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Contractual Rights and Checks as Security in Israel

Shalom Lerner*

I. Contractual Rights as Security

A. *Typical Cases*

In Israel, as in other countries, a creditor's right to receive money from his debtor constitutes a base for securing credit. Thus, *B*'s right to receive a sum of money from *A* in a few months enables him to take a loan from *C* and charge to the latter his right against *A*. The charging of the right thus enables *B* to receive interim financing. Case law provides numerous examples of the practical importance of charging rights, a few of which are presented below:

1. A contractor wins a government or public tender for the construction of a huge project, necessitating interim financing for its execution. His expected income from the project enables him to take a loan from a bank to finance the project's execution, and the contractor can secure the loan by charging his expected income from the project to the bank.¹
2. A bank grants a loan to a contractor for the execution of a building project, funded by closed financial escorting. In this method of financing, contractor opens a bank account which is a conduit for all the income and expenses connected to the project, and the account is charged to the bank. A bank account represents a contractual right which a customer has against the bank to receive any money de-

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1. See e.g., *Katz Gen. Contractors Ltd. (in liquidation) v. Contractors Union Ltd.*, 26 (1) P.D. 60, (1971); *E.S.T. Fin. Ltd. v. United Mizrahi Bank Ltd.*, 46 (3) P.D. 570 (1992); *Adv. Levinson as Official Receiver for Olitzki Soil and Road Works Ltd. v. Ministry of Nat'l Infrastructures et al, Dinim (Dist)*, 26 (9) 935 (1988).

posited in the account. Thus by charging his bank account to the bank, the contractor is actually charging his contractual right against the bank, (i.e. his bank account) in favor of the financier (which in this case is the bank).

3. An industrial concern requires financing in order to create its commercial surplus. The bank, or another financier, grants it the financing, and the concern charges to the bank the income it expects from its customers.²
4. A person charges the car which he owns to a financier. The financier requests that he insure the car and that any right against the insurance company also be charged to the financier. This kind of charge is frequently used in the leasing of land; the lessor demands that the lessee insure the leasehold and charge to the financier his rights against the insurance company.³
5. A supplier sells merchandise to large marketing networks by credit, and within a few months expects to receive the consideration therefor. The supplier needs interim financing, and the bank grants it to him in reliance upon the supplier's rights against the marketing networks.
6. A savings account in a bank and an insurance policy secure a loan received from the bank or from the insurer.

B. Registration

A right that has been charged is valid against a third party, e.g., the liquidator of the chargor or his trustee in bankruptcy, if it has perfected by filing. Generally, collateral is perfected either by filing or by its transfer to the creditor's possession, but in respect of intangible assets, such as rights, filing is obviously the only way. A charge on a right is registered at the Charges Register in the case that the chargor is an individual, or at the Companies Register, where a company charges its rights against a debtor. A charge which is not registered is not valid against third parties, even in non liquidation cases. Thus, the charging of a right which was not registered will be ineffective against a lien that was imposed on it, though at a later stage.⁴

2. See e.g., *United Mizrahi Bank Ltd. v. Chagai Pe'er, Acct, Receiver and Manager of Griloz Textiles Factories Ltd. (In Receivership)*, 45 (4) P.D 870 (1991); *Prinir Ltd. (In Receivership) v. Israel Leumi Bank Ltd., Dinim (Dist)*, 26 (7) 320 (1998).

3. *Biderman Ins. Co. Ltd. v. Y.D. Matar Ltd. et al*, 46 (5) P.D. 397 (1992).

4. See S. LERNER, *COMPANY CHARGES* 316 (Heb. 1996).

C. *Security Interests Law and the Assignment of Obligations Law*

The Security Interests Law, 1967 regulates the charging of all assets: land, chattels and rights. The Law applies to any "assets as a security for an obligation."⁵ Even though the Law contains no definition of the term "asset," it is clear that it includes rights, inasmuch as the specific sections therein deal with rights.⁶ The Companies Ordinance relates to the charging of company property, and refers specifically to the charging of rights.⁷

Existing alongside the Security Interests Law, the Assignment of Obligations Law applies to "an assignment . . . by way of a charge,"⁸ but both laws actually operate on different levels. The Security Interests Law regulates the relations between the secured creditor and other creditors of his debtor, or from the perspective of assignments, the relations between the assignee and various creditors of the assignor. The Assignment of Obligations Law, on the other hand, focuses upon the relations between the account debtor and the assignee.⁹ "The charging of a debt—regardless of its form—is an assignment for the purposes of the Assignment of Obligations Law and a charge for the purposes of the Security Interests Law."¹⁰ This difference is concretized in the following example: an account debtor was aware of the charge and nonetheless paid his debt to his original creditor. Whether the account debtor is still liable to the secured creditor, the assignee, is a question concerning the relations of the account debtor and the assignee and is thus resolved by the Assignment of Obligations Law. Accordingly, the debtor must repay his debt a second time, for the benefit of the secured creditor.¹¹

D. *Sale or Charging of Accounts*

The distinction between a sale and a charge is of particular importance in civil law. In a sale transaction, all the seller's rights in a particular asset are transferred to another, the buyer. Pursuant to the sale the seller has severed his previous connection with the asset sold. In other

5. The Security Interests Law, 1967 20 L.S.I. 44, § 1(a) [hereinafter Security Interests Law].

6. *E.g.*, *id.* §§ 9(b), 17(4) and 20. For general background, see JOSHUA WEISMAN, SECURITY INTERESTS LAW 20 (G. Tedeschi ed. 1975) (Interpretation of Contracts Law).

7. Companies Ordinance [New Version] 1983, §§ 165, 178(a)(4).

8. Assignment of Obligations Law, 1969, 23 L.S.I. 277, § 1(b) [hereinafter Assignments of Obligations Law].

9. *Biderman*, *supra* note 3, at 405-06. The exception to this is section 4 of the Assignment of Obligations Law, which regulates the relations between two assignees of the same right.

10. Joshua Weisman, *Rights as Security*, in LECTURES GIVEN AT JUDGES' SEMINAR 21, 23 (S. Shetreet, ed., 1976). See also WEISMAN, *supra* note 6, at 22-24.

11. Assignment of Obligations Law, *supra* note 8, § 2(b).

words, a sale is the transfer of ownership of the asset.¹² In a charge transaction, the chargor transfers to the secured creditor a part of what he has; he remains the owner of the asset, and transfers a property right which is of a stature less than ownership. In the next paragraphs, we shall deal with this distinction in the context of rights. The sale of rights will also be referred to as an absolute assignment or an assignment by way of sale, whereas the charging of rights also will be referred to as assignment by way of charge.

The classification of a particular transaction as the sale or charge of a right is of importance since different laws apply to each type of transaction, and the classification thus determines the applicable law. In establishing different rules, the legislator had different interests in mind, the expression of which is dependent upon the existence of a clear criterion for distinguishing between the sale of a right and its charge. First of all, we will deal with the main differences in the laws applying to the transaction and we will then deal with the criterion which assist in making the distinction.

Following are a number of important distinctions between the two kinds of assignment. An assignment by way of sale is generally valid even in the absence of registration. A trustee in a bankruptcy or a liquidator of the assignor is therefore unable to apply for its avoidance by reason of its non-registration, unless the assignment was a general one, with no specification of the contracts or the names of the account debtors.¹³ On the other hand, the validity of a charge against third parties is always conditional upon the registration of the assignment. There are other legal systems which impose the duty of registration as a threshold condition for the validation of both assignment by sale or by way of charge. This is the Law in the United States and in Canada,¹⁴ and it was recently proposed in Israel too. This approach assumes that most of the sale assignments are financial assignments intended to procure financing for the assignor. In these cases the assignee is liable to endanger the rights of other financiers who may also have imposed a charge, but who, in the absence of registration of the sale assignment, have no way of being in-

12. The definition given in section 1 of the Sale Law—1968, 22 L.S.I. 107, does not specifically refer to the issue of transfer of ownership, being content with the laconic determination that “a sale is the vesting of an asset for a price.” In other legal systems, the definition emphasizes the transfer of ownership; compare English Sale of Goods Act § 2(1) with U.C.C. § 2-106(1) (1977), which, in the definition of sale, refers to “the passing of title . . . from the seller to the buyer . . . for a price.”

13. Bankruptcy Ordinance [New Version]—1980, § 97.

14. U.C.C. § 9-109(a)(3); Ontario Personal Property Security Act sec 2(b). For support of application of registration requirements on the sale of rights in England, see Royston M. Goode & Laurence C. B. Gower, *Is Article 9 of the Uniform Commercial Code Exportable?*, in ASPECTS OF COMPARATIVE COMMERCIAL LAW 298, 347 (Jacob S. Ziegel & W.F. Foster, eds. 1969).

formed of the assignee's existence. This approach sees no justification for distinguishing between financiers who structure the financial transaction as a sale and those who were imposing a charge on the right.¹⁵ Instead, American law exempts non-financial assignments from registration, for example, assignments which are part of the general sale of a business, an assignment for collection purposes only or an assignment intended to repay the assignor's debt to the assignee.¹⁶ Furthermore, the American experience indicates that the analytic distinction between the sale assignment and the assignment by way of charge is far from simple. Distinguishing between them for the sake of registration, would squander valuable "judicial energy."

In a sale transaction, all of a person's rights in a certain asset are transferred, and therefore the assignment by way of sale transfers to the assignee all of the assignor's rights and any money received from the account debtor belongs to the assignee, even if exceeding the sum originally owed by the assignor to the assignee. A secured creditor, on the other hand, is not entitled to the entire sum received from the realization of a charge, and any change remaining after payment of the debt belongs to the debtor. A creditor expects the return of his investment with a certain profit increment; he does not expect to receive the entire sum accruing from the realization of the charge. This rule derives from the fact that the charge is ancillary to the debt which it is intended to secure. An assignor, or his trustee in bankruptcy, may well claim that a particular assignment is a charge and that he is therefore entitled to receive from the assignee, the amount collected from the account debtor in excess of the assignor's debt to the assignee.¹⁷ This claim would be dismissed if the assignment were the sale of a right.

An assignor cannot cancel an assignment of a right by way of sale, just as the seller of a tangible asset is unable to renege on the sale, unless there was a breach on the purchaser's part. On the other hand, a charge is ancillary to the debt it secures and when "the obligation ceases the charge shall terminate."¹⁸ In other words, in an assignment by way of charge, the payment of the assignor's debt causes the assignment to ex-

15. See JAMES J. WHITE & ROBERT R. SUMMERS, UNIFORM COMMERCIAL CODE 66-67 (4th ed. 1995).

16. U.C.C. § 9-109(d)(4-7). Another section exempts assignments from filing, if the particular assignment as well as other assignments to the same assignee, does not transfer a significant portion of the assignor rights. See *id.*, § 9-309(2). Canadian Law does not admit of any exceptions to the requirement of registration of sale assignments, the reason being that the exceptions do not provide clear criteria for their application, which is liable to lead to the proliferation of litigation. See JACOB S. ZIEGEL & DAVID L. DENOMME, THE ONTARIO PERSONAL PROPERTY SECURITY ACT 57 n.80 (1994).

17. See *Major's Furniture Mart Inc. v. Castle Credit Corp. Inc.*, 602 F.2d 538 (1979).

18. Security Interests Law, *supra* note 5 at § 15(a).

pire, and the assignor is restored his right of action against the debtor.

The right of an assignee who is a secured creditor may be suspended by an order for staying of proceedings, the aim of which is the adoption of measures for the recuperation of a company.¹⁹ On the other hand, the Court is not authorized to prevent the realization of the right against the debtor by an assignee who purchased ownership of it.

However, the distinction between a sale and a charge is irrelevant in the context of the Assignment of Obligations Law. Both the Law and case law deal with issues like the various defenses which the account debtor can raise against the assignee, the rule applying to the debtor who discharged his debt for the assignor and not the assignee, the validity of changes inserted by the account debtor and the assignor in the original contract after the assignment and others. Regarding all of these issues, it is immaterial if the transaction was a sale assignment or the assignment by way of charge. There are, however, other laws in which the distinction becomes relevant: laws of sale regarding an absolute assignment and the laws of charges regulating the assignment by way of a charge.

The decision of whether a transaction is a sale or the charge of a right obviously depends upon the circumstances of the case. Generally speaking, an assignment which does not replace the debt but rather ensures its payment is a charge, but application of this distinction is far from simple, as we will presently observe. The distinction between a sale and a charge is not limited to rights and also arises with respect to chattels and land. Even so, it seems that in its application to rights, especially the right to receive money, the distinction is more problematic than with respect to tangible assets. This is because an assignment agreement is typified by its informality. Occasionally it is drawn up orally, its only written component being the notice to the debtor of the assignment. Furthermore, in many cases, the parties are unaware of the distinction between the two transactions and omit all reference to factors that could shed light upon the nature of the transaction.

In a judgment given by the District Court of Tel-Aviv, in the matter of *Prinir Ltd. (In Receivership)*,²⁰ the court ruled that a particular assignment agreement was a charge as opposed to a sale assignment. In its ruling the court exposed the roots of the distinction between the assignment by way of sale and an assignment by way of charge:

If the assignment is an absolute one, then the actual agreement terminates the obligations of the assignor, however, in this case we see that the bank [the assignee] has recourse to the assignor in the event of non-payment by the account debtor. Furthermore, if the assignment

19. Companies Law, 1969, § 350, 1711 S.H. 189.

20. *Dinim*, District 26 (7) 320 (1988).

is absolute, any consideration received by the assignee from the account debtor belongs to him and the assignor has no part therein, even if considerably greater than the basic debt, the defrayal of which was the purpose of the absolute assignment. In our case on the other hand, we find the provision that any balance of payment exceeding the basic debt, will be credited to the Prinir Company's account by the bank.²¹

Under the first criterion, an assignee's right of recourse to the assignor in the case of non-payment by the account debtor indicates the existence of a charge. In cases of sale of a right, the assignee does not have a right of recourse.²² According to the second criterion, the assignee's obligation to return to the assignor any consideration received upon realization that exceeds the amount of the original debt indicates that the right was charged and not sold. Had it been sold, the entire consideration from the realization would belong to the assignee.

The second criterion raises no difficulty, but, in our view, the first one is only partially correct. Israeli law does not recognize an "in rem" charge, existing independently, and not ancillary to a specific debt. The Security Interest Law regulates only a charge which is ancillary to the debt which it secures, and the general rule is that the list of property rights is a closed one, *numerus clauses*, and does not allow recognition of a different kind of charge.²³ As stated above, the ancillary nature of the charge means that the original debt is not replaced but rather provides the secured creditor with the option of choosing between realizing the charge and filing a regular claim against the debtor.²⁴ Accordingly, the charging of a right does not influence the nature of the secured debt, i.e., the assignor's debt to the assignee. The debt remains valid, and, consequently, the assignee is able to collect from the assignor if he failed to collect from the account debtor; he is not under any obligation to initially demand payment of the debt by the account debtor. An agreement under which the assignee has no right of recourse to the assignor is, therefore, a sale agreement. The absence of the right of recourse is not consistent with the nature of the charge as being ancillary to the obligation which it comes to secure. The meaning of the assignment of right as a security is that the assignor borrows a certain sum of money from the assignee and, as security for the loan, charges his right against the account debtor. The assignee's claim from the account debtor is the realization of the charge and the assignee's claim against the assignor is a claim for the payment

21. *Id.*

22. See 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1230 (1965).

23. See M. DEUTCH 1 PROPERTY 81-87 (Heb. 1997); JOSHUA WEISMAN—PROPERTY LAW—GENERAL PART 75-87 (Heb. 1993) (for property rights as a *numerus clause*).

24. Security Interests Law, *supra* note 5, § 23.

of the principal debt. Accordingly, if the agreement denies the assignee any right of action against the assignor, then there are no lender – borrower relations between them.

As stated above, the assignee's inability to claim from the assignor the payment of all moneys he gave to him indicates that the assignment was a sale. However, the opposite proposition—that the assignee's right of recourse means that it was a charge—is not necessarily true.²⁵ Occasionally, the seller of a right, the assignor, assumes the role of a guarantor for the fulfillment of the account debtor's obligations, and, in that case, it is possible to sue the assignor, should the assignee be unsuccessful in collecting from the account debtor.²⁶ Just as the seller of chattels may assume responsibility for the nature of the product for a specified period of time, and this responsibility does not affect the nature of the transaction as a sale, so too the seller of a right may guarantee the nature of the product, i.e., the ability to collect.²⁷ This kind of undertaking on the assignor's part increases the value of the right and there is no reason to prevent the assignor from assuming such a liability. A similar phenomenon exists in a transaction for discount of checks, which is also considered to be a sale transaction. The purchaser of the check who does not receive payment from the drawer is entitled to return to the endorser—the seller.²⁸

It would appear that a distinction should be made between different kinds of right of recourse.²⁹ The transferor's undertaking to pay the transferee the value of the transferred right is analogous to the liability for the quality of a transferred chattel. The exposure of the transferor is dependent upon the value of the asset that he transferred and, hence, his undertaking toward the assignee is compatible to a sale transaction. A recourse provision that fails to enhance the position of the transferee may indicate that the assignment was in fact a sale. In essence, the assignment is no different than an assignment which has no recourse option,

25. See U.C.C. § 9-502(2) (comment 4) (1972). See also R.M. GOODE, *LEGAL PROBLEMS OF CREDIT AND SECURITY* 107-08 (2nd ed., 1988).

26. See *Goldman v. Michaeli et al*, 35 (4) P.D 31, 43 (1981) (Nonetheless, there is nothing to prevent the assignor-seller from personally assuming performance of the debtor's obligations . . . similarly, there is nothing to prevent the assignor-seller from assuming an independent obligation of his own, to perform the debtor's obligations).

27. See ROSS CRANSTON, *BANKING LAW* 438 (1997) ("The company obtains immediate payment although the sale may be with recourse, obliging it to indemnify the bank against any losses").

28. See *Chow Yoong Hong v. Choong Fah Rubber Manufactory* [1962] A. C. 209. The judgment ruled that the nature of the transaction as a sale, does not change when the seller gives the buyer additional checks with his signature as security for the payment of the check, given that it is only natural that the buyer desires to secure his right.

29. The distinction between "recourse for collectibility" and "economic recourse," is dealt with at length in Peter V. Pantaleo et al., *Rethinking the role of Recourse in the Sale of Financial Assets*, 52 *BUS. LAW.* 159 (1996).

which is a sale, and in which the transferee succeeds in collecting the various sums from the account debtor. The right of recourse upgrades the quality of the item, which can also be done within the framework of a sale. On the other hand, the transferor's undertaking to pay the transferee a sum of money that reflects the sum of his investment with the addition of a certain increment appears to be more similar to a loan and a charge. In such a case, the transferee has the right to receive a sum from the transferor, which is not conditional upon the value of the asset that was transferred, and it would therefore seem that the asset serves as security and not as an asset that was purchased by the transferee.

In accordance with our approach, the assignee's right of recourse against the assignor does not unequivocally indicate that assignment is a charge. The following factors which are associated with the right of recourse may tilt the scale in favor of the assignment being a charge:³⁰

- Payment of interest by the assignor to the assignee indicates that the transaction is a loan and not a sale, especially when the interest rate is established unilaterally by the assignee.
- The assignor's option of repurchasing the right, contingent upon certain circumstances, may indicate a charge.
- A prohibition on the assignor against unilateral use of the money received from the assignee, compelling him to use the money in a particular manner. This kind of restriction is normally imposed upon a borrower and not a seller.

The distinction between sale and charge is reflected by the degree of risk assumed by the assignee. Generally speaking, the purchaser is liable for any damage occurring to the item after its delivery³¹ and receives the full benefit of any increase in value. If the assignee is a secured creditor, on the other hand, he is not fully affected by changes in the value of the charge, for he has the option of a personal claim against his debtor. If however, all risks, and not just the right of recourse, are assumed by the assignor, it indicates that the transaction is a charge.³² On the other hand, in the event that changes in the value of the rights transferred affect the transferee and not the transferor, the transaction will be considered to be a sale.

30. Regarding the distinction between the selling of a right or charging it, see also A.D.C. Giddins, *Block Discounting: Sale or Charge*, 130 NEW L.J. 207 (1980).

31. Sale Law, 22 L.S.I. 107 § 22 (1968).

32. See *Major's Furniture*, supra note 17.

II. Checks as Security

A. *The Post-Dated Check*

A check is a bill of exchange, in which its drawee is a bank. It is a particularly widespread form of payment in Israel. Though during the past decade payment with a credit card has become increasingly popular, it is unlikely that it will replace the check as a means of payment.³³ Payment by check obviates the need for carrying substantial amounts of cash, with its attendant dangers. On the other hand, a check is not legal tender and the creditor is entitled to refuse to accept it and to insist upon payment in cash.

The typical check in Israel is the post-dated check. When the actual sale transaction is completed, an average purchaser writes upon the check a date that post-dates the date of the transaction. This kind of check serves as a means of payment, as well as a form of credit given by the payee to the drawer. Originally, the check was intended exclusively as a means of payment, and the legislature attempted to combat the phenomenon of post-dated checks by adding section 73A of the Bills of Exchange Ordinance, which states that "A check issued before the date stated thereon as the date of the check, or issued without any date, shall be payable upon issue, and the date of issue shall, for all intents and purposes, be deemed to be the date of the check."³⁴ The assumption was that people would not draw post-dated checks, for the banks were liable to honor the check prior to the date indicated as the date of issue. However, the amendment of the law did not succeed in uprooting the phenomenon. Ultimately it was the legislature that backed down, determining that a post-dated check would not be payable or acceptable prior to the date indicated thereon.³⁵ In doing so, the legislature accepted the public practice and began regarding the post-dated check as a "an accepted financial instrument with no particular negative ramifications."³⁶ Case law has oft repeated that the check, as opposed to the note, is not a means of procuring credit, but is exclusively a means of payment—

33. Compare COENRAAD VISSER ET AL., GIBSON'S SOUTH AFRICAN MERCANTILE AND COMPANY LAW 462 (1997) (the use of credit cards in the United States is widespread, even so, during the nineties, the use of checks increased at the rate of 2% per annum. In 1996, sixty-four million checks were written in the United States) with John R.H. Kimball, *Check Collection in the 21st Century*, 33 UCC L.J. 3 (1998) (where the author emphasizes that payment by way of check is still the most frequent mode of payment, with the exception of cash).

34. Sefer HaHukim [legislative enactment of the Knesset] no. 413 at 40.

35. Bills of Exchange Law New Version 1967, amendment #4, 1980 34 L.S.I. 67 § 73(b) of the Ordinance; Sefer HaHukim no. 64.

36. Hatzoot Hok [legislative draft bills] no. 1979 at 272.

however, given the proliferation of post-dated checks, it is doubtful whether this distinction is actually valid.

B. *Check as Collateral*

In business accounts, the bank grants credit to its customer against various collaterals provided by the customer. Checks which are deposited in the customer's account for collection are common collateral given by the customer to the bank. These checks are charged to the bank by a provision which is usually signed when opening business accounts. There are numerous merchants who receive post-dated checks from their customers and they charge these checks to the banks, who in consideration thereof grant them credit. The banks assume that if their customer—the payee of the check—encounters financial difficulties and is unable to pay his debts, then they will be able to receive payment from the drawers of the checks. The frequency of this phenomenon was recognized in the case law, which stated that: “taking bills for securing a debt in the cash account is a daily occurrence in banks.”³⁷

In practice, the bank makes two separate agreements with its customers regarding the pledging of checks, each at a different time. The first agreement, in accordance with which the account is opened, generally stipulates that all checks deposited by the customer in the bank for collecting purposes will be pledged to the bank in order to secure the debts of the customer to the bank. Later on, when the customer actually deposits checks in the bank, the deposit form bears the heading “Security Checks,” in which it states that the checks being delivered to the bank will be pledged to him as security for the customer's debts to the bank. At this stage a pledge is created, given that the bank is in possession of the checks. The charge referred to in the first agreement relates to future, undefined checks and, as such, is likely to be interpreted as being a floating charge.

In Israel, from amongst the various actions based on bills, the collecting bank's claim against the drawer of a check is the most frequent. From the perspective of the laws of security interests, such a claim is the realization of a pledge in order to pay the secured debt. A pledge can be realized directly by the bank-creditor; there is no requirement that the bank first apply to the Chief Execution Officer.³⁸ The bank is obliged to manage the realization in “reasonable commercial manner.”³⁹ Selling the secured asset is not only in the creditor's interest; it is debtor's interest too. The debtor's interest is that a reasonable price be received for the

37. P.K.O Bank Ltd .v. Kibovitz, 22 (1) P.D. 264, 266 (1968).

38. Security Interests Law, *supra* note 5, § 17(3).

39. *Id.* § 19.

pledge, reflecting its market value, given that if the consideration received exceeds the debt to the creditor, the balance belongs to the debtor. The tendency of the law is to prevent a quick and unfair sale of the pledge by the secured creditor, who may act exclusively in his own interest and sell the asset at a price lower than its real value.

This law bears interesting implications for the bank which is owed a sum of money by its customer and holds as security a number of checks that were drawn to the customer order, and that the aggregate value of these checks considerably exceeds his customer's debt. In order to facilitate the collection of the checks and to promptly receive the money from the drawers, without protracted legal proceedings, the bank may make an agreement with the drawers under which it waives its rights to the full value of the checks. Any agreement with the drawers is in effect the realization of a pledge, and it is incumbent upon the bank to also consider the customer's interest as the payee of the checks. It is for this reason that it is forbidden for the banks to conclude a commercially unreasonable compromise with the drawers, the sole purpose of which is to facilitate the bank's collection of the debt. In our opinion, a compromise would be regarded as unreasonable if the bank has a sound legal claim against the drawer, and the latter has no appropriate defense, and his financial means indicate good chances of collection.

C. The Collecting Bank as a Holder in Due Course

Despite the numerous points of similarity between the pledge of a check and the charge of a contractual right, from the bank's perspective, the pledge of a check is definitely preferable to the charge of a contractual right. Quite frequently, it happens that when the payee is insolvent, the endorsed bank is confronted with drawer's refusal to honor the check. A payee that suffers financial difficulties also often faces difficulties discharging his obligations towards the drawer of the check. As a result of the payee's breach of contract, the drawer instructs the drawee bank not to honor the check and the bank returns it to the collecting bank.⁴⁰ When the collecting bank attempts to realize the pledge, the drawer refuses to honor the check, pleading breach of agreement on the payee's part. A defense claim based on breach of contract is referred to as failure of consideration. According to the law of negotiable instruments, the defense is effective against the payee and any remote party who is not a holder in due course. The bank's ability to rebut this claim and collect from the drawer is therefore contingent upon recognition of the bank as being a holder in due course of the check. Indeed, by taking a check as a pledge,

40. See Bills of Exchange Ordinance, *supra* note 35, § 75(1) (regarding the drawee bank's obligation to comply with the stop payment order).

the bank may establish its status as a holder in due course,⁴¹ which will determine the success of its claim against the drawer. The bank that uses the check as a pledge can thus benefit from two sets of laws: the law of secured transactions establishes the rights of the bank against other creditors of its customer, and the laws of negotiable instruments enables the bank to refute various defenses raised by the drawer of the bill.⁴²

The collecting bank will sue the drawer only if its customer—the payee—is insolvent. When the customer is solvent, the bank will prefer to use other methods. If the check deposited by the customer was not honored by the drawee bank, the collecting bank that credited the customer when he deposited the check will debit his account for the sum of the check. This independent measure is preferable to resorting to courts of law, even if the bank has excellent chances of succeeding, given its standing as a holder in due course. Nonetheless, these circumstances are quite frequent and Israeli banks file numerous actions against drawers of checks, in reliance upon their status as holders in due course in order to refute any defenses raised by the drawer.⁴³ The central question in this context is under what conditions the bank receives the status of a holder in due course in relation to the drawers of the checks.

In the overwhelming majority of cases, the bank has no difficulty in acquiring the status of a holder in due course. The case law favoring the banks relies upon two central elements which have been viewed as provision of consideration by the banks, vesting them with the status of a holder in due course. These elements appear as a matter of course in all business accounts, included as standard provisions in the forms signed and thus constituting essential elements by which the bank can refute defense claims. According to the case law, banks are considered to have given consideration by crediting the account which would otherwise be in overdraft and, alternatively, in the fact that the check serves as collateral for the customer's debt to the bank.⁴⁴

Rulings in case law and the frequency of post-dated checks have converted the check into the most widely used collateral in Israel today.

41. *Id.* § 26(3).

42. Occasionally a check is not fully negotiable, i.e., a crossed check which states 'not negotiable' (section 81 of the Ordinance). This kind of check can be pledged, but any defense that is available against the payee will also be available against the endorsee. In this instrument, the endorsee bank is not a holder in due course, and will not receive rights that have priority over the rights of the payee-endorser.

43. These kinds of actions are highly rare in the United States. Between the years 1986-1996 only fifteen cases were published in which the collecting bank utilized its status as a holder in due course in its action against the drawer of the check. See Roland J. Mann, *Searching for Negotiability in Payments and Credit Systems*, 44 U.C.L.A. L. REV. 951, 1002 (1997). The frequency of the phenomenon in Israel is connected to the widespread use of post-dated checks.

44. See in depth, SHALOM LERNER, *LAW OF BILLS* 425-42 (1999).

Owners of small business, e.g., a shop engaged in selling electrical appliances or cleaning materials, do not normally have many assets to offer as collateral. Their business surplus can be offered as collateral exclusively in the form of a floating charge, and this kind of charge is recognized only in cases in which the business is a corporation. The floating charge suffers from other defects too, primarily its inferiority towards various claims such as city taxes and workers wages. The main asset which the non-incorporated business is capable of offering as collateral is therefore its post-dated checks, which represent the merchandise that was sold to customers.