M E M O R A N D U M

To: **Clients and Friends of the Firm**

From: **Yigal Arnon & Co.**

Date: **July 2011**

Re: **Overview of Israel's R&D Law and Funding by the Office of the Chief Scientist**

Introduction

This memorandum describes the major provisions under Israel's Encouragement of Research and Development Law, 1984 (the "**R&D Law**"), with respect to grants provided by the Office of the Chief Scientist of the Ministry of Industry and Trade (the "**OCS**"), and certain obligations and restrictions imposed by the R&D Law. These restrictions have important implications for technology-related transactions between Israeli and non-Israeli entities as detailed further below. A fifth amendment to the R&D Law was recently enacted under the Economic Arrangement Law, 2011-2012 (the "**Recent Amendment**"), and this memo takes into account the material provisions thereof.

Grants and Royalties

Purpose. Among the R&D Law's stated objectives is the creation of new employment opportunities in the technology industry through the encouragement of domestic research and development projects.

Grant application. A grant application must describe the research plan, the applicant company's business, and particularly the technology intended to be developed in the context of the research plan. Significantly, the application must indicate the portion of manufacturing of products developed with OCS assistance to be performed in Israel. Under the Recent Amendment, a grant applicant is required to undertake to ensure that all know-how derived from the research and development performed under an OCS-approved program, and all rights deriving therefrom, will be owned by the applicant from the time of the creation of such know-how.

Grant amount. Grants are available in amounts ranging from 20% to 50% of the approved budget. In practice, grants at the maximum rate of 50% are not awarded to companies reporting that more than half of the relevant manufacturing will be conducted outside Israel. Grants at a rate of 66% of the approved budget are available through the "Magnet/Magneton" program (a special program intended to encourage cooperation between industry and academia).

Reporting. Periodic reports must be submitted by the company to the OCS with respect to royalty accrual and application of grant monies to the approved budget. This often requires employees to itemize their time spent on particular research projects.

Royalty obligations. Royalties are payable on sales[1] of (i) products developed in the context of the research plan, (ii) associated services, and (iii) products developed with company (non-OCS) financing but based on core technology developed in the approved research plan ("Supported Products"). Royalties are paid at rates beginning at 3% of sales, depending on various criteria (see below). Royalties are payable until 100% of the amount of the grant has been repaid with interest as provided in the applicable regulations (or a higher percentage, if some of the manufacturing is transferred overseas – see below). Of particular importance to note is that restrictions on overseas transfer and manufacturing, discussed in detail below, continue to apply despite full payment of the grant. "Magnet/Magneton" grants are royalty-free.

Calculation of royalties on sales to affiliates. In case of sale by the applicant company to an affiliated company, followed by resale by the affiliated company to a third party customer, the "sale price" is deemed the consideration received upon such resale to a customer. An "affiliated entity" in this respect means (i) a directly or indirectly controlled or controlling entity, or an entity under common control; or (ii) an entity which was granted manufacturing rights in the Supported Products.

Regarding sales to an affiliate which are not for resale, the law states that "*in special cases of sale for non-monetary consideration or a price affected by a proximate relationship, the [Research] Committee may determine the sale value according to the accepted market value*."

Calculation of royalties on "combined" products. The OCS recognizes that a Supported Product may constitute a part of a "combined" product or a system of products. In such cases, royalties are paid only with respect to the Supported Product, and the sale price subject to royalty obligations is calculated in one of two ways: (i) if the Supported Product has a separate market price, then that price applies; (ii) if the Supported Product does not have a separate market price, then the applicable sales price will be determined on the basis of the relative cost of production of the Supported Product and the remaining components of the combined product.

Commitment to own Know-How. The Recent Amendment requires that a grant applicant undertake to ensure that all know-how derived from the research and development performed under an OCS-approved program, and all rights deriving therefrom, will be owned by the applicant from the time of the creation of such know-how, unless provided otherwise in the R&D Law. The primary exception in this regard, also introduced in the Recent Amendment, relates to institutions of higher learning (as defined under Israeli law). The scope of this exemption, and the way in which this exemption will be implemented, however, depends on supporting regulations which have yet to be enacted.

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[1] Royalties are paid with respect to the "sale price" or Supported Products, defined in regulations as "*an amount of any kind entered or attributed by the company in its books or audited financial reports in the context of income from the sale of a product, as calculated and listed in [US] dollars according to the exchange rate published immediately prior to the sale, including agents' commissions, marketing commissions, and costs of shipping, travel, agency fees, and the like, and excepting purchase tax, VAT and exchange rate insurance.*"

Manufacturing Rights

Manufacture of Supported Products outside of Israel; increased royalties. When submitting a grant application, the applicant must declare the manufacturing and added value[2] percentage in Israel with respect to products derived from the research program. As mentioned above, this declaration has a direct bearing upon determination of the size of the grant, and the royalty rate. Consequently, the R&D Law requires that Supported Products be manufactured in Israel in accordance with the percentage declared in the application.

The OCS has the discretion to permit overseas manufacture[3] in excess of the declared percentage. In the event of overseas manufacture, the rate of royalties are increased as follows: If the overseas manufacturing is performed by the company receiving the grant (or a related entity, as defined), then royalties on the sales of such products increase by 1%; in the event that the manufacturing is performed by *another entity*, the royalty rate is equal to (i) the grant amount divided by (ii) the amount of the grant plus the company's investment in the research project (this can be a very large percentage). In addition, the ceiling on royalties (ordinarily 100% of the grant amount) is increased as follows:

Relative portion of overseas manufacturing	Increase of royalty ceiling (percentage of the grant)
Up to 50%	120%
50% to 90%	150%
90% to 100%	300%

Alternatively, the R&D Law provides a mechanism whereby manufacturing rights may be transferred overseas in return for the transfer of other manufacturing rights into Israel, without incurring changes in royalty payments.

A grant recipient may increase the percentage of overseas manufacture in excess of the declared percentage without prior OCS approval provided that such increase is *less than* 10% (in the aggregate) of the declared percentage, so long as the OCS is notified of the change and does not does not object to such deviation within 30 days of receiving such notice.

Definition of "Manufacturing". In the case of software products, the OCS has opined that the place of "manufacture" does not have any real importance, because of the negligibility of costs and manpower associated with such activities. Thus, various "fulfillment" functions, such as

[2] "Percentage of Added Value" is defined as "*the amount of the manufacturing costs carried out in a particular country, less costs imported for the purpose of manufacturing in such country, against the price of the product ex works*".

[3] "Transfer of manufacturing rights" is defined as "*an authorization to a third party to use know-how developed in the scope of, or resulting from, a [research] plan, for the purpose of manufacturing a particular product only, while all the remaining rights to use and exploit the know-how remain vested in the transferor in Israel*".

copying software, preparing packaging, printing manuals and the like, can be performed outside of Israel without penalty. In certain cases, where it is not possible to manufacture Supported Products in Israel, the OCS may waive the royalty increase.

Transfer of Know-How

Transfer of Know-How between Israeli entities. The OCS may approve transfers of "*know-how derived from research and development in accordance with an approved program ... and all rights deriving therefrom*" ("Know-How") between Israeli entities, provided that the recipient undertakes all of the obligations in connection with the grant, including transfer restrictions and royalty payments. Approval for such transfers is easier to obtain when the recipient company intends to continue commercializing the Know-How.

Restriction on overseas transfer of Know-How. The R&D Law restricts the overseas transfer of Know-How, but the term "transfer" is not defined. Based on previous experience with the OCS, a transfer generally includes the assignment of legal rights in the Know-How (in other words, legal transfer) as well as the transfer of the substance of the Know-How (i.e., the source code in the case of software) together with rights to conduct follow on research and development work.

Authorized transfer of Know-How outside of Israel. The OCS is authorized at its discretion, to approve the overseas transfer of Know-How subject to the receipt of certain payments. The formulae for determining such payments are not always clear, and the amount to be paid may vary tremendously depending on the particular circumstances. The formulae provide as follows:

I. *Transfer of Know-How Only*. In the case of the transfer of Know-How (as opposed to the sale of a company or a company's assets), the GREATER of the following must be paid:

(i) the amount equal to the sale price[4] of the Know-How multiplied by a fraction, the numerator of which is the total of all grants[5] received by the recipient of the approval under the R&D Law, and the denominator of which is the total monetary investment in performing the research program. This ratio would normally correspond to the percentage of the program's budget financed by the OCS; or

(ii) the amount of the aforesaid grants, plus annual interest as provided by the R&D Law (based on LIBOR rates), less royalties paid.

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[4] The law offers no guidance as to how to address a sale price that is unknown at the time of the sale, and will be received in instalments over time. In practice, the OCS tries to determine the present value of the Know-How, notwithstanding all of the inevitable uncertainties inherent in such a determination.

[5] The numerator of the fraction that determines the amount to be paid to the OCS is stated to be the total of all grants received by the recipient under the R&D Law, and therefore would appear to include grants that have nothing to do with the know-how being sold. We suspect that this is simply a mistake, and that the intention was to take into account only grants that were related to the know-how being sold, but the wording of the law remains.

II. *Transfer of Entire Company*. When Know-How is transferred overseas as part of a sale of the grant recipient itself "*as a result of which the recipient of the approval ceases to be a legal entity incorporated in Israel*", the recipient of the approval will pay the GREATER of the following:

(i) The amount equal to the sales price of the grant recipient multiplied by a fraction, (x) the numerator of which is the total grants received by the grant recipient under the R&D Law, and (y) the denominator of which is the total monetary investment in the grant recipient (including OCS grants), less the amount of "net financial assets"[6]. Under the Recent Amendment, the denominator was amended to include all research and development expenses of the grant recipient, approved by the Research Committee of the OCS. This amendment is subject to the adoption of regulations in this respect, and will only come into effect upon the adoption of such regulations; or

(ii) the amount of the OCS grants, plus annual interest as provided by the R&D Law, less royalties paid.

III. *Depreciation*. The repayment amount derived from the formulae in *I* and *II* above, is reduced in accordance with the following depreciation formula: After three years have elapsed from completion of the research project, the repayment amount is gradually reduced, on a linear basis, over a seven-year period, to a minimum amount equal to the original grant amount plus interest, minus royalties actually paid. Thus, commencing ten years after the completion of the research project, the maximum payment will be the original grant, plus interest, less royalties paid. Under the Recent Amendment, this mechanism may be amended by the OCS by extending the depreciation term, subject to the adoption of applicable regulations to this effect. As of the date of this memo, no such regulations have been adopted.

IV. *Maximum Repayment Amount*. The Recent Amendment authorizes the Ministers to set guidelines with respect to a maximum repayment amount in the event of an authorized transfer of Know-How outside of Israel – applicable both to the transfer of Know-How only and the transfer of the entire company. As of the date of this memo, however, such guidelines have not yet been enacted.

V. *Sale of Company for Shares*. Special provisions apply to a sale of the company in consideration for shares in the acquiring company. These provisions are beyond the scope of this memo.

VI. *Sale to an Affiliated Entity*. In cases where no consideration is paid, where the transfer of Know-How is between affiliated entities, or by way of merger, or in the event the Research Committee believes the sale price is not "realistic", the OCS can determine the

[6] Regulations interpreting the term "financial assets" have not yet been promulgated, and accordingly such assets are not currently included in repayment calculations.

sales price on the basis of an expert opinion. An "affiliated entity" in this respect means (i) a directly or indirectly controlled or controlling entity or an entity under common control; or (ii) an entity which was granted manufacturing rights in the Supported Products.

VII. *Consideration in the form of know-how*. If consideration for the Know-How outside of Israel is in the form of know-how developed outside of Israel (i.e., the Know-How exits Israel and the consideration know-how is brought into Israel), the Research Committee can authorize such transfer without repayment.

VIII. *Exclusive license to Israeli transferor*. In connection with the transfer of Know-How only, if the overseas recipient of title to the Know-How grants back to the Israeli transferor a comprehensive, exclusive, irrevocable license, unlimited in time and territory, then the transfer can be approved without requiring any of the payments described above.

IX. *Liquidation-related transfer*. In the case of a sale in the context of the liquidation for insolvency of the grant recipient or in the case of receivership of the grant recipient, if the sales price for the Know-How is less than the amount payable to the OCS, the Committee is authorized to reduce the payable amount lower than the grant.

Licensing Arrangements. Under the current regime established by the R&D Law, there is no mechanism to obtain OCS approval for the granting of licenses to Know-How to non-Israeli entities, a problematic reality in light of the fact that licensing transactions are widespread in the high-tech industry. The R&D Law does include, however, a provision permitting the Ministers to enact guidelines governing the granting of broad licenses (that is, exclusive, irrevocable, worldwide, etc.) to foreign licensees of OCS-supported Know-How, as well as arrangements regarding payment by the licensor/grant recipient to the OCS. The Recent Amendment clarified that these guidelines may also include payment by way of installments. While the technology industry has been waiting patiently for years for the OCS to enact licensing guidelines, we understand that the OCS is now more actively pursuing this goal. As of the date of this memo, however, it is not possible to predict when these guidelines will be formally enacted.

It should be noted that one possible exception to the foregoing lacuna is the case of a grant of a broad license (that is, exclusive, irrevocable, worldwide, etc.) where the OCS may consider such license as a "transfer of Know-How" provided that the licensor/grant recipient agrees to pay a one-time payment upfront to the OCS (based on the formulae described above) even where the entire consideration under the license agreement is not fully-paid in advance. This arrangement, however, is predicated on the assumption that it is possible to calculate the full consideration to be paid in respect of the license grant, something that is rarely possible to determine in most licensing transactions since consideration very often includes royalties and payments on sublicense income – future amounts that are impossible to determine upon license grant. It should also be noted that in the past, where recipients of OCS funding granted licenses that included the right to manufacture products based on or embodying OCS-supported technology,

approval could sometimes be obtained under the "transfer of manufacturing rights" track discussed above. Such approval, however, often depended on the specific nature of the transaction and was not applicable generally to the wide range of technology licensing transactions.

General

Changes of control in the grant recipient. Under the R&D Law, the OCS must be notified of any change of control in the recipient company. Foreign entities acquiring or becoming "interested parties" in the recipient company must execute a standard form of undertaking to observe the R&D Law. The terms of certain grants require prior approval for any change of control.

Liquidation and bankruptcy proceedings. According to the Recent Amendment, in the event that a liquidation proceeding is commenced against the recipient of an OCS grant, or a request for a bankruptcy proceeding or other arrangement with creditors is filed, or where the company elects to proceed with a voluntary liquidation, the OCS must be notified promptly in accordance with the timeframes set out in the R&D Law. In addition, where a liquidator, receiver or other court-appointed official is designated for the recipient company, the OCS must also be notified.

Appeals. Decisions of the Research Committee may be reconsidered at a "further hearing" before the same committee, or on appeal to an Appeals Committee.

Penalties. Under the R&D Law, unlawful overseas transfer of Know-How is a criminal offense punishable by three years' imprisonment. We are unaware that any person has been sentenced to imprisonment on such grounds. Other violations of the law are subject to fines and the repayment of the entire grant.

This memo is provided for information purposes only. Please feel free to contact Barry Levenfeld (barry@arnon.co.il), Daniel Green (danielg@arnon.co.il) or Avigail Frisch (avigailf@arnon.co.il) with any specific questions regarding the R&D Law and the Recent Amendment.