Acquisitions of Israeli Companies: The Legal and Regulatory Framework

by

Mark A. Kass

Hogan & Hartson LLP, Washington, D.C.

Appearing in INTERNATIONAL QUARTERLY

January 2000

published by

Business Laws, Inc., Chesterland, Ohio.

Acquisitions of Israeli Companies: The Legal and Regulatory Framework*

*Mark A. Kass***

I. Introduction

The increasing prominence of Israeli technology has attracted a growing number of international partners, investors and acquirors. During 1998 and 1999, non-Israeli corporations acquired scores of Israeli companies, operating in a wide range of technology fields — the Internet, telecommunications, software, and medical devices — and including some of the more

** *Mark A. Kass, B.A. Yale University, J.D., Columbia University, is counsel at the international law firm of Hogan & Hartson LLP, based in Washington, D.C. He formerly was an associate for four years at the law firm of Yigal Arnon & Co. in Tel Aviv, Israel, and is a member of the New York, Washington, D.C., and Israel Bars. The author would like to thank his former colleagues at Yigal Arnon & Co. and Dan Ben Dror & Co. in Tel Aviv for their valuable observations and insights.*

successful and innovative Israeli companies. Acquirors include international technology giants such as IBM, America Online, Texas Instruments, General Electric, and Lucent Technologies.

The successful conclusion of an acquisition in Israel requires more than knowledge of how to evaluate technology and negotiate with Israelis. Potential acquirors and their counsel must also understand the Israeli legal framework and accommodate the special considerations for structuring and completing an acquisition in Israel. Ongoing changes in Israeli law further complicate this task. In April 1999, the Israel Parliament, the Knesset, enacted a new corporate law, effective February 1, 2000 (although the effective date may be deferred until July 2000), and in May 1999, the Israeli Income Tax Authority announced its intention to revise tax rules concerning stock-for-stock acquisitions.

For an experienced U.S. businessman or lawyer, the legal and regulatory landscape of an Israeli acquisition will be recognizable in places and alien in others. Although specific provisions differ significantly from their U.S. counterparts, the Israeli corporate and tax statutes derive from British law of 1948 and reflect Anglo-American legal traditions. At the other end of the spectrum lie Israel's labor laws, primarily the product of socialist/trade unionist legislation of the 1950s, and its extensive government benefits and tax relief programs. Those Israeli regulatory agencies involved in an acquisition, such as the Israeli Income Tax Authority and the Securities Authority, operate to a large degree on the basis of informal, unpublished rulings and opinions. As a result, most current regulatory policy may not be known outside a relatively small circle of regulators, lawyers, and accountants.

This article highlights the most important of those legal issues unique or specific to acquisitions in Israel, which need to be considered by the acquiror and its counsel. For ease of reference, I have organized the article into the following sections:

— Structuring an Acquisition: Corporate Law Issues;
— Tax Issues;
— Israeli Securities Law Issues;
— Other Regulatory Approvals;
— Labor Law Issues; and
— Special Due Diligence Issues.

Except where otherwise noted, I have assumed that the acquiring company (the Acquiror) is a non-Israeli corporation, that the acquired or target company (the Target) is an Israeli company, the shareholders of which (the Selling Shareholders) include Israeli and non-Israeli persons and entities. Stock or other securities of the Acquiror received by shareholders of the Target in a stock-for-stock acquisition are referred to as "Acquired Stock."

II. Structuring an Acquisition of an Israeli Company: Corporate Law Issues

The Israeli Companies Ordinance (New Version) 1983 (the Companies Ordinance) serves as the Israeli corporate law statute and prescribes the form of acquisitions. Effective February 1, 2000, the Companies Ordinance will be replaced by the Companies Law 1999 (the effective date of the new statute may be postponed until July 2000).

A. Overview: Structuring Israeli Acquisitions

To date, the most common structure used by non-Israeli corporations for acquiring Israeli companies has been the purchase of 100 percent of the shares of the Israeli target, without a merger resulting. The Companies Ordinance allows for such a structure, even over the dissent of shareholders holding up to 25 percent of the voting power of the target. Using this approach, acquisitions of Israeli companies, even publicly traded companies, can reach the same outcome as in a reverse triangular merger — the acquired target remains a distinct corporate entity, wholly owned by the non-Israeli acquiror.

The Companies Law 1999 revises the law applicable to acquisitions and mergers in a number of important respects and may significantly affect the structure of future acquisitions. The new law apparently increases the difficulty of forcing dissenting shareholders of publicly traded targets to sell their shares, except by way of a merger. The new law also eases the process for mergers. These changes may lead to more asset acquisitions by non-Israeli entities, which heretofore have been used primarily to acquire divisions of the larger Israeli companies, and mergers of Israeli companies into subsidiaries of non-Israeli acquirors (or reverse triangular mergers of the non-Israeli acquiror's subsidiary into the target).

B. Acquisition of 100 Percent of the Shares of the Target

1. Acquisition of the Target by Agreement with All Shareholders of the Target: No Merger

a. Process and Procedures

Both the Companies Ordinance and the Companies Law 1999 permit an

Acquiror to purchase all of the shares of a Target by agreement with 100 percent of the Target shareholders, resulting in the Target retaining its corporate existence as a wholly owned subsidiary of the Acquiror. This structure has been used for nearly all acquisitions of nonpublicly traded Israeli companies./1/ Approval by the Board of Directors of the Target is either not required, in the case of a public company, or a formality, in the case of a private company./2/ Neither the Companies Ordinance nor the Companies Law imposes special approvals of the Target shareholders or board of directors by virtue of the Acquiror's status as a foreign person or entity. Nor do they obligate the non-Israeli Acquiror to obtain any approvals from its board of directors or shareholders.

b. Bring-Along Agreements

Articles of association and shareholder agreements of high-tech companies, particularly those in which venture capitalists have invested, often contain "bring-along" clauses. A bring-along clause provides that if the holders of a designated percentage of the shares of the Target, often 75 percent, accept an offer to acquire 100 percent of the shares of the Target, then all other Target shareholders agree to sell their shares in that proposed transaction and, if necessary, to vote their shares in favor thereof. Although bring-along clauses have been enforced in the United States, this clause has not been tested in any reported Israeli decision.

If the Target under consideration has a bring-along clause, the Acquiror should evaluate its potential effect and relative strength in light of the circumstances under which it was adopted. Under Israeli law, shareholders can adopt a bring-along clause in articles of association over the opposition of holders of up to 24 percent of the shares (and, under the Companies Law 1999, holders of up to 50 percent of the shares). But the enforceability of the clause against those shareholders who voted against its adoption has not been tested. Once adopted, a bring-along clause in articles of associations will be enforceable against all subsequent transferees or holders of subsequently issued shares. In shareholder agreements, a bring-along clause will be enforceable only against parties to the agreement.

2. Acquisition of 100 percent of the Shares of the Target Without a Merger: Forcing Dissenters

In practice, shareholders of a private Target cannot always reach unanimous agreement; for a publicly traded Target, unanimity is not a realistic possibility. The Companies Ordinance provides mechanisms that compel dissenters to sell and result in the Target becoming a wholly owned subsidiary of the Acquiror.

a. Companies Ordinance: The Current Law

Sections 233 and 236 of the Companies Ordinance provide alternative procedures to force dissenting or uncooperative minority shareholders to tender their shares. The procedures apply whether the consideration offered by the Acquiror is cash or its own securities.

Although § 233 refers only to an arrangement among a company and its creditors or shareholders, the Israeli courts have extended its use to acquisitions based on English case law. Under this judicial interpretation of § 233, if the Target's board of directors and the holders of 75 percent or more of the shares voting at the shareholder meeting/3/ approve the proposed acquisition, the Target applies to the court to force the dissenting minority to exchange their shares. The court application must contain a fairness opinion that the proposed transaction fairly treats the minority. Any Target shareholder that opposes the transaction has the right to file a motion requesting that the court reject the transaction or approve it with modifications. The burden of proof rests with the petitioners seeking approval of the transaction. If the court approves the transaction, then the dissenters' shares pass by law to the Acquiror and the dissenters receive the proposed consideration. Section 233 does not contain appraisal rights of dissenting shareholders.

Under § 236, if the holders of 90 percent or more of the issued and outstanding shares (excluding any shares held by the proposed Acquiror) of the Target/4/ approve the proposed acquisition, dissenting shareholders of the Target have one month from the date of receipt of the notice of shareholder approval to file suit in Israeli court opposing the transaction. If the dissenters file a court challenge, the burden of proof lies with the dissenting shareholders. If the dissenters fail to file a timely application or if the court rejects the dissenters' application, then the transaction is consummated (one month after the deadline to file an application, if the dissenters did not file an application or, if they did file an application, upon termination of the court proceeding). The Acquiror sends notice to the Target and transfers to the Target the consideration owed to the dissenting shareholders. The Target transfers to the Acquiror the dissenters' shares, which pass as a matter of law to the Acquiror, and registers the Acquiror as the owner of 100 percent of the Target shares. The Acquiror places the consideration owed to the dissenters in a special trust fund, for distribution to the dissenters. Section 236 does not contain appraisal rights for dissenting shareholders.

Since 1995, § 233 has been used by the courts to approve the acquisition of a number of publicly traded Targets./5/ Section 236 has been the preferred mechanism of acquisitions of private companies, but its 90 percent threshold has rendered it impractical for acquisitions of publicly traded companies./6/

b. Companies Law 1999: The Future Law

(1) ***Private Companies*** The Companies Law 1999 retains a mechanism to force dissenting shareholders of a private company to sell their shares in a 100 percent share acquisition. This mechanism is identical to that of § 236 of the Companies Ordinance, except that the percentage of shares necessary for approval is reduced, under certain circumstances, from 90 percent to 80 percent. *See* Companies Law 1999, § 341.

Section 350 of the Companies Law 1999 retains the operative language of § 233 of the Companies Ordinance. Whereas § 233 has been interpreted by the courts to apply to acquisitions by third parties, the revised organization of the Companies Law 1999 raises doubts as to whether the Knesset intended that § 350 apply to acquisitions. In the organization and structure of the new law, a new Part of the law was created, entitled "Acquisition of Companies." This new Part contains § 341 (the successor to § 236 of the Companies Ordinance), but not § 350, which remains in the Part of the new law entitled "Miscellaneous." Under the organization of the Companies Ordinance, both §§ 233 and 236 were in the Part entitled "Miscellaneous," and the Ordinance had no Part dealing exclusively with acquisitions.

(2) ***Public Companies*** A completely new portion of the Companies Law 1999 — §§ 336 through 338, entitled "Forced Sale of Shares, Acquisition of Minority Shares by the Controlling Member in a Public Company" — imposes onerous requirements to compel dissenting shareholders of a publicly traded company to sell. Section 336 states that a person shall acquire 90 percent or more of the shares of a public company listed for trading on a stock exchange only by way of a "Full Purchase Order." To force dissenting shareholders to sell, the holders of at least 95 percent of the issued shares of the Target must approve the Full Purchase Order. If the vote attains the 95 percent threshold, all of the Target shares subject to the Full Purchase Order (assumed here to be 100 percent) pass as a matter of law to the Acquiror, and the Acquiror is registered as the owner of 100 percent of the Target shares. If the 95 percent threshold is not met, the Acquiror may purchase from those Target shareholders that accepted the offer no more than 90 percent of the Target's issued shares.

It remains unclear, however, whether § 336 applies to all offers or only offers by "Controlling Members." Although the title of the Article refers to acquisition by the Controlling Member and the Article appears to be modeled on U.S. corporate law provisions concerning interested stockholders (such as Del. Gen. Corp. Law § 203), the body of the Article never uses the term "Controlling Member," but instead uses the word "person." The courts will have to resolve the issue.

Section 338 contains a right of appraisal, apparently exercisable by all Target shareholders, including those that voted to accept the Full Purchase Order or abstained from that vote. The Target shareholders can exercise the right of appraisal upon application to the Israeli court within three months of the acceptance of the Full Purchase Order; they may file the application as a class action. The court has broad discretion to determine the fair value of the shares acquired by the Acquiror in view of the law's failure to specify the method of valuation or the criteria to be considered.

The continued applicability of the "§ 233" mechanism to acquisitions of public companies also remains unclear. Section 336 states that a person shall acquire 90 percent or more of the shares of a public company listed for trading on a stock exchange only in accordance with the provisions of the Chapter of the statute containing § 336. Section 350 of the Companies Law 1999, retaining the language of § 233 of the Companies Ordinance, is not located in the Chapter containing § 336.

3. Mergers

a. Companies Ordinance: The Current Law

As a matter of law, a merger transfers all assets and liabilities from the merged company into the surviving company and dissolves the merged company without any winding up. *See* § 234. The mechanisms of §§ 233 and 236 apply to the approval of proposed plans of mergers or amalgamations. The language of § 234 seems to prohibit an Israeli company from directly merging into a non-Israeli company./7/

b. Companies Law 1999: The Future Law

The new law provides a far more detailed section on mergers, modeled on U.S. statutes, with the following procedures for approval.

Following approval of the merger proposal by the boards of directors of both companies, the parties send notice thereof to the Israeli Registrar of companies and to all creditors of the two companies. Creditors have an opportunity to object to the proposal in Israeli court, and the court is empowered to prevent or delay the proposed merger if the surviving company would not be able to meet the obligations of the absorbed company.

Assuming that the court has not blocked the proposed merger, the shareholders of both companies must approve the plan — for each company, approval of a majority of all shares present and voting, plus a majority of all shares held by shareholders other than the other party to the transaction and controlling shareholders (shareholders holding 25 percent or more of the shares of the company) present and voting (for companies established prior to the effective date of the new law, the necessary votes are presumed to be 75 percent majorities, unless specified otherwise in the company's bylaws; for companies established after the effective date, they may specify in their bylaws that the majorities needed are 75 percent). Shareholder approval completes the merger, without need for any further court action.

If the holders of a majority of the shares approve the plan, but the holders of a majority of the shares held by shareholders other than the other party to the transaction and controlling shareholders do not approve, shareholders holding 25 percent or more of the issued shares of that company may petition the Israeli court for approval of the merger. The court may grant approval of the merger if it finds that merger proposal fair and reasonable, taking into account the estimated values of the two companies and the proposed consideration in the merger.

The language of the new law does not clarify whether an Israeli company can directly merge into a non-Israeli company.

C. Purchase of Substantially All of the Assets of an Israeli Company

Although the Companies Ordinance does not refer to the purchase of all or substantially all of the assets of a company, such transactions occur as a matter of course, and the obligations and liabilities of the Target ordinarily do not pass to the acquiror.

The conservative view is that the holders of 75 percent of the shares of the Target must approve the sale of all or substantially all of the Target's assets, in addition to the approval of the Target's Board of Directors. This view derives from several considerations. First, the sale of all or substantially all of the assets of a company constitutes a fundamental change in the business and arrangement of the company, like a de facto merger or liquidation, both of which must be approved by the holders of 75 percent of the shares of the company. Second, the sale may be the first step of a liquidation, and a part of a liquidation should be subject to the same 75 percent shareholder approval. This may be particularly relevant where the Target's articles of association state that the sale of all or substantially all of the assets is a "deemed liquidation" of the company, requiring that the company distribute all funds and assets following the closing of the sale. Third, at British common law, shareholders approved the sale of all or substantially all of the assets of a company. In practice, the Target ordinarily seeks the approval of the holders of 75 percent of its shares./8/

Because the Companies Law 1999 does not expressly address the sale of assets, practitioners will likely maintain their position that the shareholders of the Target must approve the sale, although disagreements may arise as to whether the requisite approval should be by a simple or 75 percent majority. The merger provisions of the new law provide for shareholder approval of a simple majority, while the liquidation provisions of the new law entail 75 percent approval.

D. Special Approval of Transactions in Which Directors Have Interests

If any of the Target's directors are to receive any special benefits in the proposed transaction (such as golden parachutes, options, seats on the board of directors of the Acquiror, or compensation increases in the case of management directors), then that director is deemed to be an interested party under the current and new statutes. Under both statutes, a director cannot participate in the consideration or vote of a matter on which he or she holds an interest, and more stringent shareholder consents of the interested party transaction may be required.

1. Companies Ordinance: The Current Law

If the Target is publicly traded on the Tel Aviv Stock Exchange (TASE), and the interested party or the interested majority of the Target directors hold 25 percent or more of the voting power of the Target's shares, then the holders of 33 percent of the shares held by disinterested shareholders must also approve the transaction. This disinterested shareholder approval may also be required if the Target is publicly traded elsewhere, although the question has not been decided definitively by the Israeli courts. *See* Companies Ordinance, §§ 96GG, 96HH, and 96JJ.

2. Companies Law 1999: The Future Law

If the Target is a public company and the interested parties to an exceptional transaction together hold 25 percent or more of the voting power of the Target's shares (or would, together, otherwise be considered a "controlling shareholder"), then either (i) the holders of 33 percent of the shares held by disinterested shareholders, present and voting, must approve the transaction or (ii) the total number of dissenting votes of the shares held by disinterested shareholders must not exceed 1 percent of all the voting rights in the Target. *See* Companies Law 1999, § 275(a).

III. Tax Issues

A. Income Tax Issues in a Stock-for-Stock Acquisition

Under Israeli law, selling shareholders or optionholders generally are subject to tax in a stock-for-stock acquisition. The exchange of shares or options of an Israeli company for shares or options of another company is deemed a sale of assets and a tax event as of the date of the exchange. *See* Income Tax Ordinance, §§ 2 and 89.

Three important exceptions exist to this general rule. First, gains realized by non-Israeli resident Target shareholders may be exempt from Israeli tax under international double taxation tax treaties. Second, with respect to Targets publicly traded on the TASE, the sale or exchange of those shares traded on the TASE are exempt from tax. Third, with respect to Targets publicly traded outside of Israel, the sale or exchange of shares of an "Industrial Company" or "Industrial Holding Company" is exempt from tax, if the seller acquired those shares (i) on a non-Israeli stock exchange or in a public offering in which the shares were registered on a non-Israeli stock exchange or (ii) at least five years prior to the sale or exchange and prior to the initial public offering of the Target, but only if the Target filed a registration statement with a non-Israeli securities authority prior to year-end 1994 and the registration statement was effective prior to year-end 1995./9/ Most technology companies qualify as Industrial Companies. *See* Income Tax Order (Exemption from Tax on Capital Gains from the Sale of Shares), 1981, as amended.

The taxation of stock-for-stock acquisitions creates significant economic disincentives, particularly when the Acquired Stock received by the Target's shareholders or optionholders) are not immediately tradable — for example, because pooling of interest rules restrict resale, the Acquired Stock is not registered under the U.S. Securities Act of 1933 (the U.S. Securities Act) or the securities received are unvested options. In such cases, tax is due immediately, even though the Target shareholder has not received cash or an immediately tradeable security. Moreover, the amount of tax derives from the value of the Acquired Stock, calculated as of the date of the closing, even though the value of the Acquired Stock may decrease before the Target shareholder is permitted to sell the Acquired Stock. This scenario frequently arises in the acquisition of a relatively young high technology company — its shares are not publicly traded; founders often own sizable minority stakes; and key employees hold large numbers of options.

Practitioners typically employ one the following four approaches to ameliorate the tax burdens in a stock-for-stock acquisition:

(1) The parties obtain an advance ruling from the Israeli Income Tax Authority, deferring the payment of tax by the Target Shareholders. Advance tax rulings are private rulings or approvals issued privately in advance of transactions, at the request of the parties to the transaction. Although advance rulings are informal and are not legally binding, the Income Tax Authority has taken the position that it will abide by the legal position in the opinion, with respect to the parties to the transaction. The standard advance ruling in a taxable stock-for-stock acquisition incorporates the following principles:

All income tax due from those Target shareholders subject to Israeli tax (the "Taxed Selling Shareholders") is deferred. If the Taxed Selling Shareholder sells the Acquired Stock during the first year following the Acquisition, tax is due at the end of that year. If the Taxed Selling Shareholder does not sell the Acquired Stock during the first year following the Acquisition, tax comes due at the earlier of the sale of the Acquired Stock or the end of the second year following the Acquisition.

— If the Taxed Selling Shareholder sells the Acquired Stock in the first year following the Acquisition, the amount of tax is based on the price of the Acquired Stock at the closing of the Acquisition; the Taxed Selling Shareholder need not pay any additional tax is due if the price of the Acquired Stock increases between the closing of the Acquisition and the sale of the Acquired Stock, but tax is not reduced if the Acquired Stock is sold at a price below that of the Acquisition. If the Taxed Selling Shareholder sells the Acquired Stock in the second year, the tax is calculated on the basis of the price of the sale, if it is higher than the price of the Acquired Stock at the closing of the Acquisition.

— The amount of tax, as calculated based on the above rules, is increased based on inflation and the length of time between the closing of the Acquisition and the date on which tax is paid.

The Taxed Selling Shareholders must deposit their Acquired Stock with a trustee approved by the Income Tax Authority. The trustee must hold this Acquired Stock until receiving confirmation that the Taxed Selling Shareholders have paid the applicable tax.

Given the holding periods of Rule 144 of the U.S. Securities Act, the sale of Acquired Stock in the first year, and possibly the second, requires registration of the Acquired Stock. Parties to these transactions use registration rights agreements to permit Taxed Selling Shareholders to sell their Acquired Stock during this two-year period.

(2) The Taxed Selling Shareholders receive some cash in the Acquisition (along with shares), in an amount sufficient to cover their tax liabilities. The feasibility of this approach depends on the pooling of interest rules, which only allow a certain percentage of the consideration to be in cash, and overall business considerations.

(3) Simultaneously with the closing, those selling shareholders not subject to Israeli tax (the "Exempt Selling Shareholders") buy for cash from the Taxed Selling Shareholders a sufficient number of shares to fund the tax liabilities of the Taxed Selling Shareholders. This mechanism shifts much of the risk to Exempt Selling Shareholders, since the value of the Acquired Stock purchased from the Taxed Selling Shareholders may decrease before the Exempt Selling Shareholders are permitted to sell.

(4) The Target or Exempt Selling Shareholders extend loans to the Taxed Selling Shareholders, in an amount equal to the amount of tax owed

by the Taxed Selling Shareholders, with the Acquired Stock pledged as security.

In May 1999, the Income Tax Authority announced that it was considering the adoption of a safe harbor regulation deferring taxation of shares of a non-Israeli company acquired in a stock-for-stock acquisition until the earlier of (i) the sale of the Acquired Stock or (ii) six months after the closing of the Acquisition. If the Income Tax Authority adopts the proposed regulations, it will probably cease to issue the private rulings described above.

B. Tax Issues Involving the Exchange or Conversion of Existing Employee Options

In the prevailing corporate culture, Israeli high technology companies typically grant options to employees at below market prices and sometimes at prices close to zero. In the context of an Acquisition, an Acquiror usually wants to exchange existing employee options in the Target into options in the Acquiror. The exchange of options, however, ordinarily requires immediate payment of tax on the difference between the cost basis of the exchanged option (often zero) and its value at the time of the exchange.

A non-Israeli Acquiror can apply to the Israeli Income Tax Authority for a special permit to exchange or convert the existing options granted to the employees of the Target into options of the Acquiror. This special permit typically states that the conversion of Target employee options into Acquiror options is not an immediate tax event and defers the payment of tax until the employee exercises the Acquiror options. The permit usually requires that a trustee hold the options and any shares issued upon exercise of the options during the two years following the date of the initial grant, and prohibits the employees from selling the securities during that period./10/

C. Stamp Tax

The transfer of shares, debentures, or other corporate obligations gives rise to an obligation to pay stamp duty, at the rate of 1 percent of the consideration paid for the securities, regardless of whether cash or in-kind. The failure to pay stamp duty is punishable by fine and late payment is subject to penalty. *See* Stamp Duty on Documents Law, 1961 (the Stamp Duty Law), §§ 10(b), 11, 14, and Schedule A. The law does not specify which party to these transfers must pay the duty; most often, as a result of negotiation, the seller assumes responsibility.

The parties need not present proof of payment of stamp tax to close an Acquisition or to record the transfer of shares with the Israeli Registrar of Companies (although proof of payment is necessary to initiate a lawsuit in Israel based on the share purchase contract or to file the agreement itself with certain Israeli government offices). As a result, the parties to share transfer transactions do not always pay stamp tax, at the risk that the tax authority may at a later date raise the obligation to pay, subject to considerable penalty.

Because the transfer of shares of a public company is exempt from stamp duty, in the past, prior to the closing of an Acquisition, shareholders have converted Targets into public companies, as that term is defined in the Companies Ordinance. Under the new Company Law, however, a private company cannot convert into a public company without offering its shares to the public.

IV. Israel Securities Law

In a stock-for-stock acquisition in which a non-Israeli Acquiror issues its stock to the shareholders of the Israeli Target, the Israeli securities laws may compel the Acquiror to file a prospectus with the Israeli Securities Authority, a time-consuming and expensive process. Certain relief may be available.

A. The Prospectus Requirement of the Israeli Securities Law: General Principles

The Israel Securities Law, 1968 (the Securities Law) states that a person shall not offer securities to the public without a prospectus published with the authorization and approval of the Israeli Securities Authority. See Securities Law, § 15(a). A person includes a non-Israeli issuer.

Neither the Securities Law nor the case law defines the term "offer to the public." The Israeli Securities Authority has taken the position that an offer to more than thirty-five offerees in any year constitutes an offer to the public for purposes of the Securities Law, and has informally provided the following guidelines:

> First, the number of offerees is measured by totaling all offerees in all transactions (related or not) consummated over the year period, including offers of issuances of shares, offers of options, and offers of preemptive rights to shareholders.

— Second, only Israeli residents, including corporate or other entities organized under Israeli law, count towards the thirty-five offeree limit.

Third, the "year" may be measured either by a twelve-month or annual calendar period, whichever the offeror prefers.

A prospectus under the Securities Law ordinarily is in the Hebrew language and covers subject matter areas outside of SEC filings, including, for example, detailed summaries of material contracts. The financial statements of the issuer must be denominated in New Israeli Shekels (NIS) and must comply with the Israeli accounting rules and regulations, regardless of its residence or place of incorporation. The Securities Authority must approve the prospectus, and the process includes comments from the authority, revised drafts and sometimes meetings with the staff. The issuer and a majority of its directors all sign the prospectus, and all bear legal responsibility for false or misleading statements therein.

B. Whether an Israeli Prospectus Is Required in a Stock-for-Stock Acquisition

1. Acquisitions of Private Israeli Companies

If, as is often the case with nonpublicly traded Israeli Targets, thirty-five or fewer Israeli persons or entities receive stock or options of the non-Israeli Acquiror in the acquisition (taking into account offers during the prior year for purposes of calculating the number of offerees), the parties can apply to the Securities Authority to confirm that the acquisition may go forward without publishing a prospectus under the Israeli Securities Law. The agency ordinarily approves these transactions, and the approval process usually takes about two weeks.

2. Offers to More Than Thirty-Five Israelis: Private and Public Target Companies

If more than thirty-five Israeli shareholders or employees are offered securities in the acquisition (taking into account offers during the prior year for purposes of calculating the number of offerees), the Securities Law compels the issuer to file a prospectus.

Where the Acquiror is a publicly traded company outside of Israel, the issuer can apply, pursuant to § 41, for an exemption from or modification of the obligation to publish a full prospectus under the Securities Law. Section 41 provides that when a company registered outside of Israel offers its securities to the public in Israel, the Securities Authority may exempt the offeror from all or part of the obligations of the Securities Law, if it finds that the laws of the country in which the issuer is registered adequately protect the interests of the investing public in Israel. The specific relief granted by the Securities Authority depends in large part on the status of the Target and Acquiror.

If the Target and Acquiror are publicly traded in the United States, the issuer probably can obtain a ruling modifying the duty to publish a full prospectus in Israel under the Securities Law. The Securities Authority recently permitted the issuer/acquiror to file a prospectus in English and to incorporate by reference certain information in the U.S. securities filings of the acquiror and target (including the S-4)./11/ If the Target is publicly traded on the TASE and also outside of Israel, the issuer may be able to obtain a ruling reducing somewhat the prospectus obligations. In such cases, the Securities Authority permitted the filing of Hebrew translations of the foreign prospectus.

C. Timing and Coordination of U.S. and Israeli Filings

Because the review process before the Israeli Securities Authority ordinarily takes longer than with the U.S. Securities and Exchange Commission, the Acquiror should coordinate the disclosures in its Form S-4 filed in the United States and its Israeli prospectus. The issuer needs to obtain the approval of the Securities Authority and to publish its Israeli prospectus prior to the meeting of the shareholders of the Target to approve the proposed transaction.

V. Other Regulatory Approvals

A. The Office of the Chief Scientist

1. General Principles

The Encouragement of Industrial Research and Development Law, 5744-1984 (the Encouragement of IR Law) authorizes the Office of the Chief Scientist of the Ministry of Industry and Trade (the Chief Scientist) to extend grants to Israeli companies to cover research and development expenses. The recipient company must pay royalties on the net sales of products developed from projects funded by the Chief Scientist, until the recipient company has paid 100 percent of the grant in NIS, linked to the dollar. The current rate of royalties is 3 percent on the first three years of sales, increasing thereafter up to 5 percent.

In evaluating a possible acquisition, an Acquiror should consider two technology limitations imposed by the Chief Scientist. First, the Chief Scientist must consent in writing to the transfer to a third party of the technology funded by the grants. Second, the Chief Scientist must consent in writing to the manufacture outside of Israel of products based on the technology funded by the grants, and where it grants approval, the Chief Scientist ordinarily increases the repayment amount to 120 percent to 300 percent of the amount granted and increases the royalty rate. *See* Encouragement of IR Law, § 19. The Chief Scientist has taken the position that the restrictions survive the repayment of the grant, and the courts have not resolved the issue. The transfer outside of Israel of technology developed in the framework of a Chief Scientist plan, by act or omission, without the approval of the Chief Scientist or in violation of conditions imposed in its approval, is grounds for up to three years imprisonment. *See* Encouragement of IR Law, § 47A.

According to the terms of the standard letter of approval of the Chief Scientist, the Chief Scientist must consent in writing prior to any transfer to a non-Israeli company of (a) 25 percent or more of the shares of the company and/or (b) any of (i) shareholder voting rights, (ii) the right to appoint a director; or (iii) the right to participate in profits of the company. Therefore, the parties must obtain the prior written consent of the Chief Scientist in any acquisition of an Israeli company that has received Chief Scientist funding.

2. Approval Process in an Acquisition

The Target files with the Chief Scientist a request for approval of the transaction, which must include the identity and description of the Acquiror, the most recent financial statements of the Acquiror, a short description of the transaction (the parties need not disclose the economic terms) and the anticipated schedule of closing. The Acquiror must execute and submit a written undertaking to the Chief Scientist, in which the Acquiror (i) acknowledges the constraints imposed by the Encouragement of IR Law on the transfer of know-how or manufacturing rights, (ii) undertakes to observe all the requirements of the Encouragement of IR Law as well as the regulations promulgated thereunder, as applied to Target, (iii) agrees that royalty payments on any sales of products by Target to Acquiror or its affiliates will be based on the prices of such products in arm's-length transactions, and (iv) confirms its intention to operate Target as an active, fully functioning company.

A representative of the Acquiror often must meet with the staff of the Chief Scientist. The approval process normally takes two to four weeks. Assuming that the Acquiror gives the undertaking, the agency ordinarily grants the approval.

B. Approved Enterprise Status

1. General Principles

The Law for the Encouragement of Capital Investments, 1959 (the Investment Law), authorizes the Israel Investment Center of the Ministry of Industry and Trade (the Investment Center) to grant certain tax benefits (and grants) to investment programs of Israeli companies. An approved program under this law is known as an "Approved Enterprise."

Taxable income of a company derived from an Approved Enterprise is subject to a reduced corporate tax rate of 25 percent (rather than the standard rate of 36 percent) for the statutory "Benefit Period." The law defines the Benefit Period as seven years (ten years for those companies in which foreign shareholdings exceed 25 percent), beginning the year in which the Approved Enterprise first generates taxable income, but ending no later than (i) twelve years from the beginning of the operation of the Approved Enterprise or (ii) fourteen years from the date of the Investment Center approval. The tax rate is reduced further based on the percentage of foreign ownership of the company. For a company with 90 percent foreign ownership, the effective tax rate is 10 percent.

Companies granted Approved Enterprise status after April 1, 1986, are eligible to receive an enhanced package of tax benefits (the "Enhanced Package"). Under the Enhanced Package, a company's income derived from an Approved Enterprise is exempt from income tax for a period between two and ten years, depending on the geographic location of the Approved Enterprise within Israel, and the company receives the standard tax benefits under the Investment Law for the remainder of the Benefit Period.

The standard Approval Letter issued by the Investment Center states that ownership of the company shall not be changed absent the prior written approval of the Investment Center.

2. Approval Process in an Acquisition

Either the Target or the Acquiror (with the acknowledgment of the Target) files a request for approval of the transaction, which includes the identity and description of the Acquiror, its most recent financial statements, a short description of the transaction (the parties need not disclose the economic terms) and anticipated schedule of closing.

The Investment Center ordinarily insists that the Acquiror submit an executed undertaking. The Acquiror must confirm that it will continue the approved investment plans of the Target and the business plans of the Target submitted by the Target to the Investment Center.

The approval process typically takes two to four weeks. If the Acquiror provides the requested undertaking, the agency ordinarily issues the approval.

C. Antitrust Issues and Approvals

1. General Principles

The parties must obtain the approval of the Israel Antitrust Authority for a proposed stock or asset acquisition or merger in which (1) the combined companies would have a market share in Israel exceeding 50 percent of the relevant market, or a smaller percentage if so determined by the Controller of Restrictive Business Practices (the Controller), (2) the aggregate annual sales turnover in Israel of the two companies exceeded NIS 150 million (approximately $36 million based on the current exchange rate of 4.2 NIS to the dollar) in the prior fiscal year to the transaction, or (3) one of the companies holds a monopoly as defined in the Restrictive Business Practices Law. *See* Restrictive Business Practices Law, 1988 (the Restrictive Business Practices Law), §§ 17a, 18.

The Controller may oppose, or grant a conditional approval (for example, requiring divestment) of, a proposed merger if competition in a market would be substantially prejudiced or the public would suffer substantial prejudice in the price level, quality, quantity, or supply in the relevant market. *See* Restrictive Business Practices Law, §§ 19-21.

2. Approval Process in an Acquisition

The application to the Controller for approval of a proposed transaction contains detailed business and financial information, including descriptions of products or services and the relevant markets. The Controller must respond to an application within thirty days of receipt. Each of the parties to the proposed transaction has the right to appeal the decision of the Controller to the Restrictive Business Practices Tribunal. In addition, third parties may appeal to the Restrictive Business Practices Tribunal the Controller's approval of the proposed transaction, but a third-party appeal ordinarily does not delay the closing of the transaction.

D. Real Property and Consents

The State of Israel owns approximately 93 percent of the land area of Israel, including nearly all property in high-tech parks and in areas developed since 1948. A governmental entity called the Israel Lands Administration administers the land on behalf of the State. The Israel Lands Administration ordinarily leases this land, pursuant to a forty-nine-year lease with the option to renew. Both the local office of the Israel Lands Administration and the national office in Jerusalem must consent in writing prior to the transfer of a lease or the ownership of a leasing entity of state-owned land to a non-Israeli resident or entity.

VI. Labor Law Issues: Severance Pay

The Severance Pay Law, 1963 (the Severance Pay Law) provides for the payment of severance pay to an employee who has been employed continuously for one or more years (a "Vested Employee") and has been dismissed by the employer or has resigned due to a demotion or other change that constitutes an "appreciable worsening of the terms of his or her employment." The rate of severance pay is one month's salary at the time of termination for each year of employment. The law allows employers to set aside sums for severance payments in government approved policies (this amount is in addition to the employee's salary), and employers typically elect to do so. The employer need not fund the entirety of its severance pay obligations under the approved policies. Any shortfall in funding should, however, be reflected in the company's financial statements as a liability, and the Acquiror should confirm the accuracy of that line item in the Target's financial statements. *See* Severance Pay Law, §§ 1(a), 11(a), 12(a).

The restructuring of the Target's workforce as part of or following the Acquisition may impose severance pay obligations. The dismissal of a Vested Employee in connection with or following an acquisition will ordinarily give rise to obligations of severance pay. The demotion, change in the duties or job description, or change in authority of a Vested Employee following an acquisition gives rise to the obligation to pay severance pay, if the change constitutes a substantial deterioration in the conditions of employment.

In addition, two provisions in the Severance Pay Law relate to a "change of employers." First, the voluntary resignation of a Vested Employee in connection with a change of employers gives rise to the obligation to pay severance pay. Second, whenever an employer changes, all Vested Employees, regardless of whether their employment terminates, are entitled to receive severance pay from the prior employer as if they had been dismissed on the date of the change in control; if, however, the new employer agrees in writing to assume responsibility for the severance pay to which all Vested Employees were entitled at the change of employers, then the immediate obligation of the prior employer is canceled. *See* Severance Pay Law, § 1(b). The courts have not decided whether a change in control of the Target/employer through the acquisition of its shares is a change in employer. To avoid the risk of having to pay severance pay to all Vested Employees at the closing of the Acquisition, the Acquiror should inform the employees in writing, typically as part of a general communication on the transaction and the future of the company, that the newly acquired Target assumes responsibility for the existing severance pay obligations towards all Vested Employees.

VII. Special Due Diligence Issues

In planning and conducting legal and factual investigations in connection with the acquisition of an Israeli company, the Acquiror should pay close attention to the local law and its effect on the assets, rights, and obligations of the Target. Many of the substantive issues discussed in this article directly impact on due diligence — the quantification of potential severance pay obligations, the status of government benefits and the actions to maintain those benefits, the due issuance of the securities to be obtained in the transaction. The following three issues also commonly arise in the course of Israeli acquisitions.

A. Checking for Liens on Shares to Be Acquired

A pledge or lien on a security is effective upon the registration of the pledge according to the applicable regulations (except as against a creditor who knew or should have known of the pledge, in which case, registration is not necessary). *See* Pledges Law, 1967 (the Pledges Law), § 4(3). The regulations state that assets pledged by a company be registered in the Registrar of Companies and that assets pledged by an individual, partnership or any legal entity other than a company be registered at the Registrar of Pledges. Where the shareholders of a Target include corporate entities, on

In addition, two provisions in the Severance Pay Law relate to a "change of employers." First, the voluntary resignation of a Vested Employee in connection with a change of employers gives rise to the obligation to pay severance pay. Second, whenever an employer changes, all Vested Employees, regardless of whether their employment terminates, are entitled to receive severance pay from the prior employer as if they had been dismissed on the date of the change in control; if, however, the new employer agrees in writing to assume responsibility for the severance pay to which all Vested Employees were entitled at the change of employers, then the immediate obligation of the prior employer is canceled. *See* Severance Pay Law, § 1(b). The courts have not decided whether a change in control of the Target/employer through the acquisition of its shares is a change in employer. To avoid the risk of having to pay severance pay to all Vested Employees at the closing of the Acquisition, the Acquiror should inform the employees in writing, typically as part of a general communication on the transaction and the future of the company, that the newly acquired Target assumes responsibility for the existing severance pay obligations towards all Vested Employees.

VII. Special Due Diligence Issues

In planning and conducting legal and factual investigations in connection with the acquisition of an Israeli company, the Acquiror should pay close attention to the local law and its effect on the assets, rights, and obligations of the Target. Many of the substantive issues discussed in this article directly impact on due diligence — the quantification of potential severance pay obligations, the status of government benefits and the actions to maintain those benefits, the due issuance of the securities to be obtained in the transaction. The following three issues also commonly arise in the course of Israeli acquisitions.

A. Checking for Liens on Shares to Be Acquired

A pledge or lien on a security is effective upon the registration of the pledge according to the applicable regulations (except as against a creditor who knew or should have known of the pledge, in which case, registration is not necessary). *See* Pledges Law, 1967 (the Pledges Law), § 4(3). The regulations state that assets pledged by a company be registered in the Registrar of Companies and that assets pledged by an individual, partnership or any legal entity other than a company be registered at the Registrar of Pledges. Where the shareholders of a Target include corporate entities, on the one hand, and individuals or partnerships on the other, the Acquiror should check for liens in both agencies.

All registrations of pledged assets of companies are recorded at the Registrar of Companies in Jerusalem, and the records are available by computer link. In contrast, the Registrar of Pledges has five regional offices, and a pledge of an asset held by a person or by an entity other than a company may be registered in any of the offices, regardless of the residence of place of business of the owner of the asset. Only registrations recorded at the Registrar of Pledges after January 1, 1994, are available by computer. If, prior to January 1, 1994, the Target issued shares to persons or entities other than companies, the Acquiror can check for liens only by manual review of the files in all five offices of the Registrar of Pledges.

The Pledges Law also provides that a pledge on a security is effective if that security is deposited with the creditor or with a bailee on behalf of the creditor. *See* Pledges Law, § 4(2). As a matter of practice, Acquirors address this issue by requiring all selling shareholders to present original share certificates at the closing, supplemented with representations and warranties from the selling shareholders.

B. Official Registry of Shares of the Target Company

Under Israeli law, a company's "Register of Members" — and not its share certificates nor the records at the Israeli Registrar of Companies — legally determine share ownership. *See* Companies Ordinance, §§ 61 and 62; Companies Law 1999, § 133. By law, every company must maintain a Register of Members, listing each member, its identity number and address, the number of shares held by each shareholder, the amount paid up or agreed to be paid up for the shares, the date of acquisition of the shares and, in the case where a shareholder has not fully paid for its shares, the amount of calls for payment on account of the shares. For publicly traded companies, the name of the transfer agent is usually used for all of the shares held by the public.

Notwithstanding the obligations of the law, Israeli companies, particularly private companies, often have no Registrar of Members. The Registrars of Members of publicly traded companies are frequently incorrect or improperly maintained.

In those cases in which a Target has a Registrar of Members, the Acquiror should check that document for accuracy. The Target should correct any inaccuracies and report any changes to the Registrar of Companies. In those cases in which a Target does not have a Registrar of Members, the Target should create a Registrar of Members as soon as possible, so that it is available for inspection by the Target's shareholders, in case disputes arise after the acquisition.

C. Technology Companies: Checking Intellectual Property Rights

The Target's right to important intellectual property may be clouded by events prior to the establishment of the Target as a legal entity. For example, prior to establishing the Target, the founder may have developed intellectual property with the assistance of former colleagues from special military units or former co-workers, some of who may not have joined the company and may not have executed intellectual property assignment agreements. In other instances, core intellectual property may have been developed at a government-owned defense industry company, and transferred, sometimes without documentation, as part of the spin-off Target was spun off. In the case of a founder who developed intellectual property while at an Israeli university or institute, the institution may not have fully waived its rights to that intellectual property.

After the establishment of a company, important intellectual property may be developed by outside consultants without written agreements, raising issues of work for hire. Sometimes, licenses or technology transfer agreements are poorly documented, or not documented at all.

These are not uncommon scenarios in Israeli companies. An Acquiror should review the Target's intellectual property and intellectual property rights to understand the Target's ownership in or right to use its technology and intellectual property. The process includes the taking of a technology history, through an interview of the founder(s) and/or chief technology officer(s) of the Target. Suggested areas of inquiry include the employment history of the founder(s); development of technology prior to incorporation; work of consultants; sources of all technology; licenses of technology to the Target and licenses of technology by the Target; and patent prosecution history. The audit includes analysis of documents received from the Target, including licenses, contracting/consulting agreements, and technology transfer agreements.

VIII. Conclusion

The legal and regulatory issues unique to Israel affect the economic parameters and structure of potential acquisitions in Israel, as well as the process and timetable for closing those acquisitions. These issues also affect the nature and extent of due diligence investigation of a potential Israeli Target. Perhaps most importantly, they also define the framework in which the Acquiror will operate its new subsidiary after the closing.

ENDNOTES

/1/ *See, e.g.*, AOL's 1998 acquisition of Mirabilis Ltd. and Texas Instrument Inc.'s 1999 acquisition of Libit Signal Processing Ltd.

/2/ Under the Companies Ordinance, a company can be incorporated as a "private" or a "public" company. A private company cannot offer its securities to the public and cannot have more than fifty shareholders (excluding current or former employees). A public company must file publicly available annual financial statements, but need not be traded publicly or have offered its shares to the public. The Companies Law 1999 defines a public company as one with shares listed for trading on a stock exchange or offered to the public by prospectus, and a private company as one that is not a public company. *See* Companies Law 1999, § 1.

/3/ If there are more than one class of shares or if options automatically convert into shares at an acquisition, then separate class meetings may be required, depending if the proposed transaction presents meaningful differences in the interests of the classes.

/4/ As with § 233, separate class meetings may be required.

/5/ *See* Lannet Ltd.'s 1995 acquisition by Madge Networks; ESC Medical System Ltd.'s acquisition of Laser Industries Ltd. in 1998; and Memco Software Ltd.'s acquisition by Platinum Technology International, Inc. in 1999.

/6/ Section 236 has been used only once for the acquisition of a publicly traded company, in the 1999 acquisition by BMC Software of New Dimension Ltd., in which 60 percent of the shares of the Target remained in the hands of the founders.

/7/ Apparently, there have been no mergers of Israeli companies into non-Israeli acquirors.

/8/ *See* Elscint Ltd.'s sale of substantially all of its assets in November 1998 to Picker International (computed tomography business sold for approximately $270 million) and GE Medical Systems (nuclear magnetic medicine and magnetic resonance imaging business sold for approximately $100 million).

/9/ In the 1999 acquisition of New Dimension Ltd., the founders' shares were exempt from Israeli tax on this basis.

/10/ Following the closing of the Acquisition, counsel should also consider the Israeli tax implications in the event that the Acquiror issues options to Israeli residents, whether they are employed directly by the Acquiror or by its new Israeli subsidiary.

/11/ See the filing in the Laser-ESC transaction, 1998.