsday thinking and try to consider any eventuality. You just might discover a loophole that is exposing you to an unanticipated risk.

Risk #3:
The Government Will Claim Your Fortune after You Pass Away

After you have spent years of your life making a fortune in real estate, it is troubling to think that very little of it will go to your spouse or heirs after you die. But we do hear stories just like that, and sad to say, they usually affect small-time real estate investors, not the big players, who usually have knowledgeable lawyers who have helped them plan their estates wisely. Most often, it is the small investor who owns three or four houses who leaves a poorly planned estate to a family that ends up selling off some of the property in order to pay estate taxes.

Yet, there are alternatives even for small investors. Talk with an attorney who is an expert in estate planning to learn about strategies like these:

- Give properties to your children and heirs now so they will not have to pay estate tax on them.
- Create a trust that minimizes estate taxes when the properties you own are passed to your heirs.
- Incorporate so your holdings become a separate entity and issue shares in the corporation to your heirs now, in effect, transferring ownership to them while you are still alive.

A wise attorney will have many more strategies to offer. Wise estate planning can help assure that your wealth will go to the people you love, not to Uncle Sam.

Risk #4:
Dishonest Employees Bleed You Dry

You hire wisely. You check references. You work alongside your employees and build trust. Then one day you discover that one of them has been taking kickbacks from the landscaping company that services your properties, or perhaps you find that an employee set up a second bank account and has been depositing some of the checks there that are paid to your business. There are all kinds of thieves in the world. For some reason, probably because money is always changing hands, real estate is a business that seems to breed dishonesty. But there are ways to protect yourself:

- Sign all checks personally. This can be hard to do as your business grows, but it remains the most effective way to know just where your money is going.

- Hire an accounting firm to audit your books on a quarterly basis. Look for a company that has an aggressive attitude and stance. When employees know that every penny is being watched, they are less likely to have the small lapses in honesty that can add up and cost you a lot of money in the long and short term.

- Talk to employees about what is appropriate behavior and what is not. Explain that if a paving company wants to fly them to Acapulco for a week to "thank" them for awarding a contract that can land your company and you in trouble. Encourage the people who work for you to come to you and tell you when vendors make offers of favors or gifts. Reward them when they do.

- Scour your books for numbers that don't make sense. Last year your firm paid $12,500 to electricians. This year, that figure doubled. Last year, your rental income for a particular building was $12,000 more than it was this year, and nothing has changed as far as you know. There might be perfectly good reasons for these changes, but there might not be. It takes an eagle-eyed business owner to zero in on all statistics that are out of line and find out the reason. But eagle-eyed business owners stay in business while others fall by the wayside. If you are genuinely interested in building a fortune in real estate, it is worth the effort.

BOOKS

Success and Real Estate Wisdom

From Members of The Trump Organization Family:

Carolyn 101: Business Lessons from The Apprentice's Straight Shooter by Carolyn Kepcher with Stephen Fenichell (Fireside, $21.95)

Trump Strategies for Real Estate: Billionaire Lessons for the Small Investor by George Ross, (Wiley, $24.95)

Trump: The Art of the Deal by Donald J. Trump with Tony Schwartz (Warner, $6.99)

Trump: How to Get Rich by Donald J. Trump with Meredith McIver (Random House, $21.95)

Trump: Think Like a Billionaire: Everything You Need to Know About Success, Real Estate, and Life by Donald J. Trump with Meredith McIver (Random House, $21.95)

Trump: The Way to the Top: The Best Business Advice I Ever Received by Donald J. Trump (Crown, $18.95)

Catch the Wave: How timing can make you a fortune in real estate today by Barry Lenson (Trump University, $TK)

From Other Authors and Experts:

21 Things I Wish My Broker Had Told Me: Practical Advice for New Real Estate Professionals by Frank Cook (Dearborn, $19.95)

How to Buy a Home when You Can't Afford It by Robert Irwin (McGraw-Hill, $14.95)

The Complete Idiot's Guide to Buying and Selling a Home by Shelley O'Hara (Alpha Books, $18.95)

Home Buying for Dummies by Eric Tyson and Ray Brown (IDG Books, $14.95)

Real Estate Investing for Dummies by Eric Tyson and Robert S. Griswold (IDG Books, $14.95)

Mortgages and Financing

Financing Secrets of a Millionaire Real Estate Investor by William Bronchick (Dearborn, $18.95)

Keys to Mortgage Financing and Refinancing (Barron's Business Keys) by Jack P. Friedman and Jack C. Harris (Barron's, $7.95)

What Every Real Estate Investor Needs to Know About Cash Flow...And 36 Other Key Financial Measures: Guidelines, Formulas, and Rules of Thumb for Making Money in Real Estate by Frank Gallinelli, (McGraw-Hill, $16.95)

All About Mortgages: Insider Tips for Financing and Refinancing Your Home by Julie Good-Garton (Dearborn, $19.95)

Mortgage Encyclopedia: An Authoritative Guide to Mortgage Programs, Practices, Prices and Pitfalls by Jack Guttentag (McGraw-Hill, $19.95)

Pocket Mortgage Guide: 60 of the Most Important Questions and Answers about Your Home Loan - Plus Interest Amortization Tab by Jack Guttentag (McGraw-Hill, $9.95)

How to Save Thousands of Dollars on Your Home Mortgage by Randy Johnson (Wiley, $17.95)

Mortgages 101: Quick Answers to Over 250 Critical Questions about Your Home Loan by David Reed (Amacom, $16.95)

Mortgages For Dummies by Eric Tyson and Ray Brown (IDG Books, $16.95)

Home Fix-Up and Renovation

New Complete Guide to Home Repair & Improvement (Better Homes and Gardens, $24.95)

Home Improvement 1-2-3 by The Home Depot (Home Depot, $34.95)

The Stanley Complete Step-by-Step Revised Book of Home Repair and Improvement by The Stanley Company (Free Press, $35.00)

Home Inspections

The Complete Book of Home Inspection by Norman Becker (McGraw-Hill, $19.95)

Inspecting a House (for Pros for Pros) by Rex Cauldwell (Taunton Press, $19.95)

Insurance

Insurance for Dummies by Jack Hungelmann (IDG Books, $14.95)

Miscellaneous Real Estate Investing

Flipping Properties: Generate Instant Cash Profits in Real Estate by William Bronchick, Robert Dahlstrom (Dearborn Book, $18.95)

The 106 Common Mistakes Homebuyers Make (and How to Avoid Them) by Gary W. Eldred (Wiley, $16.95)

Buy Low, Rent Smart, Sell High by Scott Frank and Andy Heller (Dearborn, $18.95)

INTERNET RESOURCES

Floods and Flood Insurance

The Federal Emergency Management Agency (FEMA) National Flood insurance Program: http://www.fema.gov/nfip/whonfip.shtmat

The Federal Emergency Management Agency (FEMA) FloodSmart information page:
http://www.floodsmart.gov/floodsmart/pages/index.jsp

Home Inspections

National Association of Home Inspectors Inc: http://www.nahi.org

American Society of Home Inspectors: http://www.ashi.org

National Association of Certified Home Inspectors:
http://www.nachi.org

Insurance Ratings and Resources

A. M. Best: http://www.ambest.com

Moody's: http://www.moodys.com

Insure.com: http://www.insure.com

Mortgage Calculators

Note: Many mortgage calculators on the Internet are really front pages for lenders who are trying to sell you their products. The ones we have chosen below are not.

Mortgage-Calc.com: http://www.mortgage-calc.com

Calulator.com: http://www.calculator.com

YourMortgageCalculator.com: http://www.yourmortgagecalculator.com

Up-To-Date Information on Current Mortgage Rates

Mortgage-Calc.com: http://www.mortgage-calc.com

The Federal Reserve Bank: http://www.federalreserve.gov

News on Lending, Current Market Trends and Other Topics

Counselors of Real Estate: http://www.cre.org

Fannie Mae: http://www.fanniemae.com

Fannie Mae Home Buying Guides: http://www.homebuyingguide.com

The Federal Reserve Bank: http://www.federalreserve.gov

HSH Associates: http://hsh.com

RealEstateABC.com: http://www.realestateabc.com

About the Author

Barry Lenson has invested in residential real estate for the past two decades. He was a pioneer investor in the booming Jersey City, New Jersey market. Mr. Lenson has written numerous books, most recently *Catch The Wave: How Timing Can Make You a Fortune in Real Estate Today* for Trump University. His other books include the Amazon.com self-help bestseller *Good Stress, Bad Stress.* He earned degrees from McGill University and Yale and lives with his family in Millburn, New Jersey and Exeter, New Hampshire.