Unilateral and unjustified termination of a license and supply agreement for medicinal products

Judgement of the Provincial Court of Madrid, of 17 December 2014, No 438/2014

Background

In 2008 two pharmaceutical companies signed a license and supply agreement for medicinal products, according to which the licensee assumed the obligation to purchase the product exclusively from the licensor for a period of 5 years. Furthermore, a penalty clause was included, according to which in case the licensee purchased the medicinal product from other suppliers the licensor would be entitled to request a compensation representing 100% of the value of the product not acquired from licensor.

Two years later, the licensee placed several orders for medicinal products from a third party and informed the licensor of its intention to terminate the contract. The licensor brought a lawsuit against the licensee requesting the corresponding compensation. The Court of First Instance ruled that the licensee had breached the contract and sentenced it to pay a fine of 1 million €, calculated according to the referred penalty clause, decision that was later confirmed by the Provincial Court.

Principle of relativity of contracts

The licensee claimed that it was entitled to freely terminate the contract arguing that when entering into the supply agreement the former shareholders of the licensee, who were engaged in the process of selling the company to a new owner, committed themselves to modify the license and supply agreements signed by the licensee in order to obtain a right of unilateral withdrawal in favor of the licensee. The Provincial Court understood that the "principle of relativity" of contracts should be applied. According to this Principle, contracts are only effective between the parties. The Court said that according to this principle, the former shareholders of the licensee cannot be asked to modify the terms of the license and supply agreement, as it is a different contract in which they were not a party. Moreover, the licensor was completely alien to this agreement between the shareholders sellers and the purchasers of shares from the licensee, and therefore such agreement could not possibly cause a prejudice to licensor.

Scope of the penalty clause

Alternatively, in case the free termination right was not recognized by the Court, the licensee asked for a reduction of the penalty clause arguing that it was disproportionate. However, the Provincial Court confirmed that violating the duration and exclusivity agreed between the parties are "total breaches" that prevent the penalty clause from being reduced. The Court also rejected the argument of non-proportionality of such clause, because it was freely and voluntarily agreed between the parties, two important companies in the industry under equal conditions.

In short, the judgment is a wake-up call against the temptation to give in to the rush and pressure that usually precede the signing of any contract. Assuming obligations whose content and scope are, sometimes, not entirely clear, could bring unnecessary risks.