CA 3912/90

Eximin SA, a Belgian corporation

v.

Itel Style Ferarri Textiles and Shoes Ltd

The Supreme Court sitting as the Court of Civil Appeal

[22 August 1993]

Before President M. Shamgar and Justices E. Goldberg, Y. Malz

Appeal on the judgment of the Tel-Aviv-Jaffa District Court (Justice H. Ben-Atto) on 12 August 1990 in Civil File 2093/86.

Facts: the appellant bought 3,000 pairs of denim boots from the respondent for a customer of the appellant in the United States. The boots had a pocket on which a letter 'V' was sewn. When the boots reached the United States, they were detained in customs because the design violated a trade mark registered in the United States.

The issue in dispute was: who was responsible for ignoring the question of whether the design involved a breach of a registered trade mark?

Held: (Majority opinion — President M. Shamgar, Justice Y. Malz) Since both parties knew of the possibility that there might be a registered trade mark, and neither investigated the matter, both parties acted with a lack of good faith. Consequently, liability for the damage should be allocated between the parties.

(Minority opinion — Justice E. Goldberg) Since the appellant (the importer) asked for a change in the boots' design because of customs problems, the respondent (the manufacturer) was entitled to rely upon the appellant knowing United States law and taking the necessary precautions to ensure it was not infringed. Therefore no lack of good faith should be imputed to the respondent, and full liability for the violation of the trade mark should rest with the appellant.

Appeal allowed in part, by majority opinion.

Legislation cited:

Contracts (General Part) Law, 5733-1973, ss. 12, 39, 61(b).

Contracts (Remedies for Breach of Contract), 5731-1970, ss. 10, 14(a).

Sale (International Sale of Goods) Law, 5731-1971, Schedule, ss. 1, 52, 52(a), 82, 88.

Sale Law, 5728-1968, ss. 6, 18.

Israeli Supreme Court cases cited:

[1] CA 815/80 *Harlow and Jones GMBH v. Adders Building Materials Ltd* [1983] IsrSC 37(4) 225.

[2] FH 36/84 *Teichner v. Air France Airlines* [1987] IsrSC 41(1) 589.

[3] CA 338/73 *Parcel 677 Block 6133 Co. Ltd v. Cohen* [1975] IsrSC 29(1) 365.

[4] CA 144/87 *State of Israel v. Engineer Faber Building Co.* [1991] IsrSC 45(3) 769.

[5] HCJ 59/80 *Beer-Sheba Public Transport Services Ltd v. National Labour Court* [1981] IsrSC 35(1) 828.

[6] CA 825/79 *Sherbet Brothers Building Co. Ltd v. Schwartzbord* [1982] IsrSC 36(4) 197.

[7] CA 804/80 *Sidaar Tanker Corp. v. Eilat-Ashkelon Pipeline Co. Ltd* [1985] IsrSC 39(1) 398.

[8] CA 158/77 *Rabinai v. Man Shaked Ltd (in liquidation)* [1979] IsrSC 33(2) 281.

[9] CA 789/82 *Ezra v. Mugrabi* [1983] IsrSC 37(4) 565.

[10] CA 714/87 *Sher v. Cohen* [1989] IsrSC 43(3) 159.

For the petitioner — A. Brumer.

For the respondent — D. Blum.

JUDGMENT

President M. Shamgar

1. (a) This is an appeal on a judgment of the Tel-Aviv District Court, which dismissed the appellant's claim for restitution and damages.

(b) The relevant facts, as determined by the trial court, are as follows: the appellant, a Belgian company, bought from the respondent, an Israeli company, 3,000 pairs of denim boots, for a customer of the appellant in the United States. The boots were of a special design that was popular at that time: the boot appears to be part of the trousers with a pocket on which the

shape of the letter 'V' is sewn. The respondent manufactured boots like these, before the appellant contacted it, for the local market, and it manufactured boots like these also for export, *inter alia* to Germany.

The appellant sent the customer six different designs, and it approved one of these designs, with two changes: removing the 'forza' mark that was sewn on the design and replacing the neolyte sole with a leather sole. The respondent manufactured the entire quantity of boots in accordance with the order, sent the goods to the United States and received the full price, which was guaranteed by documentary credit.

When the goods reached the United States, it turned out, allegedly, that the design violated a trade mark registered in the United States, and the consignment was therefore detained in customs.

(c) The appellant sued for restitution of the price of the goods, arguing that the transaction failed through the fault of the manufacturer. At a preliminary hearing, the parties accepted a proposal of the court to minimize the damage. The appellant removed the 'V' mark from the boots and the customer in the United States bought them at a reduced price. Consequently, the claim was reduced to the difference in the price that represented the appellant's loss. The trial court ruled that the responsibility for ignoring the breach of the trade mark registered in the United States lay, in this case, with the appellant, and it dismissed the action.

This is the subject of the appeal before us.

2. The parties raised different and diverse arguments in this appeal, some of which in the abstract, relating to the nature of the transaction and its significance with regard to determining liability, and others in the concrete, relating to the specific relationship that developed between the parties. We will consider the arguments in the order they were raised.

3. *The nature of the transaction and its significance for determining liability between the parties*

(a) Article 1 of the schedule to the Sale (International Sale of Goods) Law, 5731-1971 (hereafter — 'the International Sale of Goods Law'), provides:

> '1. The present Law shall apply to contracts of sale of goods entered into by parties whose places of business are in the territories of different States, in each of the following cases:

(a) where the contract involves the sale of goods which are at the time of the conclusion of the contract in the course of carriage or will be carried from the territory of one State to the territory of another;

(b) where the acts constituting the offer and the acceptance have been effected in the territories of different States;

(c) where delivery of the goods is to be made in the territory of a State other than that within whose territory the acts constituting the offer and the acceptance have been effected.

2. Where a party to the contract does not have a place of business, reference shall be made to his habitual residence.

3. The application of the present Law shall not depend on the nationality of the parties.

4. In the case of contracts by correspondence, offer and acceptance shall be considered to have been effected in the territory of the same State only if the letters, telegrams or other documentary communications which contain them have been sent and received in the territory of that State.

5. For the purpose of determining whether the parties have their places of business or habitual residences in "different States", any two or more States shall not be considered to be "different States" if a valid declaration to that effect made under Article 2 of the Convention dated the 1st day of July 1964 relating to an Uniform Law on the International Sale of Goods is in force in respect of them.'

The appellant argues that this law applies to the present case. As the respondent does not contest its applicability, I will assume that the said law does indeed apply. I will add that the International Sale of Goods Law reflects customary international law with regard to sale transactions between countries, even though changes have occurred in customary international law since its enactment: in 1980, the United Nations Convention on Contracts for the International Sale of Goods (hereafter — 'the Vienna Convention') was ratified in Vienna, and this in practice replaced the Convention relating to an Uniform Law on the International Sale of Goods that was signed in the Hague in 1964, to which the law referred. I will address the changes that have been made since the law's enactment, in so far as this is necessary.

(b) Article 52 of the said Schedule provides:

> '1. Where the goods are subject to a right or claim of a third person, the buyer, unless he agreed to take the goods subject to such right or claim, shall notify the seller of such right or claim. Unless the seller already knows thereof, and requests that the goods should be freed therefrom within a reasonable time or that other goods free from all rights and claims of third persons be delivered to him by the seller.
>
> 2. If the seller complies with a request made under paragraph l of this Article and the buyer nevertheless suffers a loss, the buyer may claim damages in accordance with Article 82.
>
> 3. If the seller fails to comply with a request made under paragraph l of this Article and a fundamental breach of the contract results thereby, the buyer may declare the contract avoided and claim damages in accordance with Articles 84 to 87. If the buyer does not declare the contract avoided or if there is no fundamental breach of the contract, the buyer shall have the right to claim damages in accordance with Article 82.
>
> 4. The buyer shall lose his right to declare the contract avoided if he fails to act in accordance with paragraph l of this Article within a reasonable time from the moment when he became aware or ought to have become aware of the right or claim of the third person in respect of the goods.'

This section is similar to section 18 of the Sale Law, 5728-1968, which provides:

> '(a) The vendor shall deliver the item sold free of every charge, attachment or other third-party right.
>
> (b) The vendor shall notify the purchaser immediately of any claim of rights in respect of the item sold, of which he knew, or should have known, before delivery of the item sold.'

The appellant argues that article 52 applies also to a trade mark right held by a third party. In his work 'The Sale Law, 5728-1968', in *A Commentary on the Law of Contracts*, The Harry Sacher Institute for Research on Legislation and Comparative Law, G. Tedeschi ed., 1972, at p. 98, Professor Z. Zeltner points out (with regard to section 18 of the Sale Law) that:

> 'The expression "other third-party right" includes, apparently, patent and trade mark rights held by a third party.'

E. Zamir, in 'The Sale Law, 5728-1968' *Interpretation of the Law of Contracts* (the Harry Sacher Institute for Research on Legislation and Comparative Law, G. Tedeschi, ed., 1987), at p. 374, also points out (with regard to section 18) that:

> 'The third party's right does not need to be in the sale item itself. If, for example, the sale item or the transfer thereof to the purchaser involves a breach of an intellectual property right, such as a patent, copyright or trade mark, this is also a breach of section 18(a) in the relationship between the vendor and the purchaser.'

See also footnote 73.

For a comparison of the provisions of contractual legislation and the provisions of the International Sale of Goods Law, see CA 815/80 *Harlow and Jones GMBH v. Adders Building Materials Ltd* [1], at p. 230.

(c) A more specific provision to this effect may be found in Article 42 of the Vienna Convention:

> 'Article 42
>
> (1) The seller must deliver goods which are free from any right or claim of a third party based on industrial property or other intellectual property, of which at the time of the conclusion of the contract the seller knew or could not have been unaware, provided that the right or claim is based on industrial property or other intellectual property:
>
> (a) Under the law of the State where the goods will be resold or otherwise used, if it was contemplated by the parties at the time of the conclusion of the contract that the goods would be resold or otherwise used in that State; or
>
> (b) In any other case, under the law of the State where the buyer has his place of business.
>
> (2) The obligation of the seller under the preceding paragraph does not extend to cases where:
>
> (a) At the time of the conclusion of the contract the buyer knew or could not have been unaware of the right of claim; or

> (b) The right or claim results from the seller's compliance with technical drawings, designs, formulae or other such specifications furnished by the buyer.'

See also section 2-312(3) of the American Uniform Commercial Code (U.C.C.):

> '2-312 Warranty of Title and Against Infringement; Buyer's Obligation Against Infringement.
>
> (1) Subject to subsection (2) there is in a contract for sale a warranty by the seller that:
>
> (a) The title conveyed shall be good, and its transfer rightful; and
>
> (b) The goods shall be delivered free from any security interest or other lien or encumbrance of which the buyer at the time of contracting has no knowledge.
>
> (2) A warranty under subsection (1) will be excluded or modified only by specific language or by circumstances which give the buyer reasons to know that the person selling does not claim title in himself or that he is purporting to sell only such right or title as he or a third person may have.
>
> (3) Unless otherwise agreed a seller who is a merchant regularly dealing in goods of the kind warrants that the goods shall be delivered free of a rightful claim of any third person by way of infringement or the like but a buyer who furnishes specifications to the seller must hold the seller harmless against any such claim which arises out of the compliance with the specifications.'

With regard to German Law see: N.M. Galston, *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, New York, 1984, at p. 633.

(d) The accepted interpretation of these provisions is that the seller's duty to transfer unencumbered ownership also includes the duty to transfer ownership unencumbered by rights such as trade mark rights vested in a third party. This interpretation *prima facie* supports the appellant's position.

(e) Attention must be paid to the limitations that appear in the same art. 42 of the Vienna Convention. These are also stated in case-law relating to the other aforementioned sections. In other words, art. 42 is a kind of miniature codification of the qualifications that have been developed over the years

with regard to the seller's duty to transfer ownership free of any third-party claims. Its provisions can therefore also be of assistance, by way of analogy, in the case before us. This is also in keeping with the desire to unify the law, as held in FH 36/84 *Teichner v. Air France Airlines* [2], at p. 611:

> 'National distinctiveness, which is a valuable asset within the confines of a particular legal system, may have problematic results when an event — such as an international flight — transcends borders and becomes involved with several legal systems. This is the reasons for the trend of unification in extensive spheres of law, primarily those relating to international transport and commerce…'

It should be noted that the international norm, in this case, agrees with, and integrates into, the national norm.

Thus, as in the provision of art. 42(1) of the Vienna Convention, the seller will be liable only for a right of which he knew or of which he could not have been unaware (where a standard close to knowledge is intended). See J. Honnold, *Uniform Law for International Sales*, Deventer, 2nd ed., 1991, at p. 350; this assumes that we are speaking of such a right in the State where the product will be sold (provided, of course, that this State was determined in the contract between the parties) or in any other case, in the buyer's State.

Similar to the provisions of art. 42(2) of the Vienna Convention, the seller shall be exempt from liability if the buyer knew or could not have been unaware of the right, or if the infringement of the right derives from compliance with specific instructions of the purchaser. It should however be noted that we are referring to conditions that the buyer asked the seller to fulfil, and not conditions left to the seller's discretion. With regard to conditions left to the seller's discretion, opinion is divided as to who should be held liable for the infringement of the right (see Galston, *supra*, at pp. 34-36, and with regard to section 2-312(3) of the U.C.C., see also J.J. White & R.S. Summers, *Handbook of the Law under the Uniform Commercial Code*, St. Paul, 2nd ed., 1980, at p. 364). In cases dealing with liability for infringement of a third party right, the buyer is required to notify the seller within a reasonable time of discovering the infringement, and the notice must state the nature of the right. However the seller may not raise the argument that he was not notified of the infringement if he knew of it.

It should be noted that the parties may contract out of these provisions in the contract between them, whether expressly or by implication.

The question that arises in this case is, therefore, whether there was a restriction to the seller's liability, or, alternatively, whether it can be inferred from the behaviour of the parties before making the contract that they wanted to restrict the seller's liability.

(f) It is not disputed that that both the appellant and the respondent knew that the goods were intended to be sent to the United States. Moreover, both of them could not have been unaware of the possibility that a registered trade mark existed. The trade mark is registered by the American company 'Levis'. This company is not a small, unknown company. This company's goods are marketed around the world and any sensible person ought to have assumed that such a company would register a trade mark for its products, at least in its country of origin, which is the United States. This assumption is especially valid with regard to the appellant and the respondent, both of which are companies that do business in this field and are aware of its special characteristics. We cannot accept a claim by either of them that it did not know or could not have known about the existence of this registered trade mark. With regard to the respondent, this knowledge can also be inferred from the testimony of Mr Ben-Vered, who confirmed that the respondent knew that denim manufacturers normally register trade marks for their products, and the respondent did its best to make sure it did not infringe them. This is the case, to a greater degree, with regard to the appellant's customer, who is resident in the United States and does business there in selling products of this kind. It is true that he did not do business directly with the respondent, but only with the appellant, but the appellant cannot claim that its customer did not need to inform it about a registered trade mark. This argument was not even made, and in any case it concerns the relationship between the appellant and the customer, who is not a party in this proceeding. In so far as this appeal is concerned, the appellant acted for the customer, and the knowledge imputed to the customer may also be imputed to the appellant, particularly in view of the customer's active involvement in the actual transaction.

It transpires, therefore, that, *prima facie*, the seller's liability is limited, since the buyer was also aware of the problem with the goods. We will discuss the significance of this qualification for the purpose of determining liability below, but first let us examine the intention of the parties, on the basis of the contract made between them and their behaviour before signing it.

(g) The appellant approached the respondent with a request that it manufacture for it boots of the kind described. I am prepared to assume, in the appellant's favour, that it chose a design from among those in the possession of the respondent, without submitting any design of its own, since the facts show that six similar designs were sent to the customer in the United States. Sending the designs also makes it clear that the question whether the appellant brought this design to the respondent or not is insignificant. The customer certainly should have known about the existence of a registered trade mark. At least he should have suspected this, and this gave rise to a duty to look into the matter before approving one of the designs. Moreover, not only did the customer approve one of the designs, but he also asked for changes to be made to it. The nature of this request shows the customer's familiarity with the laws of his country of residence. From the moment that the customer did this, the respondent was entitled to assume that *prima facie* there was no problem whatsoever with the goods. We say *prima facie* because in the case of a company like Levis, the respondent should indubitably have suspected the existence of a registered trade mark. What is more, the appellant is correct in arguing that the respondent should have assumed no more than that the buyer examined the fitness of the product's design merely for his own needs, without examining whether it complied with the law in the United States.

It transpires that even from the behaviour of the parties before signing the contract we can infer that the purchaser accepted, if only in part, the risk that the goods did not comply with certain requirements under American law. In this respect it may be added that the trial court even made a finding of fact, that under United States law the importer-buyer could have obtained permission from the 'Levis' company to import these boots. Nonetheless, I am not prepared to accept the unequivocal conclusion of the trial court that the exporter-seller was entitled to rely absolutely on the importer making the necessary preparations, from his point of view, for receiving the goods in the United States. As the party familiar with the special nature of the business and as the party who in principle is supposed to be liable for a breach of a registered trade mark in such a case, it should have ascertained whether the importer acted properly, or, at least, it should have raised the question.

(h) In order to remove all doubt, I will point out that the question whether the transaction was a F.O.B. transaction or a C.I.F. transaction is insignificant. The dispute between the parties relates to a preliminary stage of execution, and the question of liability for infringement of a registered trade

mark is not contingent on the type of carriage transaction. The proof of this is that the various sections, whether in the International Sale of Goods Law or in the international conventions, do not refer to this at all.

4. *Determination of liability of the exporter-seller and the importer-buyer*

(a) The result of the above is that there is *prima facie* a qualification to the liability of the seller-exporter; at the least, the behaviour of the parties shows that it is not necessarily the seller who should bear the liability. On the other hand, it appears that the full liability should not be imposed on the buyer-importer.

The parties' behaviour shows that they did not trouble to cooperate with one another. The parties disagreed about the responsibility for carrying out various actions, and instead of sitting down and resolving the differences, each of them acted, apparently, as he saw fit, ignoring the damage that was likely to be caused and assuming that the other party would be liable for it. Each of the parties, in fact, foresaw the damage but did not trouble to clarify the risk of its happening to the other party, nor did it trouble to disclose it to the other and prevent the damage, even though it was clearly able to do so. Albeit the lack of cooperation (or lack of disclosure) of the type that existed here does not exempt the party who must carry out an action from its duty, but the question is whether it is not sufficient to grant him a partial defence.

(b) The behaviour of each of the parties, as described, amounts to lack of good faith in performing the contract (s. 39 of the Contracts (General Part) Law, 5733-1973 (hereafter — 'the Contracts Law'), and also s. 6 of the Sale Law), and perhaps even to lack of good faith at the negotiation stage (s. 12 of the Contracts Law). The remarks of Prof. G. Shalev in her book, *The Laws of Contracts*, Din, 1990, at p. 43, are most pertinent in this respect:

> 'The golden path in implementing the principle of good faith is found in a balance between the ethical basis for the principle and the requirements of trade. Following this path dictates proper behaviour in conducting business. The principle of good faith symbolises an abandonment, to some extent, of individualism and egoism, but it does not dictate absolute altruism… the general requirement to act in good faith should therefore be seen as a balanced requirement of consideration for the other party and cooperation with him, for the realization of the purpose of the contract.'

In order to remove doubt, we will point out that the provisions of the Contracts Law also apply to the case before us, if not directly, then by virtue of section 61(b) of the Contracts Law.

Both sides acted in bad faith. This is in fact consistent with the two aspects of the principle of good faith. On the one hand, we are talking about a cumulative requirement, which imposes an additional obligation to the express obligations under the contract, namely the obligation to act in good faith. This requirement is relevant to the duty of the seller-exporter to inform the importer-buyer, even though he knew, for example, that the latter would be liable (in view of the said qualifications). On the other hand, this is also a moderating provision, which in the appropriate case allows a deviation from the requirement to carry out the contract perfectly. This description is relevant to the duty of the importer-buyer, not to sit by idly, even though he assumed, for example, that the exporter-seller would be liable. Prof. G. Shalev says of this in *The Laws of Contracts*, at pp. 43-44:

> 'The joining effect of the principle of good faith is reflected in all those cases in which it was held that the debtor must carry out his existing obligations in good faith, or in which an additional obligation was imposed upon him. The moderating effect of the principle of good faith is reflected in those cases where this principle allows a deviation from perfect performance of the obligation, provided that the performance and the deviation therefrom were done in good faith. In practice, this moderating effect is reflected in transferring the obligation to act in good faith from the debtor to the creditor under the contract, and it is equivalent to the requirement to exercise good faith with regard to rights arising from the contract.'

See in this regard also what was said in CA 338/73 *Parcel 677 Block 6133 Co. Ltd v. Cohen* [3], at p. 369, about s. 6 of the Sale Law:

> 'We will consider here the *two aspects of section 6. One aspect is the performance of a contract by the debtor party, who is liable to carry it out in good faith and in accordance with accepted practices.* The legislator could not have been referring to the accepted practices among swindlers; rather the debtor must act in accordance with the accepted practices in fair negotiations. *The second aspect of that section is the extent of the right of a party claiming a right under the contract; he too is subject to the same rule, which means that the entitled party may*

> *not pounce on a word in the contract and abuse it; rather he must exercise that right given to him in accordance with accepted practices among people who conduct their business in good faith and honestly*. It should be emphasized that the legislator used the words 'an obligation that arises' and 'a right that arises from a contract', and significance should be attached to this. These obligations which are stated in s. 6 are additional obligations and rights that are added to what is stated in the contract, and they should be regarded as if they were expressly written in the contract' (emphasis added).

Prof. M. Mautner says in his book, *The Decline of Formalism and the Rise of Values in Israeli Law*, Ma'agalei Da'at, 1993, at pp. 58-59:

> 'The operation of section 39 is based on the assumption that the legal relationship between two persons is governed by a certain norm, whether contractual or otherwise, which creates an obligation and a right between the parties. Section 39 governs this norm, by expanding the scope of the debtor's obligation or by limiting the scope of the creditor's right. The duty imposed in the section is therefore an altruistic duty. The term 'altruism' is generally used to describe a situation where a person does not act out of a desire to promote his own interests, but his action is based on an intention to promote the interests of another. Altruism is the opposite of egoism, which in essence is acting while regarding the interests of each individual in society as invariably distinct from those of others. A party who is subjected to the duty of good faith must therefore adopt altruistic behaviour, which means he must act to protect the interests of the other party, beyond what is stipulated in the norm that governs his relationship with that party.'

Incidentally, Prof. Mautner also sought to characterize the duty of a litigant to act in good faith as an altruistic obligation, which means he must act to protect the interests of the other party, beyond what is stipulated in the norm that governs his relationship with that party.

The said duties are also expressed in the laws of international sale, as reflected in article 52 of the Schedule of the International Sale of Goods Law and in article 42 of the Vienna Convention. By virtue of these sections, the first and main duty is the duty of the exporter (the seller) to transfer the right to the importer (the buyer) free of any third-party rights. The other duty is the

duty of the importer, if he is aware of such a right, to act himself so that the transaction is not frustrated, or at least to inform the exporter of the difficulty that is likely to arise, so that the latter may act accordingly. Similarly, the exporter too must inform the importer, if he thinks that a difficulty is likely to arise, particularly if he can assume that there is a qualification of his liability. These provisions are admittedly not stated expressly in the said articles, but they undoubtedly arise from them and are required by the very existence of a relationship whose purpose is cooperation between the buyer and the seller for the success of the business relationship between them.

Failure to comply with the requirement of good faith amounts to a breach of contract, and since in our case each of the parties lacked good faith, we are speaking of reciprocal breaches of the contract (see Shalev, *The Laws of Contracts*, at p. 65). The breach of each of the parties contributed ultimately to the breach made by the other party which resulted in the damage. It can also be viewed as a breach that contributed directly to the damage.

As stated above, the duty of disclosure may already have arisen at the negotiation stage, but as long as it was not carried out, the duty remains, and so if it was also not carried out at the contractual stage, the lack of good faith amounts to a breach. This was held also in CA 144/87 *State of Israel v. Engineer Faber Building Co.* [4], at p. 778:

> 'The duty to act in good faith can also take the form of a duty of a party to the contract to disclose important facts during the contractual period… The question of the existence of such a duty and of its scope naturally vary from case to case… The duty of disclosure during the contractual period exists — or more precisely continues to exist — whenever the duty of disclosure was not carried out by a party at the pre-contractual stage, and the necessity of the disclosure continues to exist also during the contractual stage, and the degree of necessity is such that failure to comply with it amounts to behaving unfairly and not in accordance with accepted practices and in good faith.'

In any case, the question is what is the consequence of a lack of good faith that amounts to a breach by both parties.

(c) Article 82 of the Schedule of the International Sale of Goods Law provides:

> 'Where the contract is not avoided, damages for a breach of contract by one party shall consist of a sum equal to the loss,

> including loss of profit, suffered by the other party. Such damages shall not exceed the loss which the party in breach ought to have *foreseen* at the time of the conclusion of the contract, in the light of *the facts and matters which then were known* or ought to have been known to him, as a *possible consequence* of the breach of the contract' (emphasis added).

Similarly, art. 74 of the Vienna Convention provides:

> 'Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.'

In Israel, s. 10 of the Contracts (Remedies for Breach of Contract) Law, 5731-1970 (hereafter — 'the Remedies Law'), provides:

> 'The injured party is entitled to damages for the damage caused to him *as a result of the breach* and its consequences which the party in breach foresaw, or should have foreseen, at the time the contract was made, *as a probable consequence* of the breach' (emphasis added).

The idea underlying the principle of causality is that the person in breach is liable for the damage resulting from his action. Therefore, if two persons caused the damage, neither should be preferred to the other, but the liability should be divided between them so that each shall be liable for his share of the damage.

(d) The finding that each party should be liable for the damage for which he is responsible is also consistent with the requirement to mitigate the damage.

Article 88 of the Schedule of the International Sale of Goods Law provides:

> 'The party who relies on a breach of the contract shall adopt all reasonable measures to mitigate the loss resulting from the breach. If he fails to adopt such measures, the party in breach may claim a reduction in the damages.'

Similarly, section 77 of the Vienna Convention provides:

> 'A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated.'

Similarly s. 14(a) of the Remedies Law states:

> 'The party in breach is not liable for damages under sections 10, 12 and 13 for damage that the injured party could have prevented or mitigated by reasonable measures.'

These sections effectively limit the entitlement of the injured party to damages and constitute an incentive for the injured party to act to prevent and reduce his damage. However, the rule concerning the mitigation of damage comes into effect only after the breach, whereas we are concerned with the 'mitigation of damage' at stages preceding the breach or at stage of the breach itself. The use of s. 10 of the Remedies Law (or art. 82 of the Schedule to the International Sale of Goods Law) to achieve this purpose will preserve coherence and contribute to the integrity of the system. For why should we only hold the injured party liable to prevent his damage *ex post facto*, if he can easily do this *ab initio*? We used the word 'easily', since we are not talking about actual prevention but about not acting to create or to increase his damage. This applies *a fortiori* to our case, where the injured party is also in breach.

(e) It is true that the court tends to attribute unequivocal and absolute implications to a lack of good faith. Thus, a party's lack of good faith may deprive him of a remedy or confer a remedy on the other party. In this respect Justice Barak states (in HCJ 59/80 *Beer-Sheba Public Transport Services Ltd v. National Labour Court* [5], at pp. 838-839):

> 'Sometimes the result of non-compliance with a duty is the payment of damages or specific performance. Sometimes the result is that the party in breach is refused compensation or enforcement. Sometimes the result of the breach is that the other party is empowered to do certain acts within the sphere of the contract which otherwise would have been deemed a breach, or that the party in breach is denied a power given to him under the provisions of the contract. Sometimes the result is merely that

> the action done in breach of the duty has no effect and is invalid…'

The same has also been held with regard to improper behaviour that did not necessarily amount to a lack of good faith. CA 825/79 *Sherbet Brothers Building Co. Ltd v. Schwartzbord* [6] concerned a memorandum for the sale of land. The parties agreed they would prepare a detailed contract after they agreed the payment terms. But the buyer was evasive and on two occasions did not come to meetings arranged by the parties for preparing the formal contract, which led the seller to believe that the purchaser wished to withdraw from the transaction. Although the law did not regard the buyer's behaviour as amounting to a withdrawal from the transaction, and the memorandum remained valid, Justice D. Levin nonetheless ruled that the buyer's claim for damages should be dismissed *in full*, in view of her behaviour:

> 'Although the appellant did not formally cancel the memorandum, and she cannot be blamed for its non-realization, we cannot ignore the fact that her behaviour, as described above, contributed to the complication that ultimately led to this litigation. The transaction was in its initial stages, and on the determined facts, the appellant had not yet altered her situation as a result of the contract. In these circumstances I do not see what damage she can claim, and what justification there is for finding in her favour and awarding her any real damages' (*ibid.*, at p. 210).

It should be noted that in the other cases described, only one of the parties acted in bad faith or negligently, whereas in the present case, both parties lacked good faith.

Moreover, if it is possible to deny a remedy completely in cases like the aforesaid, then a partial denial of damages is even more possible, and as I shall show below, it is also desirable.

(f) As stated, the accepted premise is that contractual liability is absolute liability, in the sense that it usually arises in full force irrespective of the nature of the breach, the intentions of the party in breach or other circumstances. But even if we accept this premise, it does not mean that we cannot take into account the lack of good faith of both parties to the contract. Both parties in this case are tainted by this behaviour.

(g) It was pointed out in CA 804/80 *Sidaar Tanker Corp. v. Eilat-Ashkelon Pipeline Co. Ltd* [7], at p. 426, that:

> 'There is no *a priori* jurisprudential understanding of the term "absolute liability". Its meaning varies with the context in which it appears and the purpose that it is intended to serve.'

With respect to the method of examining the nature of absolute liability, we must refer to the statutory provision (the internal examination), in order to determine whether we can derive the purpose of the absolute liability from it. In this way we can also examine the applicability of defences such as a lack of good faith (of both parties, as in this case) to this provision. We must also consider general legal principles (the external examination). Accordingly, what will determine whether a lack of good faith can be imputed to a party to a contract who is *prima facie* entitled to compensation for damage resulting from a lack of good faith on the part of the other party, is the purpose of the law: in our case, this means the International Sale of Goods Law and general legal principles.

(h) The purpose of the International Sale of Goods Law is in effect to establish a standard contract that shall be deemed to be adopted by the parties, unless they make a stipulation to the contrary. The purpose of this contract is to allow the parties to realize their wishes to the maximum, while allocating between them the various risks involved in the transaction. The premise of the law is that the responsibility for performing a particular act in a transaction should be imposed on the party that can perform it in the best possible way.

Performance in the best possible way means, *inter alia*, performance at the lowest cost, since the presumption in this kind of commercial transaction is that the parties wish to derive the maximum benefit from the transaction. Therefore, the International Sale of Goods Law will not impose liability for doing a particular act on a party that may perhaps be able to do it well, if this will involve a considerable expense that may even negate the benefit that the parties will derive from the transaction itself.

Allocating the risks allows each of the parties to act in the knowledge that the other party will act in a manner consistent with the purposes of the transaction. In other words, the law gives both parties *the possibility of reliance*, which is one of the main aims running throughout the law of contract.

(i) Does achieving the purposes of the law depend upon the existence of absolute liability? Quite the contrary. Like any contract or transaction, the sale transaction is also based on a desire for cooperation between the parties, assuming, of course, that the cooperation will benefit each of them, and both of them jointly. There is no reason to assume that this cooperation ends with making the contract, and in our case upon reaching an agreement whose essence is the applying the International Sale of Goods Law to the relationship between the parties. As stated above, even a duty of disclosure that is not discharged at the pre-contractual stage remains in force at the contractual stage. It is only reasonable that along their joint path the parties will encounter various problems that require some flexibility and even a deviation from what was originally determined. Without doubt, cooperation will also be needed in the future. One aspect of this cooperation is the recognition that damage may be caused to one of the parties as a result of lack of good faith by both parties. 'Cooperation' in such a case is reflected in the allocation of liability for damages between the two — an allocation made after the event, which may in fact encourage cooperation from the outset.

(j) This determination does not conflict with the parties' reliance, since a party to a transaction who knows of a particular problem involved in it (and in our case it has been proved that both parties could have known) and does not raise it with the other party, knowing that such an act may in fact lead to frustration of the transaction, cannot claim that he relied upon the other party investigating the matter. This very argument contains a large degree of lack of good faith (see also: Dr A. Porat, *Allocation of Liability in the Law of Contract* (Doctoral Thesis), 1989, 88).

Moreover, it is possible that the very allocation of liability will strengthen the reliance of the two parties to the transaction, for when they know that each of them is under a duty to help the other to act — to a reasonable degree, naturally — their faith in the performance of the transaction will be strengthened and their reliance will be increased. We can also refer in this respect to the remarks of Dr Porat, *Allocation of Liability in the Law of Contract*, at p. 90:

> '... when the contract obliges both parties to perform somewhat complex obligations towards one another, rather than, for example, the mere payment of money. In such circumstances, each party knows that he is often likely to encounter difficulties in performance, from which the other party can help him to extricate himself easily. If, in his understanding of the legal

position, the other party is not obliged to help him even when it does not require an investment of resources, then his confidence *in his own ability* to perform the contract will be diminished. In any event, his confidence that he will receive, or that he is entitled to receive, the counter-performance of the other party will diminish. If however, in his understanding of the legal position, the other party must help him to a reasonable degree, his confidence in his own performance will increase, while at the same time his confidence that he will receive counter-performance will also increase, and as a result his ability to rely on the contract will increase.'

Prof. Mautner, *supra*, writes, at p 57:

'Because it is intended to guarantee the fulfilment of the reasonable expectations of the parties from their legal relationship, the duty of good faith in section 39 is the legal expression of the sociological concept of "trust". A number of sociologists regard the concept of "trust" as a key concept for understanding the way in which modern society functions. It can be stated simply that trust exists where the individual can assume that another individual or institution, whose behaviour is liable to influence him, will act in a way that can reasonably be expected of persons or institutions of that type… The trust is needed where the activity requires reliance on another, without real knowledge of the details and manner in which he acts… Sociologists who have dealt with this concept think that the degree to which we need to rely on trust has increased greatly in modern times, when many of our actions require reliance on the behaviour of many people, and understanding their ways of acting requires expertise that we do not have. Not only are they beyond our control; we do not even know them. Indeed, these sociologists assume that in the absence of trust in interpersonal relationships and in the absence of trust in the proper function of institutions, the order of modern society will collapse, to be replaced by utter chaos and a regression to a primitive era of self-reliance.

… I believe that there is a firm bond between the concept of trust and the legal concept of good faith. The idea underlying the two concepts is identical: the basis for the sociological concept

> of trust is the possibility that each individual may rely on the fulfilment of his reasonable expectations of other individuals and institutions to behave as required by their position or function. The basis for the legal concept of good faith is the possibility that each individual may rely on the fulfilment of his reasonable expectations of the legal relationship which he has with another, even if this expectation is not completely protected by the specific legal norm that defines the relationship.'

(k) To the same extent, the determination above does not affect the basic allocation of risks between the parties. The International Sale of Goods Law does not anticipate a situation where both parties can efficiently and cheaply avoid a difficulty that arose subsequently. A risk of this kind is not defined in the law, and consequently there is no initial allocation for it. A subsequent allocation, in accordance with the lack of good faith of each of the two parties, does not therefore conflict with the initial allocation (see also Dr Porat, *Allocation of Liability in the Law of Contract*, at p. 93).

(l) There is of course no doubt that the allocation of liability in our case is consistent with ideas of morality, justice and prevention of unjust enrichment that are the source of Israeli law in general, and the law of contract (including sales contracts) in particular. Where two parties cause damage, it is neither fair nor moral for one party to be liable for the full damages of the other. Why should a party to a contract be entitled to full compensation for damage caused also by his own foolish behaviour and lack of good faith? Moreover, allocating the liability between them will encourage good faith or care on the part of the two parties to the transaction. Recognizing a lack of good faith of a party to a contract does not prejudice the morally binding force of the other party's promise (in this respect, see: P.S. Atiyah, *Promises, Morals and Law*, Oxford, 1981). In reply to the question whether a specific promise is also considered to include the element of the consent included therein being irrevocable and therefore morally binding, we can also take into account the lack of good faith of the party to whom the question was addressed (see also: Porat, *supra*, at p. 122).

Similarly, this recognition does not prejudice the autonomy of the individual's will and the idea of trust, which underlie the need to keep promises (see in this respect: C. Fried, *Contract as Promise*, Cambridge, 1981). A person interested in furthering his desire by placing himself in the hands of others to make a mutual profit is not interested in subjecting himself to the arbitrariness of the other party, so that the latter may both contribute to

a breach and still insist upon full compliance with the promise. There is no moral value in this. The desire to create relationships of trust between people also does not justify a party contributing to a breach of a promise and insisting, nonetheless, upon full performance thereof. We should emphasize that recognizing the lack of good faith of both parties does not mean that the promisor is released from his promise, nor that it is legitimate to breach a promise. The idea behind it is merely the determination of reduced sanctions because of the lack of good faith of the party who was given the promise. In this respect it should be noted that Israeli law tends to read implied terms and conditions into contracts, which are mainly based, *inter alia,* on good faith.

In a similar context Dr Porat, *supra,* at p. 107, says:

> 'External intervention in the contents of the contract, whether direct or indirect, both by virtue of a specific statutory provision and by virtue of a provision of a law that gives the court broad discretion, emphasizes the fact that the modern contract should not be regarded as a formal instrument for allocating risk and planning for the future. The external intervention is sometimes not specifically anticipated; this is so where it is done by virtue of general provisions of law, which must be given meaning in accordance with the circumstances or considerations of legal policy. In this way, a price is paid in a decrease in security and certainty, reliance is adversely affected and legal principles are not always clear and obvious. Recognizing a defence of contributory negligence in these circumstances is merely the addition of another external criterion, which is not always consistent with the expectations of the two parties, and the reasons for its existence are first and foremost morality, justice and fairness.'

We can only add that if intervention is possible in a case of a contract written by the parties themselves, how much more so in a case of a contract whose contents are determined by a law and with regard to which it can be assumed that the principles of fairness are the central pillars of the legal system that led to its legislation.

(m) In a situation like the one before us, where in practice both parties contributed by their behaviour to the damage, allocating the liability is the desired result. The plaintiff can no longer claim that he was entitled to rely upon the performance of the other party, since the defendant has an equal right to say this. Similarly, the plaintiff cannot rely on arguments concerning

the moral aspect of keeping promises. There is also no difficulty in applying the doctrine, for just as the defendant's liability for the plaintiff's damage will be determined, so too will the plaintiff's liability for the defendant's damage be determined. Any other ruling would lead to an absurd, since as each of the parties is in breach, we should *prima facie* impose on each of them absolute liability for the damage caused by the breach to the other party.

The fitting solution in circumstances like these is to allocate liability between the parties. In this respect Dr Porat, *supra*, at p. 212, says:

> 'We are dealing with two sets of behaviour, at the same level, with identical characteristics, where neither has any advantage over the other. The equality described above almost cries out, for reasons of justice and fairness, for equal treatment of the plaintiff and the defendant, i.e., an allocation of responsibility. It is impossible to determine who should be preferred. This is even a situation which would lead to a vicious cycle of claims without any solution.
>
> Any solution, other than an allocation of liability, would be arbitrary and, for that reason, unjust.'

(n) This ruling has an additional advantage in that it unites the principles for compensation in the law of torts and the law of contract. The appeal before us is an example of a case that lies on the borderline between the two fields. This borderline must inevitably be blurred in the appropriate case.

In fact, each of the parties could have argued that the other was negligent or, to be more precise, made a negligent misrepresentation. The compensation claimed would be for damage caused unlawfully. There is no real reason to apply different principles of compensation in the two cases.

There is also no doubt that a case of this sort is particularly suited for an allocation of liability. What reason is there for establishing a different liability in accordance with the drafting of the statement of claim? On the contrary, this would divert the consideration of the case from substantive issues to merely technical issues regarding the nature of the grounds set out in the statement of claim, thereby emphasizing what is trivial instead of what is important (see Porat, *supra*, at p. 115).

(o) It is interesting to note that in similar cases the court has recognized, even if only tacitly, the possibility of allocating contractual damage in accordance with the degree of culpability of the two parties. This is so in cases where the court considered the revaluation of the contractual price. The

court tended to justify the revaluation, or not making a revaluation, *inter alia* with reasoning relating to the relative culpability of the two parties. In the words of Justice Barak in CA 158/77 *Rabinai v. Man Shaked Ltd (in liquidation)* [8], at pp. 291-292:

> 'In principle, a court asked to make an order of specific performance has three options: the court can refrain from granting the order; it can make an order of specific performance as stated in the contract; it can make an order of specific performance with instructions to revalue the price… In CA 277/57, the court refused… to make an order of specific performance with regard to a contract for the sale of land... *where the buyer had delayed in performing it*, during which time the price had fallen to less than a fifteenth of the original price. The court adopted the same approach… when it refused to make an order of specific performance with regard to the contract for the sale of land… (emphasizing) that it did so in view of the special circumstances of the case, in which *the buyer had shown inflexibility*, a fact that reduced the degree of the deliberate refusal of the seller to transfer the asset. In a number of judgments, this court has made an order of specific performance and refused to revalue the price… while emphasizing the *deliberate behaviour of the seller*, who not only breached the contract but also put off the buyer repeatedly and intentionally refused to honour the contract that he had made... Finally, in a number of cases, this court has made an order of specific performance while *partially revaluating the price*… Recently… we ordered specific performance of a contract for the sale of an apartment, which the seller had deliberately breached, and it gave instructions that *part of the price would be paid with linkage* to the increase in the consumer price index' (emphasis and parentheses added).

This was also the case in CA 789/82 *Ezra v. Mugrabi* [9], at p. 574, where Justice Bejski held:

> '… in enforcing a contract, the consideration or balance of the consideration payable is revalued as of the date of enforcement… the same applies with regard to restitution in the case of a breach of contract… subject to the court's discretion regarding the degree of revaluation… taking into account the

> circumstances relating to *the nature of the breach, the behaviour of the person in breach, and the circumstances* that should be taken into account for this purpose' (emphasis added).

See also: M. Hork, 'Adjustment of the Contractual Price', 8 *Iyunei Mishpat,* 1981, 88, at p. 112.

(p) Before concluding, I will mention that if we were discussing the breach of the duty of good faith at the negotiation stage, it would have been easier to recognize the doctrine of allocation of liability, since s. 12 does not originate exclusively from the law of contracts, as Prof. D. Friedman and Prof. N. Cohen point out in their book, *Contracts*, Aviram, vol. 1, 1991, at p. 636:

> 'The difficulty existing in a contractual claim does not arise with respect to improper behaviour at the negotiation stage, in view of the fact that the claim is not contractual and in view of the tortious nature of s. 12. This position is consistent with our general approach whereby the section can be supplemented by means of the principles embodied in the Torts Ordinance.'

See also CA 714/87 *Sher v. Cohen* [10], at p. 164.

However, since it appears to me that the situation before us must be classified as part of the performance stage, since we are concerned with an obligation that derives from the contract (an obligation to transfer ownership free of any right of a third party), I therefore think it correct to examine the incorporation of the allocation of liability into that material. Undoubtedly, the readiness to recognize the allocation of liability at the negotiation stage also supports the need to incorporate this doctrine also at the stage of performance of the contract, in all its stages. We should emphasize once more that since the lack of cooperation and the absence of disclosure in our case originated in the pre-contractual stage, it is easier to apply the accepted principles at this stage to them.

(q) I have determined that in this case we should recognize the allocation of liability between the parties. All that remains is to determine how this allocation is to be made.

There are three possible methods:

(1) An allocation by comparing *the degree of bad faith* attaching to each of the parties.

(2) An allocation by comparing the *causal contribution* of each of the parties to the damage.

(3) An allocation that *combines* the degree of bad faith with the causal contribution to the damage (Porat, *supra*, at p. 314).

In the case before us, where we are concerned with a situation of mutual lack of good faith, we must compare both the causal contribution of each party to the damage and the degree of lack of good faith of each of them.

Finally, in the circumstances of the case, it seems to me that the correct allocation between the parties is the *equal* allocation.

5. The result is that the appeal should be allowed, albeit in part. The exporter-seller will be liable for 50% of the damage and the importer-buyer will be liable for the remaining 50%.

In the circumstances, each of the two parties shall pay costs to the State Treasury in a sum of 6,000 NIS.

Justice Y. Malz

I agree.

Justice E. Goldberg

I agree with President Shamgar's remarks that both the appellant and the respondent 'could not have been unaware of the possibility that a registered trade mark existed,' for the reasons that he gives in his opinion. If so, the respondent's behaviour cannot be deemed to be tainted by a lack of good faith, for the appellant had the same knowledge as the respondent. The lack of cooperation between the parties also cannot be deemed a lack of good faith, when each of them also knew of the danger that the anticipated damage existed and did not need the other party in order to discover this danger.

The buyer's demand of the seller, under art. 52(1) of the Schedule to the Sale (International Sale of Goods) Law, that 'other goods free from all rights and claims of third persons be delivered to him by the seller' is based on the fact that the buyer *did not agree* 'to take the goods subject to such right or claim' (emphasis added). Such an agreement does not need to be expressly stated, and it may be inferred from the circumstances.

In our case, the learned judge determined that:

> 'The manufacturer knew that the plaintiff had examined the sample in the United States and received the customer's consent. This examination resulted in two special changes being ordered, of which at least one — the replacement of the soles — relates to customs problems. In this situation, a representation was made to the manufacturer that the party making the order knew the laws of the country of destination and the duties it imposed on him thereunder, and that he had complied with these obligations as an importer… the manufacturer was permitted to rely on the importer making the necessary preparations, from his point of view, for receiving the goods in the United States.'

What emerges from the remarks of the trial court is that the appellant, who, as stated, knew that there was a possibility that a registered trade mark existed, also knew the laws of the country of destination, and therefore it can be regarded as having agreed to assume the risk involved therein. If it turned a blind eye, this does not justify allocating the liability between it and the respondent.

I would therefore dismiss the appeal.

Appeal allowed in part, by majority opinion (President M. Shamgar and Justice Y. Malz), Justice E. Goldberg dissenting.

22 August 1993.