

Stored Materials Payments

Why is it Necessary?

What are the Risks for the Players?

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My old lawn mower gave up last week and I bought a new one, nice and shiny with large wheels and plenty of power. I'm sure my neighbor wishes he had one just like it. Since it was too large for my car, I had the store deliver it to my driveway in time for all my weekend chores.

We have been representing Equity Investors over the last few years providing various related due diligence services associated with real estate developments. With some of these projects we have experienced some difficulties in helping our clients establish reasonable policies as to the issue of 'Stored Materials Payments'. We trust this information will be helpful to you in 'getting through the long grass' by establishing reasonable and workable policies related to paying for 'Stored Construction Materials' and reaching consensus in the pre-loan closing agreements with all the involved parties.

What does the term 'Stored Materials Payments' mean and what are the basic risks for all of the players involved? Think of the issue similar to my new mower. I paid cash for it and would like to keep it for the foreseeable future so I store it under lock and key in the storage shed vs. outside in the back yard. The shed protects the shiny paint from weather or theft by unknown persons. The shed also protects it from my neighbor's dog who likes my yard better than his owner's (I call him vandal and he seems to like it since he keeps coming back).

This article will review our experience with this important payment and risk event that occurs on many real estate development projects over some months and can become a hotly debated matter very early in the construction phase.

In our work representing Equity Investors associated with real estate developments, we provide a range of due diligence services over the life of the project. On most projects we attend the monthly so-called *Monthly DRAW Inspection Meeting*. At this meeting we usually join the lender's inspector, developer partner and General Contractor (GC) to conduct a two step process. First, the team walks the project site to observe actual construction progress in the field and then we review the Contractor's Monthly Request for Payment. This request for payment is supported by detailed information contained on the AIA G702-703 document (see my related article on the '*Ins and Outs of Paying for Construction Work. What is the AIA G702/703?*' related to this industry standard document) and the team needs to confirm that the GC has not projected work to be

accomplished ahead of what was actually delivered by the GC's subcontractors prior to the day of the inspection.

In general, one traditional approach to manage risk during a construction project is to only pay for such materials when it has been successfully installed in place as specified in the 'approved plans' (see my related article on *What are Approved Plans? and When are They Available?*). This resolves many questions and concerns attached to paying for 'Stored Materials' since it is easy to observe if the specified work has been delivered as promised and other parties can document or certify such completion (the Architect or Engineer can and should also be held responsible for providing progressive inspections of completed work and certifying the Monthly Contractor's Request for Payment). It is also true, at the point the materials are installed it is much more difficult for them to disappear after payment is made.

We find that if the lender's Building Loan Agreement, the Developer-Equity Partner's Agreement, the Construction Agreement and related Subcontractor Agreements have not set forth clear and uniform terms on the issue of paying for Stored Materials, the borrower and the GC can have serious dispute as to the expected payment policy. If this dispute is not resolved quickly, the project's schedule can be seriously impacted, which in turn impacts overall 'General Condition' costs, project budgets and delaying other critical work by other project actors including marketing, sales and property management activities.

When I purchased my new lawn mower, I paid cash. However, in many development projects it is necessary for the GC to begin ordering all of the long lead materials, equipment or entire building components to ensure timely fabrication and future deliveries to the construction site so the overall 'flow and sequence' of construction by all of the subcontractors occurs in an organized and efficient manner.

When ordering these long lead supplies, two issues can occur related to the monthly request for payment. First, the GC may request reimbursement for any deposit payment he made to the manufacturer or fabricator. Second, he may request payment for the supplies as they arrive at the warehouse or site called 'Stored Materials Payments'. If the supplies are received at the subcontractor's warehouse, i.e., in the same town as the construction site, it is called 'Off-Site Stored Materials'. If shipped directly to the site, it is called 'On-Site Stored Materials'.



On-site Stored Materials – brick in the foreground, fabricated Wood trusses for multi-family housing project; brick is Generic – floor trusses are a more unique product for this specific project, total supply of both materials will not be installed within next (30) days of construction.



On-site Stored Materials – windows stored under cover but inadequately protected and stacked, racking of frames is judged to be highly likely by time of installation, storage methods and interior environmental condition was found to not meet Manufacturers requirements – payment was not approved.

A third example is associated with, say, pre-cast architectural or structural concrete products manufactured at the pre-cast plant and then temporarily stored in the pre-cast plant yard a few months prior to shipping to the site for erection. The pre-cast manufacturer usually needs some progress payments since some or most of the pre-cast components have been manufactured and therefore the pre-cast company has paid for all of the material and overhead costs and now expects payment prior to shipping to the site. Since we are located in the northeast, this manufacturing plant can be located in Canada thereby involving additional issues of cross border shipping and out-of-country storage and transit liability and documentation concerns.

Another contemporary example is shipping kitchen-bath vanity stone counters from China or Italy using US coastal ports and involving the ‘clearing of customs’ procedures and time lines. When I paid cash for my lawn mower, I trusted the store manager to deliver the mower to my driveway and not to sell it to someone else after I left the store, willing to pay more or to ‘go out of business’ and run for the hills before he delivered my paid for lawn mower. I also expected that when he delivered the mower, it would start – something he promised on the first or second pull of the cord.



On-site Stored Materials – Doors + Frames, well organized, properly stacked and supported and stored under cover well protected from weather and vandal exposure



On-site Stored Materials – fabricated stone kitchen and bath countertops, well organized, stored under cover well protected from weather and vandal exposure

Further, there is usually precious little temporary storage space at the site so the pre-cast components are shipped on an ‘as needed’ or ‘just-in-time’ schedule from the plant and usually ‘fly’ right off the truck trailer into erection. This erection cycle on a good size garage structure can last one to three months after an equally long fabrication period. This is only possible if the GC, erector and pre-cast manufacturing company have a working business relationship, trust that payments will be made without unreasonable risk to each of the parties and provide suitable cash flow to maintain operations. There is some tradeoff between each company’s investment of working capital and final price by the developer for the overall project, therefore, ‘Stored Materials Payments’ can be seen as a factor considered in the construction estimating, establishing hard budget and negotiating construction agreement steps.



Off-site stored Materials – Architectural Precast Concrete + Face brick panel ready for shipment and erection, however, Construction at site is not ready for erection phases



Off-site Stored Structural Precast Concrete Garage Floor ‘Twin-tee’s’ stock-piped at plant yard ready for shipment and erection

In the multifamily industry there is also a special situation related to payment of deposits and off-site stored materials payments, this situation occurs when the developer proposes to use off-site fabricated modular housing.

In general, this approach transfers most of the work from the site to an interior working environmental in a factory. The housing ‘boxes’ are constructed using ‘assembly line techniques’ not unlike that used by the automobile industry.

It is our experience that these factories may be located some distance from the site and some supplying the northeastern part of the country are located in Canada. They usually request a major down payment or deposit prior to ordering materials and starting production. Another major payment is usually requested prior to shipment of the ‘boxes’ to the site for erection.

It is important to understand that each modular ‘box’ is unique to each project and to each apartment or Condo unit type within the project (it may require more than one box to assemble each unit in the building).

Use of modular fabricated and site erected methods can provide compressed site construction periods and reduced construction costs but there are risks related to the deposit and pre-shipment payment and this type of off-site stored materials payments need special consideration and procedures.



View of modular housing construction using assembly line techniques to fabricate each 'box'; each station along the assembly line uses workmen trained in each step of the fabrication and also uses 'just-in-time' materials and building components to supply the production line. The construction work takes place within a large 'heated and weather protected' building. After each box is completed it is wrapped in weather protecting plastic sheets and moved into temporary storage in the factory yard.

Another factor impacting payment policy relates to so-called 'Furnish Only' vendors and related 'Installing Vendors'. In most projects the GC will need to obtain some materials from vendors who only supply the materials and do not also provide trained crews to install their products or materials. An example would be kitchen cabinets or door hardware. The manufacturer is only in the business of manufacturing and delivers FOB (Freight-on-board) to a warehouse or to the site, other subcontractor crews then must be retained to unload, inventory and install the materials. A similar example would be the bath plumbing fixtures; the plumber may have been hired to both supply the fixtures and install them or with some residential projects. We have experienced that the developer has a national purchase account with the plumbing manufacturer and only hires local plumbing trades to install the fixtures since the developer feels he can buy at a discount not available to the local plumber.

It has been our experience that lenders can approve payment for 'Furnish Only' materials stored at the site, but not yet installed, with less concern than that reasonable from an equity partner's perspective.

It is clear then that any standard policy construct as to payment for 'Stored Materials' must be established and applied to each proposed development project with consideration of the team's capabilities, type of building as to the probability that 'Stored Materials' payment will be requested or be necessary to support the orderly supply of products and as to the combined lender's, developer's and equity partner's objectives as to 'Risk Management'.



On-site Stored Materials under carport behind temporary fencing; crates of fabricated kitchen & bath vanity stone countertops, material will not be installed within next (30) days but order is reported by Contractor to be complete & adequate.



On-site Stored Materials banded and partially protected sheets of OSB-subflooring for multi-family housing project, bottom of pile is only supported off crushed stone using 2x4 wood studs – any localized standing water will be ‘wicked’ into sub-flooring sheets

Since our work is usually on behalf of the equity partner, we advise our clients to start with the following policy and to only ‘give up or trade-off’ aspects of the overall policy to reach team wide consensus with full understanding of the possible impact on their own ‘Risk Management’ objectives.



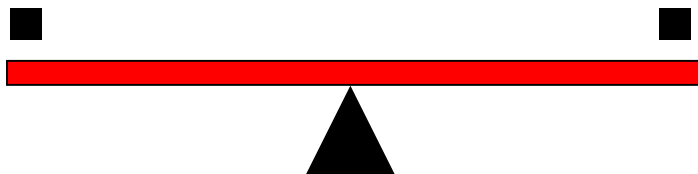
On-site Stored Materials – fabricated metal bath and kitchen exhaust ductwork – generic ductwork is piled on earth under cover in future parking garage located under new multi-family housing structure.



On-site Stored Materials – generic non-fabricated millwork running trim stock stored in subcontractor’s trailer parked on construction site – how easy is it to take trailer off-site?

Need for Adequate Construction Materials, Products & Equipment in a Timely Schedule to Ensure Proper Sequence of Construction and to Procure Materials at Best Price

‘Trade-off’ Between Reasonable Risk with Contractor’s Needs?



Suggested Policy:

- 1: Stored Materials policy and terms to be contained uniformly in the 'Building Loan Agreement' between Lender and Borrower, in the 'Partnership Agreement' between developer and equity partner, in the 'Construction Agreement' between Owner-General Contractor (GC), and all Subcontractor Agreements between CG and its Subcontractors and suppliers.
- 2: In establishing this general policy for each project, request and obtain prior to closing specific estimates from Developer and its proposed General Contractor as to what payments will be requested on a monthly DRAW schedule as to requested 'Stored Materials' as to expected stored location, vendor names, payment amounts, trades, materials, building components, equipment and obtain prior to loan closing review and approval of the proposed list from the lender's Construction Inspector as to its evaluation of the Contractor's estimates as to suitability and necessity for the proposed project.
- 3: Any and all insurance provided related to 'Stored Materials' must list the equity partner as Additional Ensured (lender and owner will also have their own requirements for the same).
- 4: We have also found it very useful to review the final policy with the Developer and GC in the 'Equity Construction Consultant's Construction Phase Kick-off Meeting'. This 'Kick-off Meeting' should occur in the first week or two after the GC enters the site to start construction; the lender's Construction Consultant should be invited to this meeting.

ON-SITE STORED MATERIALS:

>Material must be stored in a secure location that protects the material from the negative effects of weather, humidity, damp or wet floors and like conditions and must be supported, piled or arranged as set forth in manufacturer's printed recommendations or warranty requirements or as set forth in any related ASTM Standards. GC to provide all background information necessary to document it has identified all such standards and requirements and has followed such – in some cases it is helpful if the GC provides record photographs.

>Printed material inventory log must be provided by Owner and/or GC recording that it has inspected and verified material meets specified quality and quantity. In some cases the Owner's Architect-Engineer should also provide evaluation. If so, Architect-Engineer may find that it will limit its verification since the material, products or equipment has not been installed and combined with other materials, products or equipment necessary to demonstrate that the entire assembly or component is in working condition.

Stored materials must be clearly labeled in a manner that identifies the component using as much as possible information from the 'Approved Plans'.

>GC to provide Bill-of-Sale assigned to Owner; (very often vendor will issue Bill-of-Sale to GC, however, since the Owner is making partial payment for material its needs to obtain sufficient ownership reflecting value of payment).

>GC to provide Insurance Certificate including coverage for vandalism and/or weather damage, and theft unless covered by other project insurance.

>Payment to meet only material uninstalled value, portion necessary to pay for installation, some General Conditions expenses and final installed warranty costs shall not be included in 'Stored Materials' value calculation (in some case the SCHEDULED VALUE of the material in the original AI G702-703 may have been for the installed condition and was not broken-down into a material only value plus installing value).

>Material being paid for must be incorporated into the specified construction within next (30) days (this period can be the subject of debate; the (30) day period is to ensure that material is not delivered and stored too soon on to the site for reasons not really related to good and necessary organization of the construction; in some unique case (30) days may not be enough time but in general we feel good equity partner 'Risk Management' considerations dictates that if the GC finds it must order and store materials for a longer period it take the risk including any shelf-life period).

OFF-SITE STORED MATERIALS:

Same as for On-site Stored Materials above with the following additions:

► All stored materials must meet 'Industry Standards for Bonded Storage', this includes segregated storage so materials can be easily viewed and inspected by Owner-Architect-Engineer and/or GC personnel and to protect the Owner should manufacturer declare bankruptcy after payment as to owner entering property and obtaining its paid for materials.

► In the case of off-site-stored materials, cost of possible repairs necessary after payment and possible transit and erection damage need to be retained by Owner. Retainage requirements should be higher for Off-site Stored Materials than for incorporated work. For example, if the retainage requirement is 10% for incorporated work, it should be, say, 20% for Off-Site Stored Materials. Payment for materials located out of the US should normally not be provided.

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¹ This ‘Suggested Policy’ is provided here in support of this article, to demonstrate the issues and as a general educational tool as to Construction Industry practices as we understand them, we are not lawyers and do not provide legal advice; we have mentioned in the text, that each project has unique factors that needs consideration and this information is therefore only provided as a general guideline. If you use some or all of these suggestions, we only agree to their use with the understanding that you have provided, by such use, suitable release of responsibility of any claims made by you or others for any negative impacts or resulting disputes.