

GOVERNMENT FUNDING FOR RESEARCH AND DEVELOPMENT IN ISRAEL

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The success of the high-tech sector in Israel has been driven by many factors, including the vast pool of talented scientists, engineers and researchers, a dynamic venture capital market, a genuine entrepreneurial spirit, and advanced academic institutions and their increasingly fruitful collaboration with industry. In addition, the role of the Office of the Chief Scientist (“OCS”) of the Israeli Ministry of Industry, Trade and Labor and its many programs, and the effect of the Law for the Encouragement of Industrial Research and Development, 1984, as amended (the “Law”), the implementation of which the OCS oversees, have also played an important role.

Among the Law’s objectives is the creation of new employment opportunities in the technology industry in Israel through the encouragement of domestic research and development projects. The principal means by which these objectives are accomplished are by financial grants for research and development made by the OCS to companies that meet the relevant criteria. Foreign companies interested in investing in Israeli companies, or which are seeking to engage in an M&A transaction with an Israeli company, must ensure that part of the due diligence process includes a determination of whether such entities have received OCS grants. Where the OCS has funded, even in part, the development of a company’s proprietary intellectual property, the recipient becomes subject to royalty payments, reporting requirements, and certain restrictions on changes in ownership and transfers of technology and manufacturing rights, as described briefly below. Repayment of the grant does *not* relieve the grant recipient from these restrictions, so it is important to understand them.

Royalty Payments. In general, the recipient of an OCS grant is required to repay the grant by the payment of royalties on the sale of products developed using the grants or the provision of associated services, until 100% of the grant is repaid, together with an interest component. Following payment in full of the applicable royalties due, there is no further liability for payment of royalties. It should be noted that in the event that the development of a product for which OCS funding was obtained is unsuccessful, or if the product does not generate revenues, then subject to certain exceptions the recipient company is not obligated to repay the grant received for product development.

Issuance of Shares; Change in Ownership. According to the Law, the OCS must be notified of certain changes in the ownership and control of the grant recipient. Specifically, a recipient company must: (i) notify the OCS of any “change of control”; and (ii) notify the OCS of any transfer of the means of control (i.e., voting rights or the right to appoint a director or the CEO) to a non-Israeli person or entity, which transfer would result in such non-Israeli becoming an “Interest Holder” (as defined) in the recipient company. In certain cases, a recipient company may not issue shares to foreign or domestic shareholders without the consent of the OCS. This consent is usually obtained as a matter of course, subject to the foreign investor executing a standard form undertaking to uphold the Law. OCS funding is a common occurrence in Israeli high-tech companies, and the need to obtain consent for a change in control does not represent an obstacle to private placements, M&A transactions or public offerings.

Transfer of Technology. In general, when a recipient of OCS funding desires to transfer to a third party know-how and technology derived from an OCS-funded research and development program and the related rights (“Know-How”), whether in whole or in part, OCS approval must be obtained. Where such transfer is between Israeli entities, the OCS may grant its approval provided that the recipient undertakes all of the obligations in connection with the grant, including transfer restrictions and royalty payments. Approval for such a domestic transfer is relatively easy to obtain when the recipient company intends to continue commercializing the Know-How.

Where such transfer contemplates the transfer of Know-How to non-Israeli entities, however, the OCS may approve the transfer in certain cases, at its discretion, and subject to specific limitations and payment obligations, which may be significant. These restrictions would survive the acquisition of an Israeli OCS grant recipient by a foreign technology company, and could prevent transfers of source code and other manifestations of Know-How from the Israeli target company to its new non-Israeli parent company. Accordingly, it is well worth determining the “price tag” of obtaining OCS approval for the transfer prior to consummation of the acquisition.

It should be noted that these restrictions do not limit end-user licenses granted to non-Israeli entities in the ordinary course-of-business, but rather restrict, *inter alia*, any outright asset sale, as well as asset sales disguised as broad licenses (i.e., exclusive, irrevocable, perpetual), although the Law is not clear on the latter point. The restrictions on the transfer of technology are also interpreted by the OCS to include the physical transfer of the embodiments of the OCS-supported technology outside of Israel, such as the overseas transfer of source code developed with OCS funding.

Location of R&D Activities and Transfer of Manufacturing Rights. The Law also requires that all research and development relating to an OCS funded product be conducted in Israel, unless the OCS is persuaded that it is vital (for technical and operational reasons, not just for financial savings) that part of the research and development be conducted abroad. When submitting a grant application, a company must declare the percentage of manufacturing of

the resultant product which will be performed in Israel with respect to products derived from the research program. This declaration has a direct bearing upon determination of the size of the grant. Consequently, the Law requires that OCS supported products be manufactured in Israel in accordance with the percentage declared in the application. The OCS has the discretion to permit overseas manufacture in excess of the declared percentage (deviations of up to 10% do not require consent, but the OCS must be notified). Consent is contingent upon payment of additional royalties, at rates and subject to ceilings set out in the relevant regulations, up to three times the amount of the grants. It is noteworthy that the manufacture of software packages (sometimes called "fulfillment services"), which have been fully developed in Israel, is not ordinarily deemed manufacture under the Law.

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