Are You Supplying Goods or Services? The Latest from the Michigan Court of Appeals

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The legal analysis of a contract claim often begins with a non-obvious question – does the contract involve goods or services? The question matters because important differences exist between the law of contracts for goods (Article 2 of the Uniform Commercial Code) and services (common law), such as differences in battle of the forms, statute of limitations and implied warranties.

In most cases, the answer is obvious -- if you sell a bolt, you are selling goods, because bolts can be moved, and that is the definition of a "good" under the UCC. But, what if you are in the business of electroplating bolts? Are you selling electroplating services which incidentally involves the use of electroplating materials, or are you selling electroplating materials which incidentally involves the service of applying the materials?

That is the question that the Michigan Court of Appeals recently addressed in the case of *Challenge Mfg. Co. v. MetoKote Corporation*. The Court held that, at least on the facts presented there, electroplating is a service, not a good. It thus reversed the lower (trial) court decision, which held that it was a sale of goods, and thus subject to the UCC. (Readers with a long memory may recall an earlier Client Alert from March 2021, which discussed that now reversed lower court decision). The Court of Appeals' decision is especially important because it is a "Published" opinion, meaning that it is binding on all other Michigan state courts, unless and until the Michigan Supreme Court decides differently. It is also very likely to be followed by federal courts applying Michigan law.

This Alert will outline the reasoning of the Court of Appeals and then provide potential responses to the new decision.

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Why did the Court find that Electroplating was a Service?

In Michigan, the question of whether the law of goods or services applies in "mixed transaction" is traditionally decided under the "predominant factor" test, i.e., whether the acquisition of goods is the buyer's primary purpose or "ultimate goal," with related services incidental, or vice versa. But "predominant purpose" provides, at most, a conceptual framework, not clear answers in hard cases. As a result, there is an extensive body of case law answering the "predominant purpose" question through a highly fact-specific analysis that does not yield rules that are readily applied to the next case.

The facts in *Challenge Machinery* are that MetoKote took possession of parts (plenums) manufactured by Challenge, applied an "off-the shelf" coating, and then returned the coated parts to Challenge, charging a per-piece fee, rather than purchasing and reselling the parts. In concluding that the predominant purpose of the transaction was services, not goods, the Court pointed to three factors [numbers inserted in quotation]:

> *[1] Challenge was not concerned with the ingredients used in the coating or the coating process, as long as the coatings met GM's specifications. . . . [2] MetoKote only had one type of e-coat material, which . . . [it] did not formulate . . . or alter the material . . . on the basis of customer specifications. Application of the e-coating constituted an extensive process with more than 20 steps. . . . [3] The pricing was calculated per plenum. There were not separate charges for the material and labor.*

The first factor does not appear to be particularly helpful in distinguishing goods from services. It can probably fairly be said that in most automotive supply chain transactions, the "primary purpose" of an intermediate tier buyer is to meet its customer's specifications. In any case, it is not clear why that purpose favors characterizing the transaction as services, rather than goods. It may be true that "Challenge was not concerned with the ingredients used in the coating . . . , as long as the coatings met GM's specifications," but it would seemingly be equally true that Challenge didn't care what techniques were used to apply the materials so long as the finished part met GM's specifications.

The second factor – that MetoKote used an "off-the-shelf" chemical, but a complex methodology for applying it, is more helpful. The Court seems to have concluded that the principal value MetoKote provided was its skill in application, not its skill in making coating materials. Supporting this interpretation, the Court distinguished an earlier case on the ground that seller there used "proprietary coatings . . . [that were] sought by its customers."

The third factor – that pricing for the coating material was not unbundled from the coating services - is difficult to interpret. The Court might mean that if the price was unbundled, there might be two contracts: one for goods and one for services. But that would be contrary to a substantial body of law rejecting the argument that, for example, if the part corroded, the applicable law would differ depending on whether the problem was with the materials or their application. The Court might also mean that the relative cost or price of the materials and the application services was relevant to whether the predominant purpose of the transaction was goods or services. But it is not obvious why

that assessment requires that the respective costs or prices be separately itemized. That assessment is a fact question that is routinely answered in the industry without need for itemization in the contract or invoice. There might even be piece cost breakdowns that were exchanged or created and, if not, in many cases the seller will have cost-accounting information sufficient to the task. In sum, the lack of itemization appears to have been important to the court, but it is not clear why.

Practical Advice

The *Challenge Manufacturing* decision provides useful guidance, but it may not provide clear answers if the facts vary even modestly. Moreover, even if it yielded clear answers, there might be reasons that either the buyer or the seller prefers that either the UCC or the common-law apply. As is usually the case, the best way for contracting parties to avoid legal uncertainty is to expressly answer the question in the contract. Don't leave it to a court to decide (and attorneys to argue about) the question.

As to whether the UCC or common law is substantively preferable (i.e., will give the answer you prefer), that requires careful consideration of the nature and risks of the transaction. It is not as simple as the UCC is better (or worse) for buyers. Instead, real analysis, with the assistance of counsel, is required.

Finally, the goods or services issue again illustrates that time spent upfront at the contracting stage is generally time and money well spent, as compared to waiting for litigation to answer important questions.

For further information about these issues, please contact the authors of this Client Alert.

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