

BANK LEUMI LE'ISRAEL LTD v TAUBER

ISRAELI SUPREME COURT JUDGMENT ON TRUST LAW

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A judgment rendered by the Supreme Court of Israel on 19 July 2011 in the matter of *Bank Leumi Le'Israel Ltd et al v Marsha Tauber et al*¹ provides a rare opportunity to review several matters related to questions of trust, namely the conflict between sections 3(b) and 5 of the *Israeli Trust Law 1979*² (the Trust Law), equitable rights in Israeli law, and the interdependence between the beneficiaries of a trust and the creditor of the trustee – thereby delving into the essence of the concept of trust according to Israeli law.

On 14 October 1993, the Respondent (or the Trustee) purchased rights in a certain real estate property (the Property). The Respondent registered the rights to such Property in the Israeli Land Registry on 17 September 1995. When later the Respondent failed to pay his debts to Bank Leumi (or the Appellant), the Appellant commenced legal proceedings against him. As a consequence of such legal proceedings, the Respondent was declared bankrupt and Bank Leumi obtained a lien on the Property.

When the receiver started proceedings for the sale of the Property, the other Respondents (Respondents or Beneficiaries) applied to the district court in a motion to stay the receivership proceedings on the Property and to remove the lien of the Appellant, claiming that the Respondent purchased the Property in trust, with the Respondents as beneficiaries. The Beneficiaries presented a trustee declaration in accordance with the *Israeli Real Estate Taxation Law 1963* (the Tax Declaration)³ under which it was specifically stated that the Respondent purchased the Property in trust for the Beneficiaries, as well as tax confirmations provided by the Israeli Land Tax Authorities (as required under applicable law) and a power of attorney issued by the Respondent to the Beneficiaries to sell, transfer, rent and pledge the Property.

The Respondent claimed that the reason for the delay in the transfer of the rights to the Property from him to the Beneficiaries was related to the relationship between them, and did not affect in any way the legal validity of the trust.

The Respondent's claim was based, in part, on a judgment of the Tel Aviv District Court, which ruled⁴ that despite the

importance of the registration of rights and the emphasis on the publicity of property rights, the mere fact that the Property was not registered as being held in trust did not affect the right of the Beneficiaries to the trust assets, even though the creditors of the trustee registered a lien on the same asset. The court held that the main reason for prioritising the right of the Beneficiaries over the right of the Trustee's creditors was the high fiduciary obligation owed by the Trustee to the Beneficiaries, and the affinity of the Beneficiaries to the trust assets.

The Appellant appealed to the Supreme Court and claimed that, as the Trustee had not registered an annotation in the Land Registry regarding the Property being held by him in trust, the Trustee deprived the Appellant of any chance to have knowledge that the Property was actually held in trust, which in turn constituted a breach of the duty of care vis-à-vis the Appellant. Therefore, the appellant argued that it should prevail against the Beneficiaries in the race for the Property.

The Supreme Court focused on one question, namely which section in the Trust Law should govern – s3(b) or s5. To answer this question in favour of s3(b), the Court relied on five sources: (i) case law, (ii) doctrine, (iii) the fundamental concept of trust, (iv) the principle of good faith in the Israeli Trust Law and (v) comparative law.

1. THE CONFLICT BETWEEN S3(B) AND S5 TO THE ISRAELI TRUST LAW

Section 3(b) to the Trust Law states: 'No recourse can be had against the assets of the trust except for debts accruing in respect of the assets, or debts arising from the acts of the trust.'

Section 5 to the Trust Law states: 'A trust is in force against anyone who knew about it or should have known about it, and when an annotation was registered in accordance with s4 – against the whole world.'

Section 4 to the Trust Law states: 'When the trust contains an asset in respect of which any action requires a registration in a statutory register, the trustee shall have the right to notify the registrar regarding the trust and the registrar shall register an annotation accordingly.'

If s3(b) prevails over s5, then the legal consequence is that personal creditors of a trustee, i.e. creditors of such

trustee that have no relation to the assets of the trust itself, are not able to discharge the personal debts owed to them by the trustee out of assets of the trust, even if the trustee failed to register an annotation in a statutory register where the law enabled him to do so. On the other hand if s5 to the Trust Law prevails, then the legal consequence would be that the right of the beneficiaries of a trust will be subordinate to the right of the personal debtors of the trustee if such debtors had no notice of the trust, since no registration of such trust was made by the trustee.

SUPREME COURT CASE LAW: EQUITABLE RIGHTS IN ISRAELI LAW

To understand the conflict between sections 3(b) and 5 to the Trust Law, you have to review the recent Supreme Court case law adjudging Israeli equitable rights in the context of trusts. The said case law was developed in the past years and was in the centre of legal discussions and academic publications in Israel, as it generated a significant change in Israeli property law by determining equitable rights within the context of trusts. The Court summarised this case law and following is a brief summary of the major cases that created such Israeli equitable rights in the context of trusts.

In the Civil Appeal of *Ford*,⁵ the Supreme Court held that the rule provided in s5 prevails over the rule provided in s3(b) in the sense that creditors are subject to the rights of the beneficiary of the trust only when they actually knew or should have known about the underlying trust or when an annotation was registered regarding such trust in a statutory register. The approach taken in the *Ford* case prioritises the importance of the registration of rights as an act of perfection, making the rights enforceable *in rem*, thereby protecting the effective force of the Land Register as a register that evidences the legal rights to the property.

In the context of a constructive trust, the Supreme Court ruled in the Civil Appeal of *Boker*⁶ that the creditors of a seller, who is still the registered owner of a property, are not subject to the obligations of the seller towards the purchaser of the

property, the constructive beneficiary. Therefore they are free to foreclose the property. Thereby, the Supreme Court negated any equitable rights of the new purchaser/beneficiary to the property. This judgment, however, related specifically to a constructive trust and, in any event, was later overruled in the *Aharonov* case (as below).

In *Aharonov*,⁷ the Supreme Court held that, while theoretically the equitable right of the purchaser of a property can be based on principles of trust set forth in the Trust Law (the principles under which the seller shall be deemed a trustee, and the purchaser shall be deemed a beneficiary of a trust in relation to the purchased property), the court left undecided the question whether it can create a constructive trust in cases where the parties did not actually contract to have a trust relationship. Consequently, the court ruled that the priority given to the first purchaser of a property over creditors of the seller is based on Israeli-made equitable rights which reflect the standard of fiduciary obligations expected from the seller, thereby applying principles of trust without directly applying the trust relationship (constructive trust).

While subsequent case law generally followed the *Aharonov* case, there were some decisions which qualified its scope. In *Ganz*,⁸ the court ruled that the bona fide standard expected from the owner of the equitable right demands that he will do everything in his capacity to register an annotation in the Land Registry, and if he did not do so, he might lose his priority over the creditors of the trustee. In *Bank Hamizrahi Hameuhad*,⁹ the Supreme Court held that the duty of the purchaser of a property (i.e. the owner of equitable rights) to register an annotation needs to be examined in the light of the nature of the relationship between the purchaser and the creditor. The scope and substance of the bona fide duty of the purchaser depends on the nature of the property right and the conflicting interests thereto. Nevertheless, the mere fact that the purchaser did not register an annotation did not automatically suggest that the purchaser breached bona fide obligations.

'Good faith is deemed to be breached when the trustee acts in breach of his fiduciary duties, but not in cases of absence of registration, as in *Tauber*'

In summary, the above judgments trace a significant shift in the approach taken by the Supreme Court regarding the tension between the beneficiary of a trust (or the equitable owner) and the personal debtors of the trustee (or the seller and legal owner). In *Boker* the court negated the idea of equitable rights. In *Ford* the court ruled that the right of the beneficiary is subject to the rights of the trustee's creditors, when the trust was not registered and was not known to the trustee's creditors. In *Aharonov*, the Court revived the doctrine of Israeli-made equitable rights and prioritised the owner of equitable rights over the creditor of the seller, the legal owner. Nevertheless, in *Ganz* and *Bank Hamizrachi*, the Court ruled that in certain cases the principle of good faith should be considered as part of the Israeli equitable rights doctrine.

Based on the above cases the Court in *Tauber* ruled that even though the discussion regarding equitable rights focused on the conflict between the purchaser of a property and a creditor of the seller, it is clear that equitable rights were acknowledged by the Israeli jurisprudence in the above cases. As there is no doctrine of equity, as such, in Israeli law, the Courts in effect have resorted to Israeli trust law. The equitable rights under consideration, even though they were created in the field of real estate law and not trust law, nevertheless project to the field of trust law because of the similar legal characteristics between the beneficiaries of a trust and the purchaser of a property.

1.1. DOCTRINE

The doctrine concerning the tension between s3(b) and s5 of the Trust Law is based on the development in case law.

Most authors¹⁰ argue that even when the equitable right – the right of the beneficiary – lacks the publicity aspect, such right should prevail over the right of the creditors of the trustee. Their argument is that the trust creates relationships that are on a superior legal level to simple contractual relationships. Moreover, although the Trust Law provides

that one of the ways to create a trust is by way of contract, nevertheless, within the contractual framework, it is the provisions of the Trust Law that prevail over the provisions governing contracts in general in Israeli law. Therefore, the relationship created by trust agreements appears to produce higher expectations in the beneficiary regarding his rights over the property held in trust. Such exaggerated equitable expectations increase the affinity to the property and present a strong challenge to the legal ownership of the trustee.

By contrast, there is a doctrine¹¹ that restricts the application of s5 to acts carried out by the trustee with third parties in breach of his fiduciary obligations. In such a case, the clear language of the Trust Law (s14) entitles the Court to annul such an act, but only when the third party knows, or should have known, of the breach. This appears to imply that when the acts of the trustee are not in breach of his fiduciary duty, the impact of s5 is akin to the preponderance of the doctrine cited above: equitable rights prevailing even in the absence of knowledge or publicity.

THE TRUST CONCEPT

In resolving the conflict between the two sections in the Trust Law, the Court analysed the concept of trust. In a trust, the trustee is the owner, or at least a quasi-owner, of the asset, but his rights are limited by certain ownership rights of the beneficiary. English scholars have defined this division of ownership so that the trustee is the owner of legal property rights and the beneficiary is the owner of an equitable property right¹². The relevance of this division to Israeli law is that it further defines the rights of the trustee. As the legal owner of the property, the trustee's ownership is characterised mainly by his duties rather than his rights. This is reflected in the Trust Law: s8 prohibits receipt of fees by the trustee for his services, unless it is part of his business; s10 specifies the broad responsibilities of the trustee and the high standard by which he needs to comply when discharging his duties as a trustee; s12 defines the serious liability of the

trustee for damages incurred as a consequence of a breach of his duties; s13 prohibits the self-enjoyment of the property of the trust by the trustee.

The Trust Law incorporates the principle that the trustee must be fully subject to the purpose of the trust and, although a trust creates a division between the trustee's legal ownership and the beneficiary's equitable ownership, the Trust Law acknowledges the high expectations of the beneficiary from the property by obliging the trustee to act only for the achievement of the purpose of the trust and the interest of the beneficiary, thereby narrowing the trustee's legal ownership right.

The Court thus held that in a direct conflict between the rights of the beneficiaries and the rights of creditors of the trustee who foreclosed the property registered in the name of the trustee, the interest of the beneficiaries ought to prevail because the creditors of the trustee had foreclosed a specific property which they did not purchase and for which they had no specific rights. Therefore, they did not have the same expectations as the beneficiaries of the trust. Subordinating the specific right of the beneficiaries in the Property to the ancillary expectations of the creditors to satisfy their general debts from the Property would negate the whole purpose of the trust and the strong affinity it creates between the beneficiaries and the Property held in trust.

1.2. THE PRINCIPLE OF GOOD FAITH

The Court elaborated on the importance of the principle of good faith in relation to the institute of trust. The principle of good faith plays a prominent role in Israeli jurisprudence and the standard of 'good faith' varies from one field of law to another in accordance with the legal interest at stake. In relation to trust law, the standard of good faith is a derivative of the institute of trust. The Court determined that the Respondents' failure to register an annotation with respect to the trust for 15 years did not constitute evidence that they were acting in bad faith, for three reasons:

- First, as the Trust Law provides that it is not mandatory to register an annotation regarding a trust, and the Israeli legislator did not stipulate a period in which such registration becomes mandatory. The parties to the trust did not try to conceal information they were required to disclose, but rather decided not to make the trust public by registering an annotation in the Land Registry.
- Second, there was no legal connection between the creation of the trust and the registration of the trust in a public registry. The two are independent acts and the registration is not constitutive of the trust.
- Third, when the parties were legally obliged to report the trust, they did so. The Trustee filed the Tax Declaration with the Israeli Tax Authorities stating that he purchased the Property in trust for the Beneficiaries.

The Court, therefore, concluded that the principle of good faith applies to trust law, and that the good faith is deemed to be breached when the trustee acts in breach of his fiduciary duties or when the parties to the trust create a sham trust agreement, but not in cases of absence of registration of the trust, as in the present case.

1.3. COMPARATIVE LAW

The Court – somewhat unusually, but no doubt because the institute of trust is so well developed in US law – also resorted to US legal sources in support of its holdings. US trust law accords priority to the relationship between the trustee and the beneficiary of a trust over the external interest of third parties in an asset. Section 308 to the *Restatement (2nd) of Trusts* (as cited in *Tauber*) states: '308 Creditors of Trustee: a creditor of the trustee personally who attaches trust property or obtains and records a judgment against him or levies execution upon the trust property is not a bona fide purchaser although he has no notice of the trust.'

The idea was further explained in the commentaries: 'Judgment Creditor. Although by statute or otherwise a

'Tauber contributed a detailed analysis of the essence of the basic concept of trust: the division of ownership of property into legal and equitable interests'

creditor who obtains judgment is entitled to a lien upon land or other property of the judgment debtor, the judgment creditor is not a bona fide purchaser, and he cannot enforce such a lien upon property which the judgment debtor holds in trust.'

In other words, even though the creditor is a judgment creditor, their lien does not obligate the beneficiary. US scholars further explained the rationale behind this principle.

'Indeed, even if the trustee intentionally breaches her duty to the beneficiary, and specifically pledges trust property as security for credit extended to the trustee by a third party creditor who is unaware that the property is held in trust, the creditor will not be permitted to enforce his security interest in the trust property, which instead will remain available only to the beneficiary. Even here, the law apparently presumes that the trustee's creditors are in a better position than the beneficiary to look out for themselves (or, to use the conventional Calabresian terminology, that they are the cheapest cost avoiders).' (Hansman and Mattei¹³)

Finally, Justice Handel, who rendered the main opinion in *Tauber*, reviewed traditional Jewish law cases to support the ruling.

By way of example, the Talmud says that a bona fide creditor of a thief, who takes goods from the thief to discharge a debt owed to him by the thief, is not entitled to the same protection provided to a bona fide buyer who bought stolen goods from a thief. The buyer, who unlike the creditor purchased the specific goods for a certain consideration, is protected by the Market Overt rule, which favours a bona fide buyer of stolen goods from a thief over the rightful owner. The difference between the bona fide buyer and the creditor is their affinity to the goods.

According to the Talmud, the affinity and the reliance of the buyer on the right to the goods are significantly stronger than those of the creditor. Justice Handel deduced from this

rule that the beneficiaries' direct affinity and reliance on the Property brings them closer to the legal owner (the trustee), and therefore the right of the beneficiaries prevails over the right of a creditor.

2. COMMENT

Tauber did not effect a significant change in the law, except as shall be explained below. The main importance of the *Tauber* case lies in the detailed analytical summary of existing case law, academic doctrinal publications, and the development of Israeli-made equitable rights, as well as comparative law, in connection with the Court's attempt to solve the conflict between sections 3(b) and 5 to the Trust Law. The case has further significance because of the high value the court accords to the expectations of the beneficiaries of a trust and the resulting affinity of such beneficiaries to the relevant property held in trust.

Tauber, however, is perhaps significant in further¹⁴ developing the doctrine of constructive trust in Israeli jurisprudence, albeit impliedly.

Aharonov left undecided the question whether the court can apply the doctrine of constructive trust because it relied on the limitation imposed by s5 in preference to the application of trust relationship and principles of trust law to the conflict between the purchaser and the creditor of the seller. In *Tauber*, however, the Court held that the trust was a contractual trust¹⁴, and as such, it did not support the position that the rights of the beneficiary would be limited by s5 of the Trust Law. In doing so the Court appeared to establish, by implication, the legal environment for applying the constructive trust doctrine.

Indeed, the Court would need to resort to the constructive trust doctrine because it is difficult to see what evidence there was of a contractual trust. No verbal evidence was presented as to the existence of such a contract, and the only written evidence of the trust was the tax declaration and a power of attorney given to the purchaser to sell and transfer the property held in trust.

As to the tax declaration, the best opinion among authors and professionals is that such a tax declaration, although it uses the word 'trust', in essence is only evidence of a nominee or agency relationship, albeit one that is governed by fiduciary principles. The tax declaration in fact is no more than a document stating that a property purchased by one person is registered in the name of another. The person in whose name the property is registered is simply lending his name (*prêt-nom*) to the purchaser, who is both the legal and equitable owner of the property. Such a relationship cannot give rise to a contractual trust relationship. While the tax authorities normally require the production of a 'trust' agreement to accompany the tax declaration, such a 'trust' agreement need not be according to the Trust Law and may simply be an agency agreement, as far as the tax authorities are concerned. As to the power of attorney given to the beneficiaries to sell and transfer the property held in trust, it is again evidence more of an agency relationship between the parties than of a trust relationship, since it places the control over the property in the hands of principal/beneficiary and not in the hands of the trustee.

The judgment is also significant in that by resolving the conflict between the two sections, it contributed what is probably the most detailed analysis to date by an Israeli Court of the essence of the very basic concept of trust: the division of ownership of property into legal and equitable interests. In doing so, the Court impliedly confirmed the reliance of Israeli trust law on the principles of trust in the common law, notwithstanding the fact that under Israeli law – contrary to the generally accepted principles in common law – a trust may be created by contract, and notwithstanding the fact that under Israeli law there is no clear indication that the trustee is the legal owner of the property¹⁵.

Nevertheless, the greatest significance of the *Tauber* case, certainly at a practical level, seems to be (even though the Court did not specifically state so) that the principle laid down in the *Aharonov* case shall apply also

in receivership proceedings¹⁶. In other words, the rule stating that Israeli equitable rights accord the beneficiary of a trust a prior claim to the trust asset over the claim of the creditors of the trustee (the 'Aharonov Rule') also applies when the creditor of the trustee and the beneficiary of the trust are both parties to the receivership proceedings commenced against the trustee.

Unlike the *Aharonov* case, therefore, the *Tauber* case effectively incorporates the English doctrine of equitable rights, which prefers the owner of equitable rights over the trustee, the legal owner, and over any creditor of the trustee, and extends the application of this doctrine to receivership proceedings¹⁷. In the *Aharonov* case the Court referred to the English cases but only as a guide¹⁸. As in *Tauber*, the Appellant (creditor) already initiated receivership proceedings to collect the debt owed to him by the Trustee – unlike the *Aharonov* case, which did not involve receivership proceedings – therefore, by applying the Israeli doctrine of equity rights (the Aharonov Rule) the Court has set a precedent regarding the role of these rights in receivership matters.

Even if one readily accepts the jurisprudence which provides for a strong affinity between the beneficiary of a trust and the trust assets, as well as the high expectation of the beneficiary of a trust to such trust assets, it is a moot point whether the Aharonov Rule, as applied by this jurisprudence, should also apply in receivership proceedings. The Court did not appear to address this issue as such.

The Aharonov Rule prevents the creditor of the trustee from foreclosing the property held in trust for the beneficiary, but it does not prevent the creditor from foreclosing other assets of the seller in order to discharge the debt owed to him. *Tauber*, by applying the same rule in receivership proceedings, significantly decreases the chances of the creditor collecting the debt owed to him. The reasoning of *Aharonov* was that the expectation and affinity of the beneficiary to the trust property are stronger than the expectation and affinity of the creditor to the same property.

'The greatest significance of *Tauber*, certainly at a practical level, is that the principle laid down in *Aharonov* shall apply also in receivership proceedings'

After all, it does not matter to the creditor whether they collect their debt from the trust property or from the other assets of the trustee, in the event that they are unable to foreclose the trust property. Therefore, the creditor's rights in respect of the trust property should be subordinate to those of the beneficiary, who has an expectation and affinity to the specific property.

In receivership proceedings, however, the expectations of the beneficiary and the creditor are not that different¹⁹. The creditor does not have an expectation to recover their debt by way of a specific asset of their debtor, but they have a rightful expectation to collect their debt by any one of the assets of the debtor (whichever it may be). Nevertheless, since (under the Aharonov Rule) they are unable to foreclose the trust property, they can only look to the other assets, but these assets are now under receivership and therefore the creditor's expectations are considerably reduced.

You would presume, therefore, that lawyers who represent financial institutions may raise the question whether the Court should have given the beneficiary an unconditional priority also in receivership proceedings. Should the Court not have set forth a more flexible model, based on a case-by-case review, in order to determine the relevant priority of either creditor or beneficiary, and the balance between the conflicting interests of such creditor and beneficiaries? The reliance of the creditor on the public registry in receivership proceedings may have been accorded greater importance under such circumstances.

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¹Civil Appeal 5955/09 (Israel Supreme Court) *Bank Leumi Le'Israel Ltd et al v Marsha Tauber et al* (judgment dated 19 July 2011)
²The Trust Law is the governing statute regarding trusts
³The Tax Declaration is submitted in compliance with s73 of the *Real Estate Taxation (Appreciation, Sale and Acquisition) Law 5723-1963*. See discussion of the Tax Declaration in the comment section
⁴Civil Motion 3783/08 (Jerusalem District Court) *Hofman et al v Bank Leumi Le'Israel Ltd et al* (judgment

dated 24 June 2009)
⁵Civil Appeal 371/89 *Orit Shechter Ford v Ford Construction and Investment Company Ltd*
⁶Permission for Civil Appeal 178/70 *Boker v the Anglo Israeli Company for Management and Responsibility Ltd*
⁷Civil Appeal 189/95 *Soldier Treasury Bank v Mazal Aharonov*
⁸Civil Appeal 2643/97 *Ganz v British and Colonial Company Ltd*
⁹Civil Appeal 790/97 *Bank Hamizrahi Hameuhad v Gadi Avraham*
¹⁰Miguel Deutch, *Property Vol 4* p341;

Professor Nili Cohen, 'The Contract of a Minor to Purchase a Property Against the Creditor of the Seller', *Hapraklit Vol 41* 161, p179; Professor Shalom Lerner, *Set-off of Debts*, 2009, p117. As cited in *Tauber*
¹¹Shlomo Kerem, *Trust Law*, 1979, pp32-328
¹²J H Baker and S F C Milson, *Sources of English Legal History*, 1986; Henry Hansmann and Ugo Mattei, 'Trust Law in the United States. A Basic Study of Its

Special Contribution', 46 *Am J Comp L* 133 (1998); Sara Worthington, *Equity* (2nd ed, 2006). As cited in *Tauber*
¹³Hansmann and Mattei (as above)
¹⁴The Court reasoned that the question whether a trusts relationship was established between the parties is a question of fact. Since the district court already ruled that a trust relationship between the parties was established even though the only written evidence of the trust was the tax declaration, and as

the appeal court does not interfere with factual findings of the District Court, the Supreme Court (being a court of appeal) decided not to review this question
¹⁵According to the proposed amendment to the Trust Law (as part of the new *Civil Code*), the trustee shall be deemed an owner of the property held in trust
¹⁶Although we note that in Civil Appeal 3911/01 (Israel Supreme Court) *Zohar Caspi et al v Shlomo Ness* (judgment dated 17 October 2002)

the Supreme Court went in that direction as well, without actual discussion regarding the conflict between s3(b) and 5 to the Trust Law and the conflicting interests of the beneficiary and the creditor in the context of trust relationship.
¹⁷*Snell's Equity* (London, 29th ed, P Baker and P Langan, 1990, 23)
¹⁸*Aharonov*, p250
¹⁹Miguel Deutch, 'The Rise and Descent of the equitable right in the Israeli Jurisprudence', *Eyunev Mishpat Volume 24*, 313-368, p342