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Factoring in Israel

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I. INTRODUCTION

Factoring is a comprehensive, long-term relationship between a factor and an entity that sells assets or provides services to business customers ("supplier"). The factor provides the supplier with various services: financing, ledgering, collection of receivables and protection against customer default.[1] The UNIDROIT Convention on International Factoring defines a factor as an entity that performs at least two of the following functions: financing the supplier; maintenance of the receivables; collection of receivables; and guaranty against default by customers.[2] Due to the close legal relationship involved, many factoring agreements provide for exclusivity and prohibit the supplier from assigning its account receivables to any third party.

Factoring transactions have many nuances. In some cases, the supplier's customers are notified of the transaction, and are then required

1. PETER M. BISCOE, LAW AND PRACTICE OF CREDIT FACTORING 3 (1975). For different types of factoring, *see* NOEL RUDDY, SIMON MILLS & NIGEL DAVIDSON, SALINGER ON FACTORING 16-22 (4th ed. 2006).

2. UNIDROIT Convention on International Factoring, May 28, 1988, 27 I.L.M. 922, *available at* www.unidroit.org/english/conventions/1988factoring/1988factoring-e.htm.

to pay their debt directly to the factor. In other cases, the customers are not supposed to be notified of the transaction; this structure, known as non-notification or invoice discounting factoring, is preferred when the assignment of rights might be construed as financial weakness and adversely affect the supplier's business. In such cases, the supplier collects the debts for the factor, and holds the money in trust until actual transfer.[3]

Data collected by the World Bank indicates the increasing of the use of factoring. In 2005, about $1 trillion of factoring transactions took place. In certain countries with rapidly emerging economies, such as China, Mexico, Turkey, and Brazil, the scope of factoring transactions increased by more than 50% between 2000 and 2005. In each of these countries, the scope of factoring transactions exceeded $5 billion per year. One of the reasons for this increasing use is probably that factoring is a convenient financing method for new or growing businesses that do not have sufficient tangible assets to offer as collateral. Factoring is also suitable for seasonal traders that require financing for their expenses, before they receive income from customers.[4]

The factor and the supplier enter into a framework agreement that stipulates the terms for future transactions with respect to the transfer of monetary rights vis-à-vis specific customers. A factoring agreement typically includes a non-recourse provision, namely, that in the event that the factor is unable to collect the debt from the customers, the factor may not claim such debt from the supplier, except if the customer refuses to pay due to a commercial dispute regarding the quality of the product or service. Once the framework agreement is signed, the supplier offers the factor specific debts to be included under the framework agreement. The factor examines the financial position of each specific customer, and decides whether to purchase the rights against him. In a non-recourse agreement, the factor relies on the financial position of the supplier's customer, and therefore thoroughly examines it's financial position. This type of transaction is prevalent mainly in countries that have a developed credit rating system from which the factor can draw information about numerous businesses.[5] If the factor decides to purchase the rights with respect to a certain customer of the supplier, the factor and the supplier enter into an assignment of rights agreement. The assignment of rights

3. ROBERT R. PENNINGTON, BANK FINANCE FOR COMPANIES 42-43 (1987); International Factors v. Rodriguez, [1979] Q.B. 351 (U.K.).

4. Ken L. Lott & Robert G. Meyers, *Secured Lending*, 28 MERCER L. REV. 699 (1977).

5. *See The Role of Factoring for SME Finance*, AccessFinance (The World Bank Group) Dec. 2006, *available at* http://siteresources.worldbank.org/INTACCESS FINANCE/Resources/AFIssue15.pdf.

agreements is in accordance with the general terms of the framework agreement.

Factoring also plays an important role in international trade. In this arena, two factors are involved instead of one. The exporter sells goods to the importer under a supplier credit arrangement. The exporter contracts with a local factor, which works together with a factor in the country of the importer, and the two factors make all the arrangements necessary for the exporter: they look into the importer's financial position, provide for financing, provide protection against default, collect the debts of the supplier, etc. The exporter receives a line of credit from its local factor for the shipments it is to make to the importer. The factor in the importer's country inquires as to the importer's financial position, and advises the factor on the exporting side of the maximum risk that the importing factor agrees to assume. The factor in the importer's country assumes the credit risks. The factor in country of export pays the exporter, and the factor in the importer's country indemnifies the other factor for this payment. The exporter sends the importer goods under a supplier credit arrangement, transfers the bills to the factor in the country of export, and is thereby released from taking any further steps. The factoring companies guarantee payment by the importer. This mechanism eliminates the use of letters of credit, and therefore cuts the costs of the transaction. Collection is performed by the factors, saving the exporter operating expenses.

The development of international factoring has led to the foundation of an international association of factors, the Factors Chain International ("FCI"). The FCI sets forth the rules to be followed by its member factors in their transactions with one another. These rules relate to the distribution of risk between factors, the obligations they owe each other, the law governing disputes between factors from different jurisdictions, arbitration procedures, etc.[6]

Factoring differs from a simple assignment of rights. In a typical assignment of rights, the assignee provides the assignor with interim financing, and in consideration thereof, the assignor assigns its rights against various debtors. The factor, on the other hand, does not necessarily provide the supplier with interim financing. In any event, even when the factor finances the supplier's operations, it also provides other services, such as debt management and collection, and protection against customer default. In non-recourse transactions, the factor assumes the supplier's credit risks, whereas in simple assignments of

6. *See generally* Factors Chain International Home Page, http://www.factors-chain.com/ (last visited Nov. 15, 2008).

rights, an assignee that is unable to collect the debt from the debtor, may collect the debt from the assignor.[7]

Although factoring is relatively new to Israel, there are now several factoring companies here. As of now, these factoring companies provide services mainly to suppliers that sell their goods or services in Israel. Factoring is of special importance in Israel, because of the centralized structure of the local banking sector. In Israel, the banks have provided most of the financing in all branches of the economy, factoring offers suppliers an alternative. This development is welcome, because it creates competition in the financing sector and pushes down costs of conducting business. I believe that the legal system should facilitate this trend by developing a body of law that would be conducive to factoring transactions. The next two chapters will address two legal questions in the field of factoring: (i) is the transaction a sale or a security interest; and (ii) in the competition between a factor and a floating charge, which of the two prevails.

II. TRUE SALE VS. SECURITY INTEREST

There are two ways in which a creditor can transact in its rights against debtors: sale and security interest. The creditor may sell its rights to a third party or take a loan from a third party against a charge on the creditor's rights against the debtor. In an assignment by way of sale, the assignee is a purchaser, and in an assignment by way of security interest, the assignee is a secured creditor in the competition with the assignor's other creditors. The assignee's position as a purchaser is better than it is as a secured creditor. For example, under corporate law, when the court issues an order of protection against creditors, the court may suspend the right of a secured creditor to exercise its collateral, provided that adequate protection is provided for the rights of such secured creditor.[8] In the event of a true sale of the creditor's rights, the court does not have the power to adversely affect such rights. There are other implications to the distinction between the sale of a right and the creation of a security interest over such right. For example, the sale of a right does not have to be officially registered, whereas the collateralization of a right requires registration.[9] Further, if factoring is used by way of a security interest, the factor must repay the supplier amounts exceeding the principal and interest fixed in the agreement.

7. CA 12027/04 Nasser Aldin Salman v. Saliba & Sons Ltd. 2005(3) Takdin Elion 1100; CA 348/79 Goldman v. Michaeli [1981] IsrSC 35(4) 31.

8. Companies Act, 1999, S.H. 189, § 350(f).

9. Security Interests Law, 1967, 20 LSI 44 § 4 (Isr.); Companies Ordinance [New Version] 1983 D.M.I 761 § 178 [hereinafter Companies Ordinance].

However, it is not always easy to distinguish between a true sale and a security interest transaction. The court has held that "the typical attribute of an assignment by way of security interest is that . . . the assignee has the right to claim the assignor's debt from the assignor, in the event that the debt is not paid by the debtor."[10] If, under the agreement between the assignor and assignee, an assignee that is unable to collect the debt from the debtor, may not then collect the debt from the assignor, the transaction does not dovetail with the principles of security interests. Collateral is always ancillary to the debt; it guarantees the liability but does not replace it.[11] A lender who took collateral and whose debt is not paid when it becomes due, may exercise the collateral and collect his debt from the proceeds, or may file claim against the borrower for repayment of the debt.[12] In other words, a lender who received collateral may claim repayment of the loan from the borrower and is not obligated to exercise the collateral. If the assignee is not allowed to claim repayment from the assignor, this is not a relationship of lender and borrower.

In light of the above, non-recourse factoring cannot be deemed a security interest relationship and should rather be classified as a sale transaction. In a factoring agreement, the supplier makes various representations, which, if breached, are cause for the factor to terminate the agreement and receive repayment of any money that the factor has paid to the supplier. For example, the supplier represents that the customer owes a certain amount of money, that the statute of limitations has not run on the debt, that the goods delivered to the customer were adequate, etc. The supplier's obligation to repay the factor in the event that these representations are breached, is not indicative of a security interest. These matters are unrelated to the classification of the agreement as a sale or security interest transaction. As long as the factor has no right to claim repayment of all the money paid under the factoring agreement, the agreement is not a security interest. A right of recourse by which the supplier is obligated to repay the full amount paid by the factor in the event that the factor is unable to collect the debt from the supplier's customers, may be deemed a loan in which the rights serve as collateral. In such cases, the factor would be well advised to register its right with the Registrar of Companies. As under United States law, registration in and of itself shall not be deemed admission that the factoring transaction is not a sale agreement, but will, at the same time,

10. CA 3966/01 Yehoshua TBWA v. Bon Mart Millennium Ltd. (In Receivership) [2003] IsrSC 57(4) 952.

11. Security Interests Law § 15.

12. Security Interests Law § 23.

protect the factor if in a future dispute the court holds that the specifics of the transaction cause it to be classified as such.[13]

III. COMPETITION BETWEEN FLOATING CHARGE AND FACTOR

A. *General—Competition Between a Floating Charge and an Assignee*

The starting point for the analysis of a competition between a floating charge and a competing right is Section 169(b) of the Companies' Ordinance, which provides as follows:

> A floating charge does not provide the holder of the debenture priority or preference over the holder of a mortgage or a purchaser for consideration of the Company's real property, even if such holder or purchaser knew, upon creation of the mortgage or upon purchase, of the floating charge; if, however, the document creating the floating charge includes a restriction on the company's right to create security interests, and if this restriction is included in the details submitted for registration of the floating charge, then the floating charge shall prevail over any security interest created in violation of the restriction after the Registrar has registered these details.[14]

A classic floating charge is subordinate to the interests of secured creditors with a specific charge and the interests of purchasers of the company's assets. However, when the debenture creating the floating charge includes a restriction on the right of the chargor company to enter certain transactions without the prior consent of the chargee, except for business inventory, and provided that the floating charge and the restriction are both registered with the Registrar of Companies, then the chargee shall prevail over the holder of any competing right. For several decades now, drafters of debentures—which in most cases are banks—have incorporated such restrictions in their debentures as a matter of standard procedure. If taken verbatim, the latter part of Section 169(b) deals with the relationship between a floating charge and a subsequent specific charge; case law, however, has applied it also to the competition between a floating charge and a sale transaction, and has held, for example, that the holder of a floating charge prevails over an assignee that purchased from the company rights against its customers.[15] One court decision seems to draw a distinction between, on the one hand, an assignment of rights that is used as payment and is designed to satisfy an

13. 13.Companies Regulations (Reporting Particulars of Registration and Forms), 1999, KT 166.

14. Companies Ordinance, *supra* note 9.

15. CA 10907/03 Bank Leumi Le-Israel Ltd. v. State of Israel—Ministry of Health et al. 2005(2) Takdin Elion 3593.

earlier debt that the assignor owes the assignee, and, on the other hand, a financial assignment of rights, designed to provide interim financing to the assignor. The assignee prevails over a preexisting floating charge in the first case, but not in the second case.[16]

The holder of a floating charge prevails over a third party where the transaction between the company and such third party is in violation of the restriction in the debenture creating the floating charge. The outcome of the competition therefore depends on how the restriction is interpreted. We believe that this interpretation should be consistent with the inherent nature of the floating charge and must take into account the fact that the chargee wants to enable the company to continue to conduct business, and at the same time to block the creation of competing rights in favor of third parties. The balance between these two forces dictates the outcome of most conflicts. If the restriction is interpreted too broadly, there will be no difference between a floating charge and a fixed charge. The interpretation of certain transactions or actions must therefore be that they do not violate the restriction found in the debenture.[17]

As noted, the holder of a floating charge has no desire to adversely affect the company's usual course of business, which requires the purchase and processing of raw materials, the purchase and sale of finished goods, etc. In order to perform such actions, the company needs financing and needs to receive various services. The holder of the floating charge wants to facilitate these activities, which will improve the company's business and therefore also its ability to repay its debts. The holder of a floating charge does not, therefore, consider the purchaser of the company's inventory to be a competitor. A similar approach may apply with respect to a supplier of raw materials or other services that the company requires in its ordinary course of business.

The main competitor of the holder of a floating charge is another provider of financing. The holder of a floating charge seeks to be the primary or exclusive source of the company's financing. It is convenient for the holder of a floating charge to grant additional loans to the company, because the charge that it has secures all of the company's debts, without a ceiling, and will also apply to any further loan that the chargee provides. The chargee has access to information about the company's business and financial position, and can therefore save costs that would be incurred in a loan to an unfamiliar borrower.

16. Bankruptcy Case 2004/01, Bank Hapoalim Ltd. v. Metula Local Council, 2001(1) Takdin Mehozi 3992.

17. SHALOM LERNER, COMPANY CHARGES 188-89 (1996).

As mentioned, the holder of a floating charge is not concerned about purchasers or suppliers, but does not welcome competing lenders. In practice, however, there is no clear cut distinction between suppliers and lenders. Most suppliers provide the company with short-term credit for payment for the goods they provide—transforming such suppliers into lenders. It is my position that the holder of a floating charge does not consider all lenders to be competitors, but only those that require collateral.

To conclude, under Israeli law, the holder of a floating charge prevails over an assignee that provides financing to the assignor, regardless of whether the assignment is a security interest or a true sale. The holder of a floating charge considers all other secured lenders to be competitors, and seeks for the company to take the financing it needs from the chargee rather than from anyone else. At the same time, the holder of a floating charge is in no competition with others, like suppliers, whose function goes beyond the provision of financing. When the holder of a floating charge is unable to provide the company with a similar product or service, it is in its best interest that the company acquire what it needs from third parties, so that it can continue developing its business. Therefore, a transaction with such entities should not be deemed a competing transaction under the second part of Section 169(b) of the Companies Ordinance, and is therefore not subordinate to the floating charge.[18]

B. Floating Charge vs. Factor under English Law

The construct of a floating charge in Israel originated from English law. Factoring transactions are common in England, and it is therefore reasonable to examine the position of English law with respect to the competition between a factor and a floating charge. A comprehensive search only found one instance in English case law that dealt with a direct conflict between the two, *In re State Securities v. Liquidity Ltd.*[19] This decision relates to a preliminary stage, an injunction, and does not describe the terms of the factoring transaction, which apparently was a security interest. No clear guideline can therefore be extracted.

Perhaps the scarcity of conflicts between floating charges and factoring companies is due to the laws that apply to floating charges in England. In England, debentures routinely include restrictions on competing transactions that did not receive prior consent of the holder of the floating charge. However, the restriction is not registered with the

18. *See* Companies Ordinance, *supra* note 9.
19. [2006] EWHC (Ch.) 2644 (Eng.).

Registrar of Companies, and only if the party to the later transaction has actual knowledge of the restriction, is such party subject to the floating charge. Knowledge of the existence of a floating charge is not deemed knowledge of the restriction included in the debenture. Consequently, later competitors are not deemed to know of the restriction, and under the English rules of equity, a later good-faith competitor prevails over the holder of a preexisting right in equity. The floating charge under English law is a right in equity rather than a right at law.

In his book *Company Charges*,[20] William James Gough provides a following summary of the prevailing law:

> A prior registered floating charge is frequently liable to rank subsequent in priority to the legal or beneficial ownership acquired by an absolute assignment of book debts under a factoring arrangement. The company is free to sell its assets subject to the floating charge, so as to confer a clear title free of the floating charge. . . .
>
> Restrictive clauses . . .inserted into the floating charge to prevent the creation of subsequent adverse title security interests fail to provide blanket protection. They are effective only if the subsequent party has actual notice of the terms of the protective clause, Prior registration of the floating charge does not fix subsequent parties with statutory constructive notice. The judicial doctrine continues that there is constructive notice only of the existence of a floating charge and not of the restrictive clause contained within the contents of the floating charge.

As we can see, English law overlooks the well-known fact that debentures almost always include a restriction on subsequent transactions. Before Section 169(b) was amended in 1980, the law in Israel was similar.[21]

C. Floating Charge vs. Factor under Israeli Law

Israel has no case law relating directly to the competition between a floating charge and a factoring transaction. The law should therefore be extracted from the general principles of law and policy considerations. I believe that factoring companies that acquire the accounts receivable should prevails over preexisting floating charges. My reasoning is explained below.

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20. WILLIAM JAMES GOUGH, COMPANY CHARGES 432-33 (2d ed. 1996).

21. *See generally* CA 471/73 Temporary receivers of Electrogenics Ltd. v. Elcint Ltd. [1974] IsrSC 29(1) 121.

We have seen that a floating charge that restricts later transactions, prevails over an assignment in which the assignee purchased or received as collateral, rights of the chargor company toward third parties. However, I am of the opinion that an assignee that is not a lender or that also provides other functions, should prevails over the holder of a prior floating charge.

In a non-recourse factoring transaction, the factor's main role is to provide protection against default by the company's customers. The factor not only provides financing, but also assumes the company's credit risks, and renders additional services. With reduced credit risks, the company's liquidity improves, indirectly improving the position of the holder of the floating charge. The credit risk reduction increases the company's chances of paying its debts to the holder of the floating charge. The holder of the floating charge is not ready to render the company the services offered by the factor.

As mentioned, the factor provides the supplier with additional services, such as loan management and collection. This allows the management of the supplier to focus on production and marketing. Relieved of such chores as loan management and collection, the supplier's turnover increases, as do the chances that it will repay the holder of the floating charge. These services are unique to the factoring company. In Israel, the holders of floating charges are typically banks, which do not provide such services. In this respect, factoring companies resemble operating lease companies. In a financial lease, the lessee only gets financing, and the lessor is therefore a lender and is subject to the Security Interest Law. In an operating lease transaction, on the other hand, the lessee also receives maintenance and repair services with respect to the leased asset, and therefore, in the event that the lessee becomes insolvent, the leasing company shall prevail over the lessee's other creditors, and no registration is required in order for such priority to be enforced. Given the above, the restriction commonly included in floating charges should not apply to factoring transactions.

Use of factoring transactions in many countries is increasing rapidly, and these transactions play an important role in international commerce. Factoring plays an important role in Israel too. The banking sector in Israel is exceptionally centralized, with two banks accounting for approximately 60% of the local financing sector. Under these circumstances, competition should be encouraged such that the cost of financing is lowered. For this purpose, alternative financing avenues should be developed. If factoring extends to Israel's foreign trade, this would help increase exports and would significantly boost the Israeli economy.

The number of floating charges in Israel is very high, and most of these charges are in favor of banks. Any company that opens a business account with a bank and wishes to receive a credit line is required to create a floating charge in favor of the bank. The subordination of a factoring company to a preexisting floating charge would severely constrain the development of factoring transactions in Israel. In order to develop, factoring transactions need a supportive legal environment. There should be a body of law that facilitates the development of factoring transactions. In the competition between a factoring transaction and a preexisting floating charge, the interpretation should be that the factoring transaction prevails.

The floating charge in Israel was originally based on the English model, but the amendment of Section 169(b) in 1980 made it stronger than its counterparts in other Common Law jurisdictions. This strength gave the floating charge a monopoly in financing, and was therefore to blame for the cost of financing in Israel. A few years after the amendment, the legislature recognized that it had gone too far, and created an express exception for a purchase money security interest.[22] A similar approach should be applied with respect to factoring. It would be best if there were an express exception for factoring, but the desired outcome can be obtained even now, if the court interprets Section 169(b) narrowly, and holds that a factoring transaction does not violate the restrictive provision in the debenture.

IV. CONCLUSION

In order for factoring to extend to export transactions, the developed states must have a unified rules governing these transactions. The legislature and the courts should cause the rules governing factoring in Israel to be consistent with those that apply in other parts of the developed world. Such uniformity would enable Israeli companies to join the FCI and facilitate Israeli exports. A country whose laws impose hurdles for factoring transactions, will not be able to partake in this important development in the international commercial arena.

Israeli law as currently in effect does not address factoring transactions; Israel should adopt laws that facilitate such transactions. Such laws can expressly prioritize factoring over preexisting floating charges. This would of course require a definition of the types of factoring transactions that would receive such preference.

In addition, the rules of assignment of rights should be adjusted to accommodate for factoring. As currently in effect, the Assignment of

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22. Companies Ordinance, *supra* note 9, § 169(d).

Obligations Law envisions a single assignment followed by a notice to the debtor. The law attributes much weight to this notice in the protection of the assignee's rights. For example, in a competition between two assignees, the assignee who first notified the debtor of the assignment shall prevail.[23] Also, the debtor may not invoke against the assignee arguments arising from other transactions he has with the assignor, if such arguments originate from facts that came into being after the notice of assignment.[24] The factor acquires many rights against the supplier's customers, and cannot rely on a notice to such customers as a key element in the protection of its rights. There are transactions in which the customers are deliberately not notified of the assignments, and in such case the factor might forfeit its rights to a subsequent assignee that notifies the customer of the assignment. In order to adjust the rules of assignment of rights to factoring transactions, it should be stipulated that registration of the transaction, rather than notice, will be the decisive element in the conflict of rights.

From an analytical point of view, the main issue discussed above—the competition between a floating charge and a factor—highlights the strength that a floating charge has under Israeli law. The charge is "floating" only by name, while in fact it has the same force as a fixed charge. In a classic floating charge, the controlling date that determines the outcome of a competition between rights, is the date on which the charge crystallized. Under Israeli law as currently in effect, however, and given the restriction in the language of all debentures and the recognition given to this restriction in statute, the critical date is that on which the floating charge was created and registered with the Registrar of Companies. This priority, which applies to all of the assets of the indebted company, is very extensive, and the conflict with the factor underscores the need to define additional exceptions.

23. *Id.* § 4

24. *Id.* § 2(a); *see* CA 8357/03 Israel Lands Administration, ILA v. Discount Bank of Mortgages, Ltd. 2006(4) Takdin Elion 124 (interpreting § 2(a)).