



How to avoid the obligation of having to purchase surplus stock under *just in time* manufacturing agreements

Supreme Court Judgment of 5 October 2016

Background

In 1990, two Spanish companies verbally entered into a *just in time* supply agreement, under which the manufacturer was bound to continuously deliver, in very short turnaround times, product orders placed by its client. Twenty-five years later, the client unilaterally terminated the agreement. The manufacturer brought suit, asking for the client to be held liable for paying for the stock that the manufacturer had purchased to fulfil the *just in time* orders and that was no longer usable, in addition to the storage and maintenance costs of said stock.

Judicial Reasoning

The Court of First Instance ruled that, given that the agreement involved a *just in time* manufacturing system, the inherent nature of the agreement implied that the supplier needed to maintain certain stock levels to fulfil the orders of its client. Therefore, although the agreement was verbal and there was no express obligation in that respect, it ruled that the client should pay for the surplus stock upon termination of the agreement. On the other hand, the Court rejected the manufacturer's claim for the client to also cover storage and maintenance costs for said stock. The client appealed before the Court of Appeal, which confirmed the Court's judgment, and thereafter also appealed to the Supreme Court.

In its judgment, the Supreme Court reasserted that *just in time* manufacturing agreements are not subject to specific legislation and are defined by being functionally linked to the product man-

ufacturing and to marketing system, in such a way that the manufacturer assumes the obligation of delivering products in a short period of time, as established in the agreement, or as deemed reasonable according to trade usages in the sector. The Court recognised that, although not agreed in writing, an essential obligation under this type of agreement is that the manufacturer ensures the availability of stock and bears the resulting costs. Whether the client is obliged to purchase the remaining stock at the end of the agreement is a different matter, according to the Court. This is not an essential obligation and, therefore, as no express covenant was in place to this end, an analysis would have to be performed as to whether on the grounds of contractual good faith, this burden should be nevertheless enforced on the client.

As part of its analysis, the Court highlighted the long standing relationship between the parties based on mutual trust and that the client had not communicated its decision to terminate the agreement with reasonable notice. It also took into consideration the manufacturer's dependency on the agreement, as the relationship with the client represented its main source of income. On the basis of the particular circumstances of the case, the Court concluded that it was reasonable for the client to assume responsibility for purchasing the surplus stock.

Based on this judgment, we believe that in order to avoid the risk of having to purchase surplus stock at the end of a *just in time* manufacturing agreement, specific provisions must be set out therein.