YIGAL ARNON & CO.
LAW FIRM

What CVC's Should Consider when Investing in an Israeli Start-Up

The State of Israel is an economic success story. It has more companies listed on US stock exchanges, barring the United States and China, than any other country in the world, the highest per capita count of engineers, and the highest density of high-tech startups. This flourishing environment provides a unique opportunity for corporations with venture capital arms ("CVC's") to invest and engage. Since the State of Israel itself is a tiny market with a population of 9 million, almost all Israeli technology companies are built with a view to becoming global companies and are therefore very open to partnering with large foreign players.

With this backdrop, there remain a number of regulatory and Israel specific factors to keep in mind when investing in an Israeli startup.

Know your Grants

Israel's Encouragement of Research, Development and Technological Innovation in the Industry Law, 1984, ("**Law**") was a unique statute intended to create new employment opportunities in the technology industry. The Law created the Office of the Chief Scientist (now, the National Technological Innovation Authority ("**IIA**")), and empowered it to provide grants for specific technology projects and to encourage domestic research and development. Most Israeli technologies are very receptive to these grants because the IIA does not receive any equity from the recipient company in exchange for the grants.

However, with these grants have come certain obligations and restrictions. An Israeli corporate recipient of an IIA grant will need to pay royalties to the IIA from future revenues if and when received, arising on account of the funded technology, up to the amount of the grant. Furthermore, they are obligated to receive IIA approval for any merger, asset acquisition, or similar change of control transaction with a non-Israeli partner. Additionally, the IIA has full discretion on whether to approve the transfer abroad of IP which was funded by the IIA and approval of such transfer can result in very large payments owed to the IIA up to as much as six times the original grant amount. There are also restrictions on the transfer overseas of manufacturing rights developed with IIA assistance, which will be subject to certain increased royalty payment obligations.

Know your IP Ownership

With the wealth of experience and knowledge available to professionals associated with universities, hospitals and the army, some Israeli startups choose to engage such professionals in the creation and development of intellectual property. In fact, one of the greatest strengths and drivers of the Israeli high-tech community is the vast knowledge and network that is derived from these types of institutions.

With that said, such institutions have internal regulations that govern external work performed by their employees and students, including with respect to IP ownership. These regulations can have far-reaching implications, including granting the institutions ownership over the IP developed by such individuals and taking priority over agreements

31 Hillel Street, Jerusalem 9458131, Israel | Tel: (+972) 2 623 9239 | Fax: (+972) 2 623 9233
1 Azrieli Center, Tel Aviv 6702101, Israel | Tel: (+972) 3 608 7777 | Fax: (+972) 3 608 7724
www.arnon.co.il | info@arnon.co.il

between the individual and the startup. Accordingly, each arrangement must be reviewed on a case-by-case basis to determine the possibility of institutional reach into the ownership of a startup's intellectual property. It is critical to ask questions about the origin of a company's IP including the personal history and background of the founders.

Know your Timing

Like many countries around the world, when acquiring or even taking a large stake in an Israeli company, the regulators are mindful of how such transaction could affect competition in the Israeli economy. Israel's Economic Competition Law, 5748-1988 ("**Competition Law**") provides that when companies merge, they may in some cases be required to have previously filed a merger notification with the Competition Commissioner (the "**Commissioner**") and receive the Commissioner's approval (it should be noted that "merger" has a very broad definition under the Competition Law). Merger transactions should be analyzed on a case-by-case basis to determine whether the notice is required and if it is, the contents of the notice. Planning ahead during the merger process should avoid the creation of unnecessary delays.

Another element that requires advanced planning is whether to request a tax pre-ruling from the Israeli Tax Authority. This may be necessary based on the nature of the transaction and the Israeli startup's specific circumstances. Israeli law has far reaching withholding obligations and this can impact many types of transactions in Israel with foreign investors including but not limited to sale of shares, payments of royalties and the receipt of interest income. In addition, in certain cases, foreign investment may even entitle the start-up to apply for additional tax benefits.

Conclusion: Know Your Environment

CVC's may also need to be mindful of the impact of overseas laws and regulations on the contemplated transaction. For example, changes in the US tax code may require coordinated planning between US and Israeli tax experts, and amendments to US regulations may require an Israeli company to examine how its nexus to the United States could potentially trigger a CIFIUS review.

In 2019 alone, Yigal Arnon & Co. represented Nvidia in its US$ 6.9 billion acquisition of Mellanox Technologies, Intel Capital in its $2 billion acquisition of Habana Labs and Stryker in its US$ 220 million acquisition of Orthospace. We look forward to broadening our relationships with CVC's in 2020.

Authors

Adrian and Simon are partners in the International and High-Tech practice group of Yigal Arnon & Co., one of Israel's leading law firms. Adrian and Simon have been representing CVC's as well as start-up companies for many years and regularly lecture on high tech and investment trends in the Israeli ecosystem

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