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Viewpoint / *Menachem Feder*

Give credit risk protection a chance

The Supreme Court has finally embraced modern finance. In a recent landmark decision, the court reversed itself and determined that sellers of goods often provide credit to buyers and deserve practical ways to protect themselves. For now, the court has confined its new approach to consignment of goods cases, but other courts should extend this triumph of practicality to a range of financial transactions.

A few weeks ago, in M.S. North Drilling v. Gviley (P.C.A. 1690/00, not yet published), the court enforced an agreement in which a seller retained title to the goods it delivered until the buyer paid the purchase price in full. The court explicitly overruled a contrasting decision it made just 10 years ago in Colombo v. Bank of Commerce (C.A. 455/89, 45 P.D.(5) 490), when the justices recharacterized such a seller-owner as only a lender with a security interest.

The court now thinks better: A consignor of goods often has good reason for retaining title and the law should stay out of the way. That good reason is protection against credit risk.

When Reuben delivers goods to Simon, but Simon is scheduled to pay later, Reuben takes on Simon's credit risk – i.e., Simon may go bankrupt and may not be able to pay. There are a number of ways to moderate credit risk, but the most common is collateral: Simon provides Reuben with an asset that will belong to Reuben only if Simon fails to pay.

But collateral raises the specter of the Pledges Law. The Pledges Law provides that it applies to any transaction "intended" to pledge an asset as a surety for an obligation. It also provides that a pledge is not enforceable against third parties unless perfected, which, in most cases, means public registration. The traditional justification for registration is protection of third party creditors, who are presumed to want to know if the assets of the person to whom they lend could suddenly belong to another.

In any event, and regardless of the reliability of that or any other rationale, tedious registration of pledges is often not practical because of the fast pace of business and the expenses involved.

To avoid all sorts of strictures that apply to pledges, parties devise a myriad of ways to make collateral arrangements look and feel like something other than pledges. For years, however, and mainly because of the Colombo ruling, courts have recharacterized as pledges nearly every transaction meant to protect a creditor in which the creditor obtains contingent ownership rights to an asset of the debtor – no matter how sound the parties' purpose and how remote the third party concerns. This approach is justified by the high-sounding mantra "substance over form", but it essentially disregards the parties' intent, often without countervailing justification.

Colombo's broad brush has been ruinous. The law has preempted many transactions that could have funded Israeli companies, without necessarily providing the required protection. An aching example can be found in the securities repurchase, or repo, transaction. Repos are important and relatively common financial products abroad, but they are almost absent in Israel.

In a repo, Simon sells securities to Reuben for cash and undertakes to repurchase the securities a short time later. Reuben is entitled to liquidate the securities if Simon defaults. The repurchase price is the original purchase price plus a negotiated differential. This differential determines the "repo rate", which is usually below the inter-bank lending rate. Because the repo is structured around a transfer of title, the cash provider – Reuben – does not normally think like a lender or expect to register a pledge. Yet, Colombo created the risk that a court would recharacterize a standard repo as a secured loan – this, even though a repo can be distinguished from a loan (a repo does not incorporate an explicit interest rate structure) and even though a repo does not necessarily jeopardize third party creditors.

In any event, recharacterization would leave Reuben with only a pledge (presumably unregistered), not ownership, in the securities he "bought" from Simon. As a result of that legal risk, many repo cash providers simply have declined to do the business in Israel.

At last, and although narrowing the M.S. North Drilling holding to consignment of goods cases, the Supreme Court has taken some edge off the Pledges Law. This opens the door for other courts – perhaps even the Supreme Court – to go further and enforce other types of ownership-based collateral arrangements, as long as legitimate concerns justify the arrangements and third parties are not harmed.

Courts should seize the opportunity. It will give meaning to the concept of freedom of contract and encourage many sensitive but important financial transactions.

Call it reality over substance over form.

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