

CONFORMITY OF THE GOODS – PHYSICAL FEATURES ON THE WANE?

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1 INTRODUCTION

For a long time it used to be easy to assess whether goods conformed to the contract. Non-conformity regularly was a consequence of the physical features of the goods. Even today many cases of non-conformity decided by courts and arbitral tribunals under the CISG still belong to this category; ready-to-wear garments do not correspond to the required measurements and have defects in tailoring, food is contaminated and not fit for human consumption, ceramic baking dishes are not heat resistant, to mention just a few. However, today more often than not things are much more complicated. Let me just give you a few examples.

Certificates of origin have long been used in international trade to prove where the goods come from or have actually been made. Such certificates are important to enable classification of the goods for customs regulations of the importing country; they may also be important for import quota purposes or for health regulations. They are also relevant where there are bans on imports from specific countries. A prominent example is the Kimberley Process Certification Scheme, an international certification scheme for rough diamonds.¹ Participants of this scheme should ensure that any diamond originating from the country does not finance a rebel group (so called ‘blood diamonds’), that every diamond export be accompanied by a Kimberley Process certificate, and that no diamond is imported from or exported to a non-member of the scheme.²

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1 The Kimberley Process ‘is a joint governments, industry and civil society initiative to stem the flow of conflict diamonds’, see the website of the Kimberley Process, available at <www.kimberleyprocess.com/home/index_en.html>. The Kimberley Process Certification Scheme (KPCS) is available at <www.kimberleyprocess.com/download/getfile/4>. It was introduced by United Nations Assembly Resolution 55/56, A/RES/55/56, available at <<http://daccess-dds-ny.un.org/doc/UNDOC/GEN/N00/562/75/PDF/N0056275.pdf?OpenElement>>.

2 See Section II and III KPCS, *supra* note 1.

In the case of consumer products, quality management today is no longer only concerned with the physical features of the end product, but tries to ensure product safety by establishing control mechanisms throughout the production process. Strict compliance with quality and safety controls is required. For example many countries have enacted so called 'good manufacturing practice' (GMP) guidelines that regulate the manufacture and testing of pharmaceutical products and medical devices.³ In defining the quality management they call for strict records of manufacture.⁴ If compliance with GMP cannot be proven, the goods may not be marketable at all, notwithstanding their actual physical features. Another example is the mandatory CE marking for certain groups of products, such as for example, electrical equipment, machinery, household appliances, toys, cosmetics – to name just a few.⁵ The manufacturer of a product has to take certain obligatory steps – such as conformity assessment, setting up a technical file etc. – before it can affix the CE marking to its product.⁶ The documentation has to be made available to authorities on request.⁷ Importers of products have to verify that the manufacturer outside the EU has undertaken the necessary steps and that the documentation is available upon request.⁸ Distributors must be able to demonstrate to national authorities that they have acted with due care and must have affirmation from the manufacturer or importer that the necessary measures have been taken.⁹

3 For general information on GMPs, see the website of the World Health Organization (WHO), available at <www.who.int/medicines/areas/quality_safety/quality_assurance/production/en/index.html>. For the EU, see Commission Directive 2003/94/EC of 8 October 2003, laying down the principles and guidelines of good manufacturing practice in respect of medicinal products for human use and investigational medicinal products for human use, available at <http://ec.europa.eu/health/files/eudralex/vol-1/dir_2003_94/dir_2003_94_en.pdf>. For the U.S.A. see Food and Drug Administration (FDA), Quality System Regulation/Medical Device Good Manufacturing Practice, available at <www.fda.gov/MedicalDevices/DeviceRegulationandGuidance/PostmarketRequirements/QualitySystemsRegulations/default.htm>.

4 See, e.g., Art. 9(1) Commission Directive 2003/94/EC, *supra* note 3.

5 The CE-mark is required for simple pressure vessels (Directive 87/404/EEC); toys (Directive 88/378/EEC); construction products (Directive 89/106/EEC); electromagnetic compatibility (Directive 89/336/EEC); personal protective equipment (Directive 89/686/EEC); non-automatic weighing instruments (Directive 90/384/EEC); active implantable medical devices (Directive 90/385/EEC); appliances burning gaseous fuels (Directive 90/396/EEC); hot-water boilers (Directive 92/42/EEC); explosives for civil uses (Directive 93/15/EEC); medical devices (Directive 93/42/EEC); equipment for use in explosive atmospheres (Directive 94/9/EC); recreational craft (Directive 2003/44/EC); lifts (Directive 95/16/EC); pressure equipment (Directive 97/23/EC); *in vitro* diagnostic medical devices (Directive 98/79/EC); radio equipment and telecommunications (Directive 99/5/EC); cableway installations designed to carry persons (Directive 2000/9/EC); measuring instruments (Directive 2004/22/EC); machinery (Directive 2006/42/EC) (effective as of 29 December 2009; formerly Directive 98/37 EC).

6 See, e.g., Art. 4 *et seq.* Directive 2009/48/EC of the European Parliament and Council of 18 June 2009 on the Safety of Toys, available at <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:170:0001:0037:en:PDF>>.

7 See, e.g., Art. 4(9) Directive 2009/48/EC, *supra* note 6.

8 See, e.g., Art. 6(1) Directive 2009/48/EC, *supra* note 6.

9 See, e.g., Art. 7(1) Directive 2009/48/EC, *supra* note 6.

Another field is the growing awareness of consumers in regard to goods being sustainably and ethically produced, organically grown or fairly traded.¹⁰ The same holds true for food that must be processed in a certain way to meet religious standards, such as *kosher* or *halal* food.¹¹ In all these cases – although there may be no difference in the physical features of the goods concerned – consumers are generally ready to pay a higher price for the goods compared to goods that are not produced or traded in this way, thus there is a distinctive market with higher prices.¹²

As regards the above mentioned non-physical features of the goods, in comparison with traditional physical features, some specific problems arise when determining conformity of the goods with the contract and the buyer's possible remedies in case of non-conformity.

2 NON-PHYSICAL FEATURES AS PART OF THE CONTRACT

Let me first discuss the question whether and how these non-physical features become part of the contract.

2.1 Contractual Stipulations

It is first and foremost up to the parties themselves to stipulate in their contract as to which non-physical features have to be present and how these must be proven. Certificates of origin are often explicitly named in the contract or in a letter of credit. There may be explicit reference to the relevant GMP, organic growing or fair trade. Likewise, it can be expected that the specification that food must be *kosher* or *halal* will usually be mentioned in the terms of the contract itself. If such express terms have been agreed by the parties they circumscribe the quality or description of the goods in the sense of Article 35(1)

10 There are numerous certifications available, that aim to ensure environmentally compatible production of the respective goods, see, e.g., the well known labels 'USDA Organic' in the U.S.A., further information available at <www.ams.usda.gov>, or 'BIO' in Germany, further information available at <www.bio-siegel.de>, or 'BIOSUISSE' in Switzerland, further information available at <www.bio-suisse.ch>, or 'AB' in France, further information available at <<http://agriculture.gouv.fr/l-agriculture-biologique>>. Furthermore see the certification 'FAIRTRADE' which has the purpose of ensuring a fair income for farmers and workers for their products, further information available at <www.fairtrade.net>. Furthermore see the label 'MSC' for sustainably produced fish, further information available at <www.msc.org>.

11 For information on requirements of *halal*, see <www.halalcontrol.eu>. For information on the requirements of *kashrut*, see <www.kosher-directory.com>.

12 Organically produced food is generally more expensive than conventionally produced food since the production costs are higher, see the website on organic food provided by the Food and Agriculture Organization of the United States (FAO), available at <www.fao.org/organicag/oa-faq/oa-faq5/it/>.

CISG.¹³ If the goods do not live up to these specifications there are no problems in finding non-conformity in the sense of Article 35(1) CISG.¹⁴

2.2 Trade Usages

Even in cases where such express terms are absent, contract interpretation and supplementation may well yield similar results to those reached with express incorporation.¹⁵ First of all, trade usage may call for such non-physical features.¹⁶ According to Article 9(1) CISG the parties are bound by any usage to which they have agreed and by any practice they have established between themselves. Furthermore, according to Article 9(2) CISG the parties are considered to have impliedly made applicable to their contract any international trade usages. In many instances such trade usages can be found.

Thus in the diamond trade the Kimberley Process Certification Scheme nowadays certainly amounts to such a trade usage.¹⁷ If one party from a member country enters into a contract with a party from another member country, trade usage calls for the necessary certificates without them being explicitly referred to in the contract.¹⁸

In many trade sectors private initiatives can be found that require minimum ethical standards such as the prohibition of child labour, setting a maximum number of working hours and prescribing human treatment, as for example the Electronic Industry Code of Conduct.¹⁹ On the international level the UN Global Compact should be specially highlighted as one of the most successful private initiatives.²⁰ Since its official launch in 2000, the initiative has grown to more than 8000 participants, including over 5300 businesses in 130 countries around the world.²¹ It covers the protection of human rights, labour,

13 This was decided by the District Court (OLG) Munich, Germany, 13 November 2002, CISG-online No. 786, available at <www.cisg-online.ch>; See furthermore I. Schwenger, 'Ethical Values and International Sales', 47 *Norsk Juridisk Tidsskrift* 451-471 (2008).

14 I. Schwenger, in I. Schwenger (Ed.), *Schlechtriem & Schwenger, Commentary on the Convention on the UN Convention on the International Sale of Goods (CISG)*, 568, at Art. 35, para. 7 (2010) (cited as: 'Commentary'). See also D. Saidov, 'Documentary Performance and the CISG' in this volume.

15 Schwenger, *Commentary*, *supra* note 14, at Art. 35, para. 7.

16 *Id.*

17 This finding is supported by the fact that the KPCS has now 49 member states around the world which meet the minimum requirements established by the KPCS, see <www.kimberleyprocess.com/structure/participants_world_map_en.html> for further information.

18 See Section II KPCS.

19 Electronic Industry Citizenship Coalition (EICC), Electronic Industry Code of Conduct, available at <www.eicc.info/PDF/EICC%20Code%20of%20Conduct%20English.pdf>.

20 United Nations Global Compact, available at <www.unglobalcompact.org/>; for further details see Schwenger, *supra* note 13, at 456 *et seq.*

21 See <www.unglobalcompact.org/> for further details.

environment as well as anti-corruption measures.²² Although the respective provisions of these Codes of Conduct are rather broad and unspecified, there can be no doubt that minimum ethical standards are to be safeguarded.²³ Thus at least between parties who belong to the trade concerned or who are members of such initiatives, minimum ethical standards become part of their contract as an international usage.²⁴

Therefore, via Article 9 CISG, in many cases non-physical features may impliedly become part of the contract in the sense of Article 35(1) CISG.

2.3 *Fitness for Particular or Ordinary Purpose*

Insofar as the contract does not – neither explicitly nor impliedly – contain any or only insufficient details in order to determine the requirements to be satisfied especially in producing the goods, recourse is to be had to the subsidiary determination of conformity set forth in Article 35(2) CISG.

First of all, the goods must be fit for any particular purpose according to Article 35(2)(b) CISG. In this context one might first think of a buyer purchasing goods to sell them in specific markets such as one specializing in organic food, biodynamic agriculture, fair trade or a special religious community.²⁵ However, this particular purpose must be made known to the seller at the time of the conclusion of the contract, be it expressly or impliedly.²⁶ This requirement may be fulfilled in cases where the buyer's firm, *i.e.*, the company's name, contains information in this regard, or where its reputation is widely known in the trade sector concerned.²⁷

A particular purpose may also arise from the sheer fact that the buyer intends to use the goods in a certain country. If the goods are to be sold in the European Union they must bear the CE mark;²⁸ any professional in the respective trade is aware of this. For example,

22 See the Ten Principles of the United Nations Global Compact, available at <www.unglobalcompact.org/About-TheGC/TheTenPrinciples/index.html>.

23 Schwenger, *supra* note 13, at 462.

24 *Id.*

25 B. Piltz, *Internationales Kaufrecht*, at paras. 5-43 (2008).

26 *Id.*, at paras. 5-41; J.O. Honnold & H.M. Flechtner, *Uniform Law for the International Sales under the 1980 United Nations Convention*, para. 226 (2009); U. Magnus, in H. Honsell (Ed), *Kommentar zum UN-Kaufrecht, Übereinkommen der Vereinten Nationen über Verträge über den Internationalen Warenkauf (CISG)*, Art. 35, para. 18 (2010) (cited as: 'Kommentar').

27 See in this regard Schwenger, *Commentary*, *supra* note 14, at Art. 35, para. 21 *et seq.*

28 This is expressly required by the EC Directives described above, see *supra* note 5 *et seq.*

such information is even given on Australian websites.²⁹ If one sells medical equipment to the United States, the seller must be aware of the particular purpose that the goods must comply with the good manufacturing practices issued by the Food and Drug Administration.³⁰

The second prerequisite laid down in Article 35(2)(b) CISG, namely that the buyer reasonably relied on the seller's skill and judgment should not cause too many problems in these cases.³¹

If a particular purpose cannot be established it might be questionable whether goods in these circumstances are not fit for the ordinary purpose such goods are used for (Art. 35(2)(a) CISG). Ordinary purpose primarily means that the goods must be fit for commercial purposes.³² In the resale business, this simply means that it must be possible to resell them.³³ If no special country or trade sector in which they were to be onsold can be discerned it will be hard for the buyer to allege non-conformity if the goods can be onsold at least in some markets.³⁴ Thus, it is certainly of special importance to the buyer to be able to establish a particular purpose in the sense of Article 35(2)(b) CISG.

3 REMEDIES OF THE BUYER

3.1 *General*

In the case of non-conforming goods the buyer may resort to the usual remedies, namely specific performance, avoidance of the contract, damages and price reduction; all such remedies raising particular questions in connection with non-physical features of the goods.³⁵

29 There are numerous mutual agreements between the European Union and further countries such as Australia, Canada and Japan. See, e.g., the Australia - European Community Mutual Recognition Agreement (EC-MRA), available at <www.tga.gov.au/international/ecmra.htm>.

30 See *supra* note 3.

31 Under these circumstances, it is very difficult for the seller to prove that the buyer did not rely on his skill and judgement, see, e.g., Honnold & Flechtner, *supra* note 26, at para. 226.

32 Schwenger, *Commentary*, *supra* note 14, at Art. 35, para. 14; See also Honnold & Flechtner, *supra* note 26, at para. 225.

33 See, e.g., Federal Supreme Court (BGH), Germany, 2 March 2005, CISG-online No. 999, available at <www.cisg-online.ch>; See furthermore Honnold & Flechtner, *supra* note 26, at para. 225; Magnus, *Kommentar*, *supra* note 26, at Art. 35, para. 13; Schwenger, *Commentary*, *supra* note 14, at Art. 35, para. 14, note 66 with detailed references.

34 See Honnold & Flechtner, *supra* note 26, at para. 225.

35 Art. 45(1)(a) and (b) CISG.

3.2 Examination and Notice

In the first place, if the goods are non-conforming the buyer must notify the seller in accordance with Articles 38 and 39 CISG.³⁶ This will be relatively easy in the case of missing or non-conforming documents that are necessary to label the goods in a certain way, to obtain administrative approval of the goods or just to on-sell them in a specific market. However, where the non-conformity simply results from the way in which the goods are manufactured or processed, any eventual examination of the goods themselves will not reveal this fact.³⁷ Thus notification can only be required from the buyer after it has actually learned about the violation of such standards.³⁸ Such knowledge may, however, be inferred from missing certificates relating to the manufacturing process or the origin of the goods.

3.3 Specific Performance

As we are dealing here with non-conformity of the goods, specific performance may be required in the form of delivery of substitute goods (Article 46(2) CISG) or in the form of repair (Article 46(3) CISG). If the necessary documents, such as documents of origin, are missing they may be supplied by the seller, a third person, or the buyer, if it is able to do so, may get them itself.³⁹ It may then ask for the costs incurred by way of damages.⁴⁰

3.4 Avoidance

Avoidance of the contract is possible only in cases where the non-conformity amounts to a fundamental breach of contract (Article 49(1)(a) CISG). This presupposes a substantial deprivation of what the buyer is entitled to expect under the contract (Article 25 CISG). Such deprivation can be ascertained, in the first place, from the terms of the contract itself.⁴¹ If the parties stipulate that certain standards must be adhered to, the parties have, thereby,

36 See generally thereto Schwenzer, *Commentary*, *supra* note 14, at Art. 38, para. 1 *et seq.* and Art. 39, para. 1 *et seq.*

37 Even if a thorough examination is conducted, such defects cannot be detected by only examining the goods themselves, see Schwenzer, *Commentary*, *supra* note 14, at Art. 38, para. 13 *et seq.*

38 Honnold & Flechtner, *supra* note 26, at para. 252.1; C. Brunner, *UN-Kaufrecht – CISG, Kommentar zum Übereinkommen der Vereinten Nationen über Verträge über den internationalen Warenkauf von 1980 unter Berücksichtigung der Schnittstellen zum internen Schweizer Recht*, at Art. 39, para. 14 (2004); Schwenzer, *Commentary*, *supra* note 14, at Art. 39, para. 20.

39 See Honnold & Flechtner, *supra* note 26, at para. 283 *et seq.*; M. Müller-Chen, in *Commentary*, *supra* note 14, at Art. 46, para. 17 *et seq.*

40 See Art. 74 CISG.

41 U. Schroeter, in *Commentary*, *supra* note 14, at Art. 25, para. 15; See also B. Gsell, in *Kommentar*, *supra* note 26, at Art. 25, para. 11.

sufficiently made clear that compliance is of special interest to the buyer and, therefore, such deprivation can be assumed in the event of a breach.⁴²

If it is clear for both parties that the buyer cannot make any use of the goods is intended – such as the European buyer who has to fix the CE mark on the goods – a fundamental breach can easily be ascertained.⁴³

In other cases it is decisive whether the buyer can reasonably be expected to use or sell the goods in another market where their general marketability is not endangered. If, for example, a fast food restaurant offers *halal* chicken nuggets alongside ordinary ones, a reasonable substitute market is available. In cases of specialized buyers, however, such as for example those specializing in organic or fair trade, this can hardly be expected. Likewise, these buyers do not have to sell the goods with a discount to their usual customers, as this might be harmful to their reputation.

3.5 Damages

The easiest way for the buyer to obtain financial redress in case of non-conformity due to non-physical features of the goods is where the parties have agreed upon a liquidated damages clause or a contractual penalty, whereby the latter generally functions as both a compensatory remedy as well as a deterrent.⁴⁴ Such a clause releases the buyer from its – perhaps difficult – obligation of proving whether or not it suffered loss at all and, if so, in what amount. However, parties may not think of such a clause, or the buyer may not be in a position to force such a clause on the seller. Therefore, it is important to examine what can be considered to be a recoverable loss within the meaning of the CISG.

In the first place, if the goods have not been sold before the non-conformity is discovered, lost profits will be likely to occur. This may be because the goods are not resalable at all – such as goods without the necessary certificates – or because the buyer decides not to resell them and cannot be expected to resell them under the given circumstances. The same holds true where, after discovering the non-conformity, the buyer is obliged to take back the goods from its customers.

42 Schroeter, *Commentary*, *supra* note 14, at Art. 25, para. 44.

43 See Piltz, *supra* note 25, at paras. 5-193.

44 See generally P. Hachem, *Agreed Sums Payable upon Breach of an Obligation, Rethinking Penalty and Liquidated Damages Clauses*, at 167 *et seq.* (2011).

If the goods have already been resold prior to discovering the breach, damage in the form of loss of reputation may furthermore come into play. As the CISG recognizes the principle of full compensation, there is no question that loss of goodwill can be recovered.⁴⁵ It might, however, be difficult to financially quantify a loss of goodwill in an individual case.⁴⁶ In assessing the amount, due regard is to be given to the standing of the individual buyer in the market. A company firmly dedicated to fair trade will sustain a greater loss to reputation compared with one which just occasionally deals in this trade sector.

Problems arise, however, where all goods have been resold and the non-conformity has never become public knowledge. Although, even in such a case, one might argue that there is a loss of goodwill that could perhaps materialize in some future sale of the business itself, for example during due diligence proceedings, the loss becomes more and more elusive.

The crucial question here is how the non-performance loss can be assessed. If there exists a market for the goods contracted for – like *kosher* food – as well as a market for the non-conforming goods – like non-*kosher* food – an easy way for the buyer to calculate damages is according to the difference of the respective market prices.⁴⁷ Problems arise if no such market for non-conforming goods exists. Is there a market for t-shirts fabricated by 10-year-olds under inhumane conditions? In these cases, another method of calculating damages is called for if one does not want to allow the seller to get off scot-free. One possibility could be to assess the decrease in value of the goods on an abstract level. The purchase price always reflects the costs of producing of the goods and a profit for the seller. If the seller, by violating ethical standards, substantially reduces the costs in production and thus respectively maximizes its own profit, the equilibrium of the contract has become unbalanced.⁴⁸ One may well argue that the real value of the goods is decreased by the amount of the reduced production costs.⁴⁹ The buyer may claim this margin as minimum damages.⁵⁰

45 See CISG Advisory Council, CISG-AC Opinion No. 6: *Calculation of Damages under CISG Article 74*, Rapporteur: Professor J.Y. Gotanda, available at <www.cisgac.com/UserFiles/File/CISG%20AC%20Opinion%206%20English.pdf>, at para. 7.1; Schwenger, *Commentary*, *supra* note 14, at Art. 74, paras. 18 and 34 for further references.

46 Schwenger, *Commentary*, *supra* note 14, at Art. 74, para. 34.

47 Art. 76(1) CISG. See generally Schwenger, *Commentary*, *supra* note 14, at Art. 76, para. 1 *et seq.* See also D. Saidov, 'Documentary Performance and the CISG' in this volume.

48 Schwenger, *supra* note 13, at 467 *et seq.*; I. Schwenger & P. Hachem, 'The Scope of the CISG Provisions on Damages', in R. Cunnington & D. Saidov (Eds.), *Contract Damages: Domestic and International Perspectives*, at 95 (2008); Schwenger, *Commentary*, *supra* note 14, at Art. 74, para. 23.

49 *Id.* See with regard to domestic law A.-F. Bock, *Gewinnherausgabe als Folge einer Vertragsverletzung: Eine rechtsvergleichende Untersuchung der vertraglichen Vorteilsausgabe unter Berücksichtigung des schweizerischen, deutschen und englischen Rechts*, at para. 469 (2010).

50 Schwenger & Hachem, *supra* note 48, at 99; Schwenger, *supra* note 13, at 468; Schwenger, *Commentary*, *supra* note 14, at Art. 74, para. 23.

The seller cannot argue that the buyer received the full re-sale price and thus ultimately did not sustain any financial loss at all, as this would contravene the principle of full compensation and the nowadays accepted aim of the law of damages, namely prevention and not just compensation. The same result can also be reached by damages based on a disgorgement of profit.⁵¹ Although this might in the end appear to be a windfall profit for the buyer, any other solution would give the very same windfall profit to the seller who has breached the contract.⁵²

3.6 Price Reduction

Finally, the possibility of a price reduction exists.⁵³ The mechanism for establishing the lower value of the non-conforming goods is equivalent to the one just discussed in relation to damages. Thus, the buyer may reduce the purchase price in proportion to the lower value that the goods actually delivered had at the time of the delivery.⁵⁴

4 CONCLUSION

Non-physical features of the goods have become more and more important in international trade. This certainly has been an enormous and probably unexpected development since the elaboration of the CISG more than thirty years ago. However, as we can see, the CISG is flexible enough to adequately deal with these new developments. On the level of defining conformity of the goods in the sense of Article 35 CISG, the criterion of fitness for the particular purpose is of utmost importance. On the level of remedies, fundamental breach and the calculation of damages are central to the discussion.

51 Brunner, *supra* note 38, at Art. 74, para. 8; Schwenger, *Commentary, supra* note 14, at Art. 74, para. 43 with further references; See also D. Saidov, 'Documentary Performance and the CISG' in this volume (also discussing disgorgement of profits under the CISG).

52 Schwenger, *supra* note 13, at 451 and 468.

53 The right of the buyer to a price reduction in the case of non-conformity of the goods is provided by Art. 50 CISG; See generally Müller-Chen, *Commentary, supra* note 14, at Art. 50, para. 1 *et seq.*; A.K. Schnyder & R.M. Straub, in *Kommentar, supra* note 26, at Art. 50, para. 1 *et seq.*; Brunner, *supra* note 38, at Art. 50, para. 1 *et seq.* For a domestic law perspective see Bock, *supra* note 49, at para. 469.

54 For the calculation of the reduction see, *e.g.*, Müller-Chen, *Commentary, supra* note 14, at Art. 50, para. 8 *et seq.*