

Licensing In Israel

1. Introduction

First of all, I'd like to thank you for choosing this workshop out of the 14 alternatives offered to you. Isn't it amazing that a country comprising only one pro mil of the world's population can merit its own workshop, in parallel with the mighty Canada and Japan!

Last year, the Economist magazine ran an article in which it rated the "Silicon Valleys" of the world, and cited Israel as a major contender to the foreign title. Israel is being cited as one of most important technology centers in the world, after the Silicon Valley, Boston and Stockholm.

As per the Economist article, 135 out of every 10,000 Israelis are engineers and technicians, as opposed to 18 to every 10,000 people in the USA.

The volume of venture capital investments in local endeavors is steadily increasing at a rate of 35% per year while Israel is 3rd in floating technological companies on the NASDAQ, trailing in quantity only behind the US and Canada.

Israel's rich reservoir of human resources is one of its most valuable assets. The foundation for our country's intellectual capital is the nation's top-notch universities and academic institutions. Additional knowledge has been contributed by the wave of immigration in the 1990's, bringing to Israel an influx of highly motivated scientists and engineers from the former Soviet Union.

Israel is also the country having the most doctors per capita, with an impressive amount of studies published in professional journals. This can be attributed to the "Jewish mother" syndrome.

Technology is playing an increasingly important role in the Israeli economy, currently generating more than 70% of Israeli exports.

2. **The Unique Aspects of Licensing In Israel**

I assume that all of you are familiar with the basics of licensing transactions, share purchase agreements and other forms of mergers and acquisitions, which are done no differently in Israel than in any other country in the Western world. Our legal system is sophisticated, and our patent law is fashioned after Great Britain's.

Foreign companies may seek to license Israeli technology through traditional licensing agreements, through share purchases and ancillary collaboration agreements, or through mergers and acquisitions. Israeli companies realized long ago that international collaborations are crucial for their survival.

Your counterparts for technological collaboration could be start-ups, more established companies or academic institutions, all of which have commercial arms that handle the licensing of their technologies.

Thus, I would like to focus on related issues that are unique to Israel, i.e. those laws that may affect or restrict an Israeli company in conveying rights in its technologies or shares to a foreign counterpart.

To this end, we must review the various forms of support that are offered by the Israeli government to technological enterprises. In the short time afforded to me, I will not, however, delve into tax and other considerations in deal structuring.

3. **Chief Scientist Funding**

Israel has a program supporting R & D that is run by the chief scientist of the Ministry of Industry and Trade.

Apart from the regular program, which finances some 50% of commercial R & D projects, there is the "Magnet" program, which supports pre-competitive generic R & D, and programs that support technology incubators (a subject that I will touch upon later).

The chief scientist's budget in recent years has been around \$ 400 million annually. However, royalties, which recipients of grants are required to pay back in the event of success, have grown increasingly larger over time; they now represent approximately one-third of the budget.

For a project to qualify for a grant, it must be both innovative and slated primarily for export. In return for the grant, a recipient must produce the product so developed in Israel and repay the amount of the grant through royalties on its sales.

As mentioned, the largest part of the Chief Scientist's budget is dedicated to the support of projects arising directly from industry. The degree of participation is generally 50% of the approved budget., but may vary from 30% for the improvement of an existing product to 66% for a start-up company. In addition, support is available for a feasibility study as well as for prototype evaluation at a customer's site.

The operation of the Chief Scientist is governed by the 'Law for the Encouragement of Industrial Research & Development' of 1984 which was updated in 1990. This law designates the Chief Scientist as head of the Research and Development Administration.

As you can see in the material I've distributed to you, as per Section 19 of the Law, a Chief Scientist funded project is subject to a number of restrictions:

SUMMARIZE MAJOR7 PROVISIONS

"Conditions for implementation of program

19. (a) *The Research Committee may, at its discretion, include in the approval preconditions for the approval's coming into effect, and conditions in connection with the implementation of the program.*
- (b) *The following conditions shall apply to every approved program:*

- (1) *the research and development shall be carried out by the applicant or by the person whom the applicant identified in the program as the person who would be charged with carrying out all or part of the research and development; **any change in the person who carries out the research and development requires approval** by the Research Committee, and replacement of the chief researcher requires approval by the Director of the Administration.*
- (2) *the know-how to be produced by the research and development, which according to the program is not the product to be produced but will be used for the production of that product, **shall not be transferred to anybody else.***
- (c) *Notwithstanding the provisions of subsection (b), the Research Committee may approve a change of the person who carries out the research and development or transfer of the know-how to another, on condition that the obligations under this Law and under the program apply to the person who receives the know-how, including the obligation not to transmit the know-how to another without the Research Committee's approval, and including the obligation to pay royalties.*
- (d) *The product that will be developed as a result of the research & development **will only be produced in Israel**, but the Research Committee may – in order to achieve the objectives of this Law, in special instances and for reasons that shall be recorded – permit, while a program is being carried out or after its conclusion, that part of the production rights to a product be transferred abroad, in a manner and on conditions that it shall prescribe.*

The provisions of the Law which prohibit the sale of the know-how developed with Chief Scientist assistance and manufacturing overseas based on know-how developed in Israel, are sometimes perceived as onerous to companies seeking grants and to companies seeking to acquire companies that have received grants. Should such consent be obtained, increased rates of royalties shall apply, as indicated in the law. In my experience, the Chief Scientist's office is receptive to the idea of technology transfer if some portion of the manufacturing is retained in Israel and the ultimate benefit to the transferring company is evident.

I'd also like to mention that the form of the letter of approval issued by the Chief Scientist with respect to each program, always incorporates an additional imposition, whereby a transfer of more than 25% of the means of control in the project-company may not be transferred to a foreign company, without the Research Committee's prior approval. All other transfers must always be certified by the Chief Scientist.

To my experience, the Chief Scientist is willing to render its consent to foreign acquisition of project companies that have received financing, practically as a matter of course, but it should be noted that under such circumstances, as a precondition to rendering its approval, the Chief Scientist will demand that the foreign acquiring party submit a letter of undertaking, confirming its acknowledgement of, and consent to abide by, the Law (which imposes penal obligations on offenders), and any special conditions attached to the program approval (see workshop material) .

Foreign clients have rightfully remarked to me that this is like stating the obvious, if not outright insulting since they see themselves and see others to be law abiding. I tend to agree with that observation, but I see this requirement as being more psychologically significant than "legally" meaningful.

The regulations that govern the payment of royalties by Israeli companies that have received grants from the Chief Scientist have been subject to constant scrutiny and amendatory acts on the part of the authorities over the past few years, and you can see the current arrangement in the package of materials I've distributed to you.

Recently, government discussions concerning the amendment of the Law have been initiated, igniting rigorous debate throughout the various business and industry sectors. Critics of the Law (in its current form) are calling for cancellation of the restriction against producing products abroad and narrowing of the restrictions on the sale of funded technology. Moreover, at present, even if all of the grants are repaid by way of royalties or otherwise, the project company remains subject to the restrictions imposed by the Law. The idea of an exit station from the Chief Scientist's assistance has been raised, with compensation being payable to the Chief Scientist. Another proposal that has attracted a lot of attention, is that funds be reserved for capital intensive projects in fields such as biotechnology, biology and chemistry, since, over the past few years most of the Chief Scientist's budget reached dot.com companies and the communications industry.

My personal view is that the development of technology is an end in itself, and should be encouraged.

I'd just like to add a few words about the highly successful technological incubators program, since some of you may be interested in acquiring one of the 1,000 some odd companies that originated from one of the 27 incubators that have sprung up around the country. The program was set up in 1991 following mass immigration from the former Soviet Union. The aim of the program is to provide a sheltered environment in which scientists can nurture their innovative ideas, while receiving financial support and guidance.

Projects are screened and must be approved both by the incubator's steering committee and a national coordinating committee. Once approved, the R & D program is carried out by a project company set up exclusively for such purpose. About half of these projects are based on the ideas of entrepreneurs who are new immigrants, who also hold 50% of the shares.

During the first two years of a project company's operation, the Chief Scientist provides financial grants, including 85% of the approved budget, up to a ceiling of \$145,000 per annum.

After leaving the incubators, companies may qualify for all other government incentive programs.

So far, more than 300 projects have left the incubators. Of these graduates, around 2/3rds have continued operations. Over three-quarters of these successful projects have attracted outside investments from both Israel and abroad.

The incubator project company that has attracted the highest amount of investment to date (\$ 23 million), is one of my firm's clients, D-Pharm Ltd.. D-Pharm is a biopharmaceutical company developing proprietary drugs using rational drug design, delivery and targeting technologies. The company, which was founded by a new immigrant from Uzbekistan in 1993, started at an Incubator with 6 employees. The company now counts 62 employees and was evaluated, for the last round of investment, at over \$ 50 million. D-Pharm has just upon a private placement, and is looking at an evaluation of between \$ 80-100 million.

D-Pharm realized that it would not have enough cash to bring its products to market, so after successfully completing Phase I clinical trials, I assisted D-Pharm in negotiating and successfully concluding a license agreement with Shire Pharmaceuticals Group of the UK, at the beginning of the year. Under such agreement, Shire was granted the right to exclusively develop and market DP-VPA, a chemical analogue of valproic acid for the treatment of epilepsy, worldwide. D-Pharm retained manufacturing rights and intends to become the sole supplier of the bulk compound. Thus, the Chief Scientist's approval of the licensing transaction was not required.

As D-Pharm now looks toward setting up a manufacturing facility, it will consider applying for "Approved Enterprise" status from the Investment Center, which is also part of the Ministry of Industry and Trade.

4. **The Investment Center (IIC)**

On the basis of the Law for the Encouragement of Capital Investments of 1959, the Investment Center may grant the status of “Approved Enterprise” to industrial projects and other eligible sectors of the economy. Approved Enterprise status entitles the project to substantial support of the State, in the form of reduced rates of taxation, tax holidays or grants.

We do not have the time to delve into the criteria employed by the Investment Center in granting “Approved Enterprise status”. I’d just like to mention creation of employment opportunities, and state of the art technology, among others.

The extent and nature of the benefits is determined by the geographic location of the investment and is also influenced by the degree of foreign investment in each particular enterprise.

You can see more about the benefits afforded by the Investment Center, in the materials I’ve circulated.

It should be noted, that all transfer of ownership in companies afforded “Approved Enterprise” status are restricted and are subject to the prior approval of the Investment Center.

5. **Cultural Differences**

The last ten years have been revolutionary to the Israeli market, and the technology that is being generated is definitely on the cutting edge.

You should remember, however, that not everyone in all sectors has caught up with the flow, although the progress is incredible.

Several years ago, when our firm started representing the Weizmann Institute Incubator, a Japanese company, represented in Israel by an American Harvard business school graduate, negotiated to acquire shares in one of the project companies that was founded by a new immigrant from Russia whom I'll call Boris. One morning, Boris arrived at my office, all bleary eyed and distraught, and announced that after conferring with his wife throughout the night, he was not prepared (and I'm quoting) "to sell his life" to the Japanese. He explained his thoughts as follows: The Japanese have demanded that the company procure "key-man insurance" on my life in an amount equivalent to their investment. I don't know anything about these Japanese, and I assume that if the project fails, they will kill me in order to recoup their investment. No amount of persuasion, including "no deal", were sufficient to convince Boris to do, what he perceived as "gambling with his life", and ultimately, the Harvard MBA decided to forego the requirement.

Nowadays, the immigrants have savvy, and most of them know how to say "stock option plan" even before they can speak decent Hebrew.

In another instance, just last month, we were representing a US company that wants to make a strategic investment in an Israeli company. The lawyer who represented the target company, had never seen a "Registration Rights Agreement" before, and flatly refused to read the 10 page document, in English. After I explained the gist of the agreement to him, we settled the issue by incorporating one paragraph into the share purchase agreement, which afforded my client's preference in registering all of their shares, an arrangement that was obviously even most favorable to my clients.

If any of you are considering licensing-in technology or investing in Israel, make sure that you retain an Israeli lawyer who is experienced in the local hi-tech field and speaks your language.

6. Closing Comments and Summary

In summary, the range of possibilities for high-tech investments, collaborations and alliances, in today's Israel, is very extensive and exciting.

When you do your due diligence review, always focus upon whether the technology in question was funded with government support, so as to ascertain whether there are restrictions on the transferability or enjoyment of the technology.

If you decide to license in Israel, you will encounter a business environment that welcomes collaboration and can find the experience professionals to help you along the way.

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