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**Position Paper with Draft Provisions
on
Termination of Long Term Contracts for Just Cause**

by

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Contents:

1. Introduction
 2. Definitions
 3. Scope of the Proposed Provisions
 4. Notion of Just Cause
 5. Notice for Terminating the Contract
 6. Effect of Termination
- Appendixes: A. Text of German BGB
 B. Draft provisions
 C. Bibliography

1. INTRODUCTION

During its 29 through 31 May 2006 meeting in Rome, the Working Group debated whether a new provision or set of provisions on the termination of contract for just cause should be introduced in the UNIDROIT Principles on international commercial contracts. There was a consensus for starting work on this topic, notwithstanding the admonition of Members of the Group who were concerned that, should a new provision in this regard appear as a weakening of the principle “pacta sunt servanda”, some practitioners might less willingly make reference to the Principles in international commercial contracts.

In his concluding remarks, the Chairman of the Group presented the following observations:

- a) There appears to be a general interest for this topic
- b) A position paper together with a preliminary draft might be prepared for the next session of the Group
- c) The scope of the proposed provision or provisions should be examined with care
- d) A careful consideration of the notion of just cause is necessary
- e) Particular attention should be devoted to the articulation of the provision on termination for just cause with the already existing provisions on remedy for breach of contract and hardship
- f) The possibility of imposing renegotiation and/or revision of the contract should be discussed together with the remedy of terminating it for just cause.

The following report is to be understood as a short preliminary study of the main issues that are raised by a provision on the termination or revision of contract for just cause without any further discussion of the issue of the adaptation or revision of the contract. Although the existing § 314 BGB (which is reproduced in Annex (A) of the Report) appears to have played an important role in the discussion of the Working Group on the advisability of exploring the possibility to draft a similar provision for the Principles, the Report does not merely propose to take up the German legislative solution. It rather derives from the consideration of cases of diverse countries and arbitral experience a set of independent proposals that are presented as a first draft (see Annex B).

2. DEFINITIONS

As they are used in the present Report and the draft provisions, the following words are defined as below:

- a) *long term contract*: a contract for the performance of a recurring, positive obligation; the definition is not identical with the concept of long term contract as has been used in the comment no. 5 to Article 6.2.2 on hardship, which defines long term contracts as “those where the performance of at least one party extends over a certain period of time”. Terminological harmonization could be sought once the scope of the provisions are better defined.
- b) *termination*: an end to the contract with effects for the future, with no restitution of the payment and no retransfer of goods or services which have already taken place in the performance of the contract
- c) *just cause*: a serious ground for modifying or ending the contractual relationship because the terminating party cannot be expected in justice, equity and good conscience to continue the contractual relationship until the agreed termination date or until the end of a notice period
- d) *compensation*: indemnification of damages includes lost profits
- e) *sphere of risks*: the type of risks that are assumed by one or the other party or parties to the contract under the agreed terms and conditions of the specific contract, including implied terms and conditions.

3. SCOPE OF THE PROPOSED PROVISIONS

A) *Termination for Just Cause as Distinguished from Other Excuses from Performance*

The proposed provisions address extraordinary changes of circumstances which substantially affect a party’s ability (or the ability of several parties to a multilateral agreement such as a joint venture with more than two partners) to continue to perform under an unchanged contract.

The proposed provisions do not collide with the force majeure provision of Article 7.1.7 because the force majeure provision addresses a temporary or definitive *impediment to performance* which could not have been expected at the time of the conclusion of the contract. However, the proposed provisions attempt to harmonize the system of applying the remedy by imposing to serve a notice to the party or parties that are not affected by the change of circumstances just as the provision on force majeure does (Art. 7.1.7 (3)).

The proposed provisions do not collide with the hardship provisions of Article 6.2 ff. because the test for just cause is not whether the performance of the contract becomes *too onerous* in view of the equilibrium of the contract as it is for hardship (see Article 6.2.2), but whether the performance can still be expected from the terminating party in spite of the changed circumstances and without having regard to the value of the performance to be received from the other party.

The proposed provisions do not collide with the initial or subsequent impossibility of the performance which the terminating party is under an obligation to make because the impossibility is seen as an *absolute impossibility of fact or law* to make the performance which is due under the contractual obligation, whereas the termination for just cause is

based on an appraisal of the extraordinary circumstances of the case and a balance between the interests of both or all parties which make of the basically possible performance an intolerable burden for the debtor.

The proposed provisions do not collide with the *contractual provisions* which the parties may have adopted to face the possibility of a change of circumstances, such as the right to terminate the contract in case of a merger of one of the parties with a competitor, the winding up of the joint venture in certain circumstances of fact or law, or the termination on notice of material default. The proposed provisions are not to be seen as yet another remedy for material breach of the contract but as supplementing the common will and intent of the parties in the cases where the terminating party could not take into account the modification of circumstances at the time of the conclusion of the contract. Parties are free to provide that the termination for just cause will be excluded or to provide for other remedies such as renegotiation or judicial adaptation of the contract only within given parameters.

B) Scope of the draft provisions as to the contracts to which they should apply

The long term contracts which are open to a termination for just cause are those which impose an obligation to do something positive, and not those which entail only a duty to abstain from doing something. For example, a 99-year lease on fee is not subject to the termination for just cause under the draft provisions, because on the main it does not entail the duty to perform positive acts. A prohibition of competition during 10 years is not subject to the termination for cause (although in certain jurisdictions it may be deemed in restraint of trade to enforce it in given circumstances, after some years, against former employees).

To the contrary, the primary target of those draft provisions are the agreements that entail positive duties of cooperation between the parties, such as the joint marketing of products or services, the exchange of sensitive information, the opening of the books for checking figures on which royalties must be computed or common efforts of research and development for new products or new processes.

Under some systems of law, those contracts could be characterized as *relational contracts*, because they institute a long term relationship of some degree of trust and confidence between the parties, without evidencing all the characteristics of a partnership or of a fiduciary relationship. In other systems of law, some of those contracts could be termed to be concluded *intuitu personae*, that is concluded in consideration of the person or persons undertaking to perform the positive acts that require mutual confidence and trust. However, it is not necessary to find that a specific confidential relationship has existed under the law applicable, such as is sometimes required for the protection of trade secrets. The finding of a confidential relationship may be subject to particular requirements that are best explained by the equitable remedies that may be available if such a relationship is found to exist, for example the accounting for the profits unduly made by the defendant (as opposed to the profits lost by the claimant which are but an element of his damage). Such stringent tests as are applicable for confidential relationship under the common law of some jurisdictions are not entirely relevant here, although the recognition of those specific relationships is part of the developing body of law on relational contracts.

Further, the contracts that are subject to a termination for cause are those which entail a continuing performance, or a periodical performance, or a repeated performance due after that some time has elapsed since the prior performance. The duration of those contracts cannot be fixed in the absolute by giving a number of years, although it is unlikely that a contract of a duration inferior to three to five years could benefit from the draft provisions. The court or the arbitrator will have to consider the investments that have been made or are still required to be made and the economic risks which have been assumed or should be assumed in the future under the contract the termination for just cause of which is alleged to be admissible.

4. NOTION OF JUST CAUSE

A) General Observation

The draft provision should not be understood as allowing a termination for convenience in case of any change of circumstances, be it ever so slight. Rather, the changed circumstances are *significant changes* that have not been taken into account by the parties when apportioning the risks under the contract at the time of the conclusion of the contract. The change of circumstances is significant when it substantially affects a party's ability to rely on a reciprocal confidence and good faith in the performance of the contractual obligation.

B) Decided Cases of Selected Jurisdictions

The following cases of jurisdictions which already know the termination for just cause best explain the sort of circumstances that may be invoked by the terminating party:

In Switzerland, the loss of mutual trust between the parties to a licensing agreement due to late performance of the inventor who had to reach the industrially mature stage for the invention was considered as a just cause for instant termination of the contract by the licensee.ⁱ

In another case, the Swiss Federal Tribunal found that the sudden dramatic diminution of the financial capacity of a lessee was sufficient for the latter to terminate the lease agreement for just causeⁱⁱ.

In a recent Swiss case, the loss of trust between a lender and the lendee was found to be sufficient for the former to terminate the contract for just cause. The loan was granted without interest because of the close relationship between the partiesⁱⁱⁱ.

The German Supreme Court held that the termination of the main agreement between the principal and the main contractor was a just cause for the latter to terminate the contract with the subcontractors for just cause^{iv}.

In another case, the German Supreme Court stated that not any and every disturbance of the mutual trust is sufficient for a party to terminate the contract for a just cause. The disturbance has to be serious to the extent that the continuation of the contractual relationship until the end of the ordinary period for termination cannot be reasonably expected^v.

According to the case law of the German Supreme Court, the actual risk of imminent insolvency of the borrower constitutes a just cause for the lender instantly to terminate the contract^{vi}.

On the main, the courts recognize as just cause the circumstances which would necessarily entail a loss of the confidence of the terminating party towards the other one when one considers the position of reasonable parties placed in the same situation. This is therefore a more objective test than whether the terminating party did really lose his or her confidence. For example, the case has been cited of one party to an advertising joint venture implying the lease of many billboards placed on public grounds and belonging to townships: when the main foreign partner of the local party was placed under arrest in a third country under suspicion of bribery of public officials of that country, the local partner could legitimately terminate the contract since the continuation of that contract would have ruined the credibility of the joint venture vis-à-vis public authorities. The example shows that the factual basis of the indictment against the foreign partner and his degree of fault were less relevant than the loss of business due to the public opinion.

5. NOTICE FOR TERMINATING THE CONTRACT

A) Purpose of the Notice

The draft provisions require the terminating party to serve a notice of termination. The purpose of that notice is two-fold.

First, it is necessary to put the party against whom the termination is requested on notice that the contract will no longer be performed by the other party. Investments must be avoided in relation with the terminated contract and new investments are to be made in order to seek new business with third parties.

In most cases of breach a contract, a reasonable time limit must be fixed to the breaching party in order to cure the breach. This has been said to be a common principle of European private law, for example in an Award ICC No 4496, Summary by S. Jarvin, in LES Nouvelles 1988, p. 23.

However, the termination for just cause is not a termination for breach. Although the fixing of a time limit to cure the just cause if it is susceptible to be changed by the party against whom the contract is terminated may not harm the terminating party, it should not be seen as a prerequisite for the validity of the notice.

B) Immediate Termination

The case law of several countries admits the immediate termination of the contract when exceptional circumstances justify it. For example, the merger of the licensee with a third party immediately endangers the confidentiality of the licensed technology. No new development should then be disclosed to the licensee and the licensee should, to the extent feasible, give back the information disclosed on paper or software. In exchange, the royalties are no longer due from the date of the terminating notice.

Nevertheless, the necessity of protecting the investments made during the contract may also lead to admit a different solution, with a transitional period allowing the licensee to look for some other licensor or buy some different technology.

Distribution agreements often provide that the distributor should be able to finish selling its inventories even after the termination. Even then, exceptional circumstances can lead to an immediate termination of the contract, for example if the distributor is charged with a criminal indictment relating to the performance of the contract—for instance, forging immatriculation papers for an automobile in order to get a commission for a sale which did not happen in fact.

C) Effects of the Notice

The Principles cannot precisely determine in which case the notice of termination will take effect only after three or six months, and in which case it should have an immediate effect. The mention of immediate effects in extraordinary circumstances should suffice to give guidance to the courts.

The notice for termination is considered as a “constitutive” declaration of will in some systems of law, for example of the Germanic family. Therefore, it might be argued that the serving of one and a sole notice of termination will exhaust the right of the terminating party. No particular wording of the Principles could avoid the arguments that a party may derive from such a characterization of the notice, but it may be useful to put into the commentary that international business usages do know the practice of repeating a notice of termination when the conditions for the exercise of the right to terminate appear doubtful at the time of the first notice, and more certain at the time of the second or a subsequent notice. It might also happen that the first notice is a notice of material default and the second notice a notice of termination for just cause, and this should not impede the court to adjudicate the claims deriving from those different notices each on its merits.

D) Grounds for Termination to be Mentioned in the Notice

The last important issue relating to the notice is whether the terminating party can rely only on the grounds that are mentioned in the notice or on further grounds that would come later to the attention of the terminating party. A distinction has to be drawn between the grounds that could not be known by the terminating party and the grounds which she knew or ought to have known at the time of serving the notice. The necessity to indicate all the grounds known to the terminating party at the time the notice is served derives from the protection of the interests of the party against whom the contract is terminated. That party must be put in the situation to know whether the grounds are serious and can be established in case of a dispute. It might appear to be unfair to allow the terminating party to retain information which is essential to the question whether the contract should continue or not. Similarly, if the terminating party enforces the right to terminate before the courts, it might be unfair against the respondent if the court could accept that the termination is valid because of some other reason or reasons than the ones that were given at the time.

Yet there may be cases in which complete information about the changing circumstances and about the reasons for the disappearance of the reciprocal confidence between the parties is uncovered only after some delay or after discovery. This could be the case, for

example, where a joint venture is undermined by clandestine manoeuvres of a partner, which attempts and succeeds to take an operational controlling majority in the joint company through the interposition of businessmen or business entities. It sometimes happens that only a report by a public authority such as the Security and Exchange Commission will determine who are the real shareholders of the shell entities that were used to acquire the majority. Then, the terminating party, which did not know about the scheme, could later allege it in the proceeding, even if it were not mentioned in the notice for termination.

In this regard, the Principles should not give too many details, as the matter is best left to the courts to consider according to their traditions.

Second, the notice may fix the exact date on which the contract ceased to be binding on the parties, at least for the main obligations. Ancillary obligations such as the duty to keep information confidential, or to refer the case to some alternative dispute resolution may survive the termination. Similarly, assets which were affected to the joint performance of some bilateral or multilateral contracts that are akin to a partnership or a joint venture may have to be liquidated and receivables may have to be cashed or guaranteed, which may last some months or some years. However, unless otherwise provided in the contract, the service of the notice of termination determines until when the profits are to be shared, even if the losses may be apportioned as under the contract after that date.

E) Other Specificities

Some systems of law require a court to decide on the termination, so that the notice has only a declaratory rather than a constitutive effect. Some other systems do not require the intervention of the court to terminate the contract. The notice then creates a new legal situation and all the rules that may be applicable to such a formative act will apply to the notice. For example, it might be maintained that under Swiss law, such unilateral act modifying the legal situation shall be exercised through an irrevocable, unconditional notice. However, it should be admissible to give a notice specifying that the contract will be terminated if certain assurances are not given or certain measures not taken (such as placing the industrial division with which the terminating party is under contract under a different umbrella than the one the merger would appear to entail at first). The UNIDROIT Principles should not take a position in this regard, as international commercial contracts may be subject to a law recognizing the validity of a unilateral termination for cause or to another law, which requires the approbation of the court.

There appears to be a need to specify that the terminating party must react as quickly as possible when the circumstances leading to a possible termination come to his or her knowledge. The terminating party should not speculate to the detriment of the other party with a “wait and see” policy and, at the same time, serve a notice in an attempt at safeguarding his rights. The principle of good faith (Article 1.7) might of course lead to an analogous reasoning, but an express provision would be clearer for all Parties.

A most delicate issue revolves around the time limit to be fixed for the contract to end. The protection of the other party’s expectations might lead in most cases to give a time limit of three months or six months, or even one year in bigger projects. In exceptional circumstances, such as are present in joint ventures for example, the structure of the contract may be such that only certain dates (closing of the accounts) can enter into

consideration. In very particular cases, the termination may be immediate. This might happen when several notices to cure a breach have been served to no avail. The immediate termination then remains the only means to stop a ruinous relationship. The immediate termination will be recognized only where no other solution is thinkable. However, in most cases, an abrupt termination which is justified in its principle but not as taking place immediately will take effect three or six months later, depending on the ordinary provision for termination in the contract itself, which the court will attempt to follow to the extent possible in fact.

6. EFFECT OF TERMINATION

The termination for just cause entails ending of the contractual relationship for the future only. It does not retroact to the time of conclusion of the contract.

The parties are still bound by a duty to liquidate their relationship, for example through disclosure of the relevant accounts and inventory.

It has been adjudicated in several French, U.S. and Swiss cases that the sheer appearance of the existence of a valid patent on the contractual technology was an advantage for the licensee. Thus, the licensor had the right to keep the royalties paid under the contract based on that patent, although it was later found to be invalid, at least until such time as the invalidity became apparent to the parties. In a similar manner, the contract which is terminated for cause has given to the parties a real economic advantage, or at least the position they had bargained for, even if an intervening just cause leads to its end. Therefore those payments which have been received need not be restituted.

The termination of multilateral contracts raises specific questions because the terminating party cannot force the other parties not to continue the contract. The apparent end of a three-partite joint venture can mark the beginning of a two-partite venture, for example. As the assets that are put to work in both consecutive ventures are often the same, the termination of the contract is more in the nature of an exit by one of the partners. Particular rules are proposed to take into account the ensuing difficulties.

ANNEX A: TEXT OF THE GERMAN BGB

§ 314 BGB**Kündigung von Dauerschuldverhältnissen aus wichtigem Grund**

(1) Dauerschuldverhältnisse kann jeder Vertragsteil aus wichtigem Grund ohne Einhaltung einer Kündigungsfrist kündigen. Ein wichtiger Grund liegt vor, wenn dem kündigenden Teil unter Berücksichtigung aller Umstände des Einzelfalls und unter Abwägung der beiderseitigen Interessen die Fortsetzung des Vertragsverhältnisses bis zur vereinbarten Beendigung oder bis zum Ablauf einer Kündigungsfrist nicht zugemutet werden kann.

(2) Besteht der wichtige Grund in der Verletzung einer Pflicht aus dem Vertrag, ist die Kündigung erst nach erfolglosem Ablauf einer zur Abhilfe bestimmten Frist oder nach erfolgloser Abmahnung zulässig. § 323 Abs. 2 findet entsprechende Anwendung.

(3) Der Berechtigte kann nur innerhalb einer angemessenen Frist kündigen, nachdem er vom Kündigungsgrund Kenntnis erlangt hat.

(4) Die Berechtigung, Schadensersatz zu verlangen, wird durch die Kündigung nicht ausgeschlossen.

§ 314 Termination, for just cause, of contracts for the performance of a recurring obligation¹

(1) Either party may terminate a contract for the performance of a recurring obligation on notice with immediate effect if there is just cause for doing so. There is a just cause if, having regard to all the circumstances of the specific case and balancing the interests of both parties, the terminating party cannot reasonably be expected to continue the contractual relationship until the agreed termination date or until the end of a notice period.

(2) If the just cause consists in the infringement of a duty under the contract, the contract may be terminated on notice only after a specified period for remedial action has expired or notice of default has been given to no avail. § 323 (2) applies *mutatis mutandis*.

(3) The person entitled may terminate only if he gives notice of termination within a reasonable period after becoming aware of the cause for termination.

(4) The right to claim damages is not precluded by the termination.

¹ Text based on the translation Jeffrey Thomas and Gerhard Dannemann on www.iuscomp.org/gla

ANNEX B: DRAFT PROVISIONS

Article 5.1.8 (2004 Edition) *(Contract for an indefinite period)*

A contract for an indefinite period may be ended by either party by giving notice a reasonable time in advance.

DRAFT SECTION 6.3 : TERMINATION OF LONG-TERM CONTRACTS FOR CAUSE

Article 6.3.1 *(Termination for just cause)*

A contract entered into for an indefinite or definite period of time may be terminated for just cause by either party at any time in exceptional circumstances, with immediate effect if it is so warranted by the circumstances.

Note: The termination for cause is conceived as extraordinary remedy (ultima ratio), giving to one party the possibility to terminate the lasting contractual relationship immediately. Therefore, the cause has to be an intolerable event. In contrast to hardship, where the balance of obligations is altered and where the contract may be in principle maintained with adapted obligations, the existence of a just cause leads to the termination of the contractual relationship.

Article 6.3.2 *(Definition of just cause)*

There is a just cause, where the continuation of the contractual relationship until the agreed term cannot reasonably be expected of the party who terminates the contract, in particular :

(a) in case of a change in the circumstances, excluding non-performance and hardship, if continuation of the contract cannot reasonably be expected from the terminating party because of the importance of such change. Importance shall be defined by taking into account the nature of the contractual relationship and the circumstances of the case;

(b) in case of loss of trust between the parties, if that trust is an important component of the lasting contractual relationship.

Note: The listing is non exhaustive and other cases are conceivable. Example of a change in circumstances: Takeover of the contractual party by the principal competitor of the other party in a joint venture or licensing agreement (change of control over one party).

NEW ARTICLES TO BE ADDED IN CHAPTER 7, SECTION 3: TERMINATION**Article 7.3.5A**

(Effects of termination for just cause in particular)

(1) If termination for just cause is justified in case of loss of trust due to the other party, the terminating party remains entitled to compensation for its damage, including lost profits until ordinary expiry of the contract or until the time when the contract could have been terminated ordinarily.

(2) If termination for just cause is justified in case of a change in the circumstances, no compensation is due in principle. However, if the ground for termination lies within the sphere of risks ordinarily assumed by the terminating party, the other party may be entitled to compensation. On the contrary, if the ground for termination lies within the sphere of risks ordinarily assumed by the other party, the terminating party may be entitled to compensation.

Article 7.3.5B

(Effects of termination on multi-party contract)

(1) The termination of a multi-party contract entails the liquidation of all assets and receivables as well as the payment of liabilities or the furnishing of appropriate guarantees.

(2) When only one or some of the parties but not all of them exit the contract or are excluded, the remaining parties do not have to liquidate assets and receivables if they assume all liabilities resulting from the common activities.

(3) Unique assets that were acquired or created in pursuance of the contract may be sold or auctioned off among all parties to the contract or to third parties.

Note: These two draft provision should be added in Chapter 7, Section 3 on Termination. They could also be integrated in a possible new chapter on “plurality of debtors and of creditors” or on “unwinding of failed contracts” (see topics proposed by the Council

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ⁱ Decision of the Swiss Federal Tribunal, ATF 92 II 299.

ⁱⁱ Decision of the Swiss Federal Tribunal, ATF 122 III 262.

ⁱⁱⁱ Decision of the Swiss Federal Tribunal, ATF 128 III 428.

^{iv} Decision of the German Supreme Court, III ZR 293/03.

^v Decision of the German Supreme Court, KZR 19/02.

^{vi} Decision of the German Supreme Court, XI ZR 50/02.