Rehab Risk Management

Preview Of What You Will Learn

Sections:

Introduction

Warren Buffet once said, "Risk it not knowing what you're doing." He couldn't be more correct. The only way to prevent something from happening is to preempt and prepare, and even still, you may not be so lucky. Real estate is innately a risky business. We all know that. In fact, most everyone who becomes involved with flipping houses will need to have a desire to take risks. But even if you like to drive a fast car, you should still know how to pump the breaks.

When rehabbing properties, we're typically dealing with houses costing thousands and hundreds of thousands of dollars. The stakes are higher. The profits are also higher and that is why so many people are willing to take on the risk. The key is to learn how to protect yourself and protect your business. From the first time your contractor picks up a hammer all the way to the open house, there are many ways to do just that. It's also important to make sure that your team values taking these precautions seriously.

All it takes is one bad move, one forgotten signature, or one overlooked procedure to cause disaster. That is why developing a risk management plan should be in the organizing and preparing stage of your rehab projects. Don't make the mistake of waiting until it's too late.

One of the most important aspects of investing is to lower your risk and protect your investment.

Approaching Risk Management

If you are new to the rehabbing process, it can be difficult to anticipate exactly what can go wrong. Even if you are a seasoned professional, it's highly unlikely that you've truly seen and done it all. We like to follow the old adage, "hope for the best, but prepare for the worst." Meaning, while we don't expect something to go wrong on every project, occasionally things do happen that are often out of our control and we want you to be prepared. How big the problem is and how hard it is to fix that problem will depend on how well you prepare, and that starts with knowing your risk.

What is Risk?

As we know, risk is inevitable in this business and it's inevitable in life. That doesn't mean you have to go hide under the covers. Risk is scary but it's also what gets you to the top. Those who take "calculated" risks are those who succeed. Bottom line.

So what exactly is risk? Risk is the potential of losing something that you value. Whether it is health, social status, money, or any number of things, we all want to protect what we value. So when something big is on the line, look around and think about your threats. In a rehabber's world, this means a threat to you as an investor, the company that you built, and also the community that you care about. We're in the business of buying and flipping houses. If we're rehabbing a house, that means demolition. Demolition means tearing things down. Tearing things down means the potential discovery of pre-existing defects and additional unforeseen expenditures. Then, of course, we have to build it back up. This adds in the delivery of expensive appliances and the creation of a newly renovated vacant home. Let's not forget the potential for improper construction and liens on your property. You have a lot of room for things to go wrong, that doesn't mean you have to sit around and watch it all happen.

Managing Risk

There are several different approaches you can take when facing potential risk. Unfortunately, most people make the mistake of sticking their head in the sand and hoping nothing happens. Recognizing that certain situations may cause problems for your project but refusing to accept that these situations may occur will undoubtedly come back to haunt you.

Here's how an unfortunate situation can potentially happen: first a person falls while on one of your properties. Whether or not he's truly hurt doesn't really matter, because he finds a doctor who will say that he can't work. If you haven't taken the proper steps to protect yourself, it will only take a lawyer a few clicks on the computer to re-

search and discover everything you own. And pretty soon, it's all tied up in a lawsuit that threatens everything you've worked so hard for. While these sort of situations don't happen very often, they do happen. So how do you protect yourself and your investments? To effectively manage risk, you have to follow four steps: **identify, assess, control,** and **review**.

Step #1- IDENTIFY

Your first step is to identify your biggest risks. For rehabbers, this can be a variety of things. Here are some of the big ones:

- Damage to your structure from fire, wind, flood, earthquake, etc.
- Theft and or vandalism.
- Injury to visitors, prospective buyers, real estate agents, etc.
- Property damage to neighbors' property.
- Bodily injury to employees working for you.

Step #2- ASSESS

Your next step is to assess each risk. Depending on your project at hand, one risk may be higher than the rest. For example, if you are working in a crime-ridden neighborhood, you are more at risk for theft. If your project is near water, it can be subject to floods. Make sure to share these known risks with your team members so that they are aware moving forward what is at stake.

Step #3- CONTROL

Once you are clear about what the risks are, you will want to put a plan into action to control them. Make your risk management approach a staple system that you introduce to each and every project and each and every person that works on your project. There are two different approaches that you can take to each risk:

Transfer: Pay someone else to assume some or all of the effect of the risk (i.e. insurance).

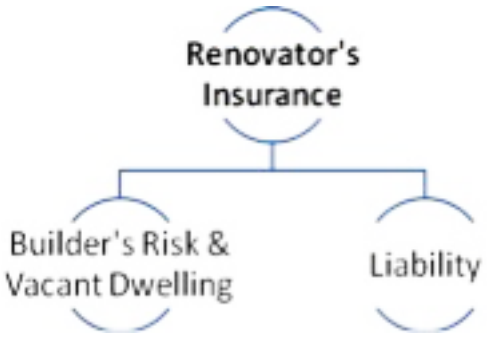
Mitigate: Either reduce the likelihood that a risk occurs, or minimize the negative consequences if it does occur (i.e. putting signs around the property).

Step #4- REVIEW AND MONITOR

It is vital that you choose your strategies and plan their implementation as early as possible in your project . Additionally, upon completion of the project you will want to take a step back to review and monitor your risk. Did the approach you have in place work? If something did go wrong, was it handled correctly? If necessary, make adjustments.

How to Control Risk

Although it may require a bit of work upfront, proactively managing your project's risks always pays dividends down the line. When it comes to protecting your assets and your business, you do not want to skimp out. After all, paying for insurance and protection is all another part of doing business. Remember, if you try to cut a corner, you're going to wind up regretting it. It's as simple as Murphy's Law: *whatever can go wrong will go wrong*. These methods can help control risky situations to either reduce the likelihood that a risk occurs, or minimize the negative consequences if it actually occurs.



Obtain Renovator's Insurance

You have insurance for your car, for your health, maybe even for your life, so you better have insurance for your rehab houses. You need to acquire insurance the day that you close on the property, and not a second later. When you obtain insurance, you want to cover the amount of money that at any given time you will have in the project. That means not only what you purchased the property for, but also the renovations you plan to put into the property. A vacant building requires a special policy, which should be purchased in two parts. The first part covers the property building itself (**builder's risk and vacant dwelling**), while the second provides premises liability coverage for bodily injury (**liability**).

Builder's Risk & Vacant Dwelling

Builder's risk covers threats such as fire, wind, theft, and vandalism and others. If a fire starts and no other insurance comes into play, this aspect of your policy will supply your money and your "replacement value." For example, if an electrician accidentally caught the house on fire, it burned down, and their insurance did not kick in, then your Builder's Risk and Vacant Dwelling policy would pay you for the replacement cost of the structure. It is important to note that this policy typically does not cover things such as earthquake, flood, or wind damage in beach zones unless the policy has been specifically endorsed to do so. So if you are renovating a property that is in an area with these additional threats, speak with your insurance provider about adding special coverage.

Helpful Tip!

Insurance companies will always look for a reason not to pay. Don't try to save money by only acquiring a rental policy. If anything were to happen to the house, the insurance adjuster will investigate and clearly see that it is a vacant dwelling.

These policies are designed specifically to cover risks to properties while a construction or renovation project is underway. Underwriters are well aware that there's no one necessarily living on the premises 24 hours a day – and they are also aware that there will sometimes be construction supplies and materials stored on site. They therefore design their policies and set premium levels with these factors in mind.

Liability

Let's face it; your rehab projects are in a neighborhood and those neighborhoods host a lot of other people. Those other people may wander onto your property at any given time, and when they do, they can hurt themselves. These policies will cover you if little Johnny were to jump over the fence on to your property and get hurt at no fault of your own. Keep in mind that if your contractor cuts his hand, this policy does not apply. Contractors are to have their own insurance policy, which we'll get into later.

These particular insurance policies are unique. They are categorized in the "**excess surplus market**" of insurance; therefore, the main carriers may not insure a house for renovations. To learn more about how to obtain this insurance, visit the website at:

www.FBRealEstateInsurance.com

Here are some other key things that you need to know about these policies:

- They are more expensive because of the high risk involved.
- Some require a minimum, meaning you will have to pay for x amount of time (often 6 months), even if you won't be there that long.
- Other policies offer month-to-month rates, or what's called "pro-rata" where you can cancel the policy if you end your renovations early.
- Some policies do not include theft or vandalism coverage, but it can be added.
- A builder's risk policy is designed to cover properties ONLY while under construction. Make sure to add the vacant dwelling policy to the builders risk insurance as well.

While you should always have insurance in case the unforeseen happens, you can lessen your chances of ever dealing with the insurance company by doing your best to prevent injuries on your properties. Protect yourself by having large and clear warning signs everywhere. If there's an open trench in the front of the yard, your contractors should be blocking it off. If you notice there are children directly next door, you may even want to consider introducing yourself to the parents and asking them to please make sure that the children stay clear.

Helpful Tip!

Even if you are only having a property for a week or a few days, you should still acquire insurance. You never know when a problem is going to happen. You may have to pay for a full month of insurance, but it will be well worth it.

Protecting Your Lenders

You aren't the only one who needs protection here. Your most vital asset needs protection too, your lender. The lender or mortgagee becomes what is called a "Loss Payee." A Loss Payee is the first person(s) who receives payment made under the policy in relation to a claim or loss. That means they will be paid before you.

For example, assume that you own a property for which "X Bank" is the mortgagee. A fire occurs and a claim is filed for the damage, which is estimated to be at $75,000. When the insurance company releases the $75,000 claim check, it should be made out to both you (the name insured policy owner) as well as the bank (as the mortgagee and loss payee). This means that X Bank must verify the claim and then endorse the check over to you before it may be cashed.

Remember!

Insurance companies will always look for a reason not to pay. Don't try to save money by only acquiring a rental policy. If anything were to happen to the house, the insurance adjuster will investigate and clearly see that it is a vacant dwelling.

Secure Your Property

Even if you have all of the necessary insurance, leaving a property unsecured is a risk you do not want to take. Since your hands are not the only ones on the project, you'll need to take the proper precautions. We all want to believe that everyone we work with and the neighborhood we work in is trustworthy and safe; however, sometimes it's just not the case. Furthermore, vandalism and copper theft have become huge problems. Copper thieves and vandals prey on vacant houses because they are easy targets. Don't let your vacant house be an easy target.

The key to avoiding theft is to make it sound and look as if you are home all of the time. Making it look as if you are home is a lot easier than you think. If you've seen the movie Home Alone, you can really understand just how creative you can actually get.

Here are five tips to help you secure your property:

1. Install Security Systems

While you are more than welcome to purchase and install real security cameras, we've found that using fake ones also work. To make it appear as if you constantly have eyes on the property, set up fake cameras. These cameras have lights on them and are often battery powered. You can put them around the property where people can see them. At the end of the day, they do not do any recording. They are simply meant to deter.

If you want an actual alarm system, it is possible to install a portable one. These portable alarm systems do have more of a cost than most other options, however they are very good for those seeking the ultimate peace of mind. There are affordable introductory prices offered that you can sign up for monthly monitoring.

Helpful Tip!

Double-check to make sure you are able to get a month-to-month contract with an alarm subscription. Many services will require you to sign up for a full year of service.

2. Create Noise

If you really want to fool someone into thinking that you have workers on site 24/7, try leaving the radio on. This noise from the music will deter most thieves who are just curious if the house is vacant. Just don't leave the radio on too loud. You don't want to disturb the neighbors. If you are in very "active" neighborhood, you may want to consider asking your contractor to leave his dog in the house overnight. It goes without saying that in this case, you would want a dog with a nastier reputation than a teacup Chihuahua. The sound of their bark should deter all other common thieves looking to pull parts for cash.

3. Light Up the Darkness

The most important tool at your disposal is lighting. It sounds simple, but a lot of people don't do it. Put a dusk to dawn flood light on the back of the house and front of the house so as soon as it gets dark, the house is lit up like Yankee stadium. It's also a good idea to put a few lights on in the house as well. Try to put them on in different rooms and set up timers so the neighborhood is not sure if the house is actually vacant or not.

4. Change the Locks

Always make sure to change the locks the first day you own the property. You never know who still has a set of keys. Once you do that, have the property on a lockbox so that tradesman can come and go freely. As you near completion, remember that you have more and more finished materials and valuables in the house that you need to secure and protect. Once the carpenter, plumber, electrician, and HVAC have dropped their fixtures and completed the house, change the lockbox code so only you and your selling team has access to the house. This eliminates too many bodies going in and out of the house that could walk off with valuables.

5. Put Up Signs

If you want an even more affordable option than installing security systems, you can simply put up signs to give the appearance that alarm systems are in place, even if they aren't. The same thing holds true for the dog we talked about earlier. If you don't have a dog you want to leave behind, try just putting up a "Beware of Dog" sign to deter any unwanted visitors.

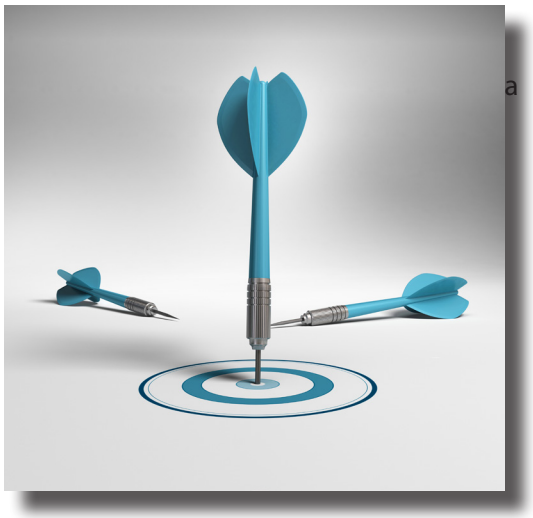
Educate Your Team

You can take all of the precautions that you can to mitigate risk, but if your team doesn't take these things seriously, your efforts will fall short. This all starts with the hiring process. With each and every contractor you pull on board with you, you will need to go over job site safety. This means roping off areas that can be dangerous, putting up signs, cleaning up after themselves, and even taking their expensive tools home with them. Contactors' equipment and tools typically aren't covered by the owner's Builder's Risk policy and these risks will usually require separate coverage.

The best way to play it safe is to keep the valuables out of the property at all times. Don't give the thieves anything to steal, meaning don't have anything on the jobsite for longer than you need. If you have something in the house you're going to install, make sure that your contractor is going to install it that day. Don't leave things loose in the house that can easily grow legs and walk off. Understand that you should not put your appliances in until the very last day before you're going to show your house. This is especially true for the rougher neighborhoods.

Taking the Target Off Your Back

Know that once you start making more and more money, you will become a bigger target for lawsuits. It is just how the world works. Why place a target on your back if you don't have to? There are few precautionary measures that you can and should take before you dive into your rehab projects.



Limited Liability Company (LLC)

In order for asset protection to actually exist, we must use a land trust in conjunction with an entity that provides asset protection. Investors are encouraged to use the Limited Liability Company (LLC) as a beneficiary to their Land Trusts. It is important for any real estate investor to know that incorporating your business is one of the best ways to protect yourself from personal liability. Achieving asset protection through anonymity with the land trust is fairly simple. After you have filed the deed and the title has vested in the trustee, you as the beneficiary will have the right (in most instances) to transfer your beneficial interest in the trust. This is where the LLC comes into play. You then complete an assignment form and transfer your interest directly to the LLC. It is also important to have the LLC accept the assignment of interest. After this has occurred, the LLC becomes the owner of the beneficial interest.

Once this is in place, if something were to happen to the property, the liability exposure will be contained within the LLC. This containment will help to protect you from personal liability. In some states, like Nevada, you can even obtain asset protection from a personal suit. Most courts will respect the nature of the LLC and not allow a judgment creditor to hurt the LLC and attach assets for an unrelated harm.

Land Trusts

There are too many real estate investors out there with properties titled in their own name. Even if you only own one investment property, just don't do it. Real estate is very public, and ownership is public record for anyone to view online. Land trusts are a very powerful tool for the savvy real estate investor. A land trust is a revocable living trust used specifically for holding title to real estate. Land trusts are typically used to house rental properties; it's rare that they are used for rehab projects. The cornerstone of asset protection is financial privacy. Trusts provide privacy by taking ownership of assets out of your name (or preventing them from going into your name to begin with) and keeping you out of the "public eye." If someone does get a judgment against you, they may not be able to levy against your trust.

Make sure you place each parcel of property in a separate land trust. The easiest way to do this is to name each trust after the property address. For example, 222 Main Street Trust. This makes is so that when someone searches for the owner of the property, your name is nowhere to be found. Also, if you put each property into a separate trust, the cluster of properties you own will not show either.

The Trustee

A land trust has a beneficiary and a trustee. The beneficiary is the owner of the property – you, and the trustee is like the manager of the trust. Keep in mind that the name of the trustee is a matter of public record and the beneficiary is not. But in a deposition, the trustee could be forced to disclose the beneficiary's name – unless the trustee is an attorney. In that case, the trustee can claim attorney-client privilege – and most likely keep your name out of it.

What Do Land Trusts Do?

Land trusts can do a lot for you as an investor, but when it comes to avoiding risk, the most important thing they do is discourage litigation. Let's face it; in most cases, people tend to only sue others who appear to have money. Attorneys who work on contingency are only likely to take cases that they can not only win, but also collect being that their fee is based on collection. If your properties are hard to find, you will appear "broke" and less worth suing. Even if a potential plaintiff thinks you have assets, the difficult prospect of finding and attaching these assets will discourage litigation against you.

Verifying Contractor Insurance

While it's true that you yourself will need to obtain insurance policies, that doesn't mean that the people you work with don't need protection as well. That is why one of the most crucial questions you have to ask every contractor that you hire is whether or not they carry liability insurance and provide workers compensation insurance. Working with a contractor who doesn't have insurance is a liability for you. Any damage or injuries that happen on the job site will be your problem if you are hasty enough to work with an uninsured contractor.

To avoid any lawsuits on your hands, you have two options: either you acquire workers compensation insurance or you require that your contractor acquire workers compensation insurance to cover himself and his team. There are actually certain laws and circumstances that may even require that your contractor cover his employees with workers compensation.

Your Contractor MUST Provide You With:

1. Proof of Liability Insurance
2. Proof of Workers Compensation Insurance
3. Certificate of Insurance from their carrier adding you as additional insured with the project address

Insurance Indemnification Agreements

Part of the critical documents that you work with when hiring contracts is a document that clearly states the insurance requirements needed by the contractor. This information should have already been outlined in the Independent Contractor Agreement, however it is prudent to have a contractor acknowledge this multiple times and put in writing that they will meet our insurance requirements and keep their insurance current throughout the duration of the job. Contractors should ideally have a minimum of $1 million in liability insurance. This Indemnification form is in addition to the documents that they will need to supply to you.

Proof of Insurance

You must immediately obtain the certificate of insurance from the contractor's company and put this in your file right away as one of your critical documents. This is not a hard thing to do for the contractor so do not let them tell you otherwise. If your contractor has subcontractors performing the improvements to the home, make sure you get a Certificate of Insurance showing adequate limits of liability and workers compensation. When you do receive this certificate of insurance, call the insurance company and verify that the policy is still active.

Example:

INDEMNIFICATION, HOLD HARMLESS & INSURANCE AGREEMENT

A. INDEMNIFICATION AND HOLD HARMLESS

To the fullest extend permitted by law, ***Contractors Name Here*** (Contractor) agrees to defend, indemnify and hold harmless ***Investors Name Here*** (Owner), its/their officers, directors, agents and employees from and against any and all claims, suits, liens, judgments, damages, losses and expenses including reasonable legal fees and costs arising in whole or in part and in any manner from acts, omissions, breach or default of Contractor, in connection with performance of any work by Contractor, its officers, directors, agents, employees and subcontractors.

B. INSURANCE

- Contractor hereby agrees that it will obtain and keep in force an insurance policy/policies to cover its liability hereunder and to defend and save harmless Owner in the minimum amounts of $1,000,000 per occurrence (or another appropriate agreed upon amount) for personal injury, bodily injury and property damage.
- Said Liability policies shall name Owner as additional insured and shall be primary to any other insurance policies.
- Contractor will obtain and keep in force Workers Compensation insurance including Employers Liability to the full statutory limits.
- Contractor shall furnish to the Owner certificates of insurance evidencing that the aforesaid insurance coverage is in force.

Project Location/Address: ***Property Address Here***
Contractor: ***Contractors Name Here***

Authorized Signature: _____ Date _____

Helpful Tip!

Always get the certificate directly from the insurance agency of the subcontractors and always do so before work starts.

More on Worker's Compensation

In most states, if even a part-time employee is injured at the workplace or while performing his or her duties (such as inspecting property, meeting with tenants, or performing remodeling tasks), the employer is 100% responsible for all of that individual's medical bills relating to the injury, for the rest of that person's life, whether it's 10 days or 10 years.

If one of your employees is injured on the job and you do not have worker's compensation coverage, you are 100% responsible for all of the associated medical bills relating to that injury, including follow-up surgeries or therapy occurring years into the future but still related to the original injury. By purchasing worker's compensation insurance, you are protecting yourself from these worries. Worker's compensation will drastically reduce the chance of you ever having to face financial responsibility for medical bills, future lost earnings, and other costs. In addition, the employee cannot come back and sue you or your business later on as they are legally forbidden to do so.

Helpful Tip!

It is important to require lien waivers from all laborers and material suppliers on any job.

Wrap Up

#1

Assess Risk

Take a step back and realize the risks you are taking when operating a rehab business. Create a risk management system to control these risks.

REHAB RISK MANAGEMENT

#3

Take the Target Off Your Back

Don't allow yourself to be a target for lawsuits. Use land trusts in conjunction with an LLC and make sure that your contractors are covering their own backs.

#2

Control Risk

Put all of the necessary pieces in place to mitigate risk including insurance and security systems.

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