

# Exporting technology from the 'start-up nation'



The Israeli government provides significant amounts of funding to the country's start-ups via the Office of the Chief Scientist. But with the financing comes restrictions designed to ensure that the success stories will benefit the country as well as the entrepreneurs. Daniel Marcus and May-ad Katz explain how the system works.

In the two last decades, Israel has become a fertile ground for technology and other start-up companies. Extensive entrepreneurship and a vibrant start-up industry have led to the country being labeled the 'start-up nation'. Every year, Israeli start-ups attract investors and buyers from around the world. The principal asset of these start-up companies (and in certain cases, their only asset) is their intellectual property – the know-how on which they are based. Consequently, it is often the case that the main objective of an acquirer of, or investor in, these companies is to obtain direct access to the intellectual property – in order to transfer it to other countries. With this in mind, foreign investors should be aware that technology companies in Israel may be subject to rather unique restrictions on the export of their intellectual property and the manufacture of their products outside of Israel. The source of these restrictions is a governmental office known as the Office of the Chief Scientist (the 'OCS'), which serves as a part of Israel's Ministry of Industry, Trade and Labor.

In this article, we will try to provide answers to the following principal questions: What is the legal basis for these restrictions? What are the content

and implications of such restrictions? And how can they be dealt with effectively? In addressing these questions, we will open a window to the

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relevant legislation and suggest solutions that may assist foreign investors in exporting Israeli intellectual property subject to OCS restrictions.<sup>1</sup>

### **OCS funding**

The start-up industry in Israel receives extensive financial support from the government, which allocates significant yearly budgets to further develop and strengthen it. For example, according to the OECD, in 2010 the gross domestic expenditure on research and development in Israel was 4.25% of

Israel's gross domestic product (in comparison to an average of 2.33% in OECD countries), while the Central Bureau of Statistics reported that Israeli companies received NIS 1.4 billion (approximately US\$400 million) from government resources. This funding, granted through various government entities and programmes, including OCS programmes, is designed to support the research and development of Israeli companies, and is recognition of the fundamental position of the high-tech industry as the main growth engine for Israel's economy.

One of the governmental entities key to providing funding for the early stages of technology companies (including the seed and pre-seed stages), when such investment is considered fairly risky, is the OCS (see 'OCS framework', below).

Receiving funding from the OCS has several notable advantages for companies: aside from the OCS's willingness to share the risk of the loss of its 'investment' in the company, the OCS does not demand any equity in return for its funding, nor does it interfere with the company's day-to-day management decisions. OCS-funded companies are required, however, to repay the funding they receive by way of royalties from future

## **OCS framework**

The Ministry of Industry, Trade and Labor's Office of the Chief Scientist (the 'OCS') oversees a significant portion of the Israeli government's support for research and development. It operates through a number of domestic and international programmes, agreements and collaborations. The R&D Fund is the main instrument by which the OCS provides its support. Its annual budget is approximately NIS 1.5 billion, and is

spent in order to support the R&D projects run by hundreds of Israeli companies. Another programme administered by the OCS is the Technological Incubators Programme, which was established in 1991. Since then the programme has undergone many revisions and it currently has 25 technological incubators, with their primary goal being to transform innovative technological ideas into viable start-up companies that, after the incubation period (typically 18-24 months), will be capable of raising

additional money from the private sector and operating on their own. The OCS's MAGNET programme encourages collaboration among industrial companies and between the companies and researchers from academic institutions.

The OCS also operates other domestic programmes such as TNUFA (assisting entrepreneurship and innovation at pre-seed stage) and the Life Science Fund, as well as various international programmes for cooperation in R&D.

sales. In addition, by receiving OCS funds, a company subjects itself to the OCS's rules and regulations.

The Law for the Encouragement of Research and Development in Industry, 1984 (the 'Law') constitutes the legal basis for the restrictions on the export of know-how and manufacturing rights, and it sets up the framework under which a company may receive OCS funding.

The process begins when a company requesting OCS funding submits to the OCS's Research Committee (the 'Committee'), a detailed plan for research and development, in accordance with specific criteria,<sup>2</sup> with the hope of obtaining its approval. In this respect, it should be noted that the Committee is obligated, when deciding whether or not to approve the granting of OCS funds to a company, to consider seriously the candidate company's declarations with respect to its plans to conduct the development and manufacturing in Israel.<sup>3</sup>

Where funding is approved by the Committee, the Committee then proceeds to determine the level of funding that it will provide. This typically ranges from 20% to 50% of the research and development expenses. Here, too, in determining the scope of the funding, the Committee is required to allocate significant weight to the company's declarations regarding development and manufacturing plans. In this manner, the OCS seeks to achieve long-term benefits by way of supporting those projects which, in its view, (i) have a high prospect for success and (ii) are likely to yield commercialization and manufacturing activities in Israel.

A company that has received the Committee's approval for its proposed research and development plan is then granted OCS funding. The company is required to repay the funding amount, plus interest, to the OCS, by way of royalties from future sales of its products<sup>4</sup>, which are produced by way of implementation of, or which incorporate or otherwise exploit, the know-how generated from the approved plan and any derivatives thereof. Among other limitations, the company will be subject to restrictions regarding the transfer of its know-how outside of Israel (but not of products which are manufactured in Israel and are subsequently exported for sale outside of Israel. This includes sales to end-users, resellers and distributors).

## Export of manufacturing

As part of the process of approving the plan that it has submitted to the Committee for OCS funding, the company is typically required to undertake that the product which will be developed as part of the OCS-funded research and development project (or any part thereof), will be manufactured in Israel.

The company will be obligated to pay royalties to the OCS based upon its sales of such products and any services provided in connection with such products, up to the total funding amount received from the OCS, plus interest.

The rate of such royalties starts at 3% and increases over time to up to 6%.<sup>8</sup>

A decision to manufacture outside of Israel requires the prior approval of the Committee, which has sole discretion to accept or deny the application for such approval. If manufacturing outside of Israel is approved by the Committee, then the approved company will be obligated to pay royalties to the OCS in amounts starting at 120% of the total funding amount, plus interest, that it received from the OCS – with the possibility of going up to 300% of such amount, as shown in the table below.<sup>9</sup>

Percentage of manufacturing transferred outside of Israel	Maximum royalties (as a % of OCS funding provided)
Up to 50%	120%
50%-90%	150%
Over 90%	300%

In this context, the Law distinguishes between two separate scenarios, both of which require the prior consent of the Committee: (a) the export of know-how derived from research and development conducted with OCS funding; and (b) the export of manufacturing rights with regard to products developed with OCS funding. Although the Law creates a distinction between these two scenarios and applies different rules and quasi-'penalty' payments to them, the basic rationale for discouraging each by way of applying the 'penalty' payments to both scenarios is the same: to increase the financial value resulting from research and development for the Israeli economy, to create jobs, to develop science-based industry, to encourage research and development in the industry, and to improve Israel's balance of inbound/outbound payments.

## Export of know-how

The Law states that know-how which is derived from research and development conducted with OCS funding, and any right resulting from it (collectively hereafter referred to as 'Know-how'), will not be transferred outside of Israel unless such transfer is carried out with, and pursuant to, the Committee's approval (which is supposed to be granted by the Committee only in special circumstances). In theory, such

approval is subject to the sole discretion of the Committee, which is not limited by, or subject to, any specific statutory criteria.

An obvious concern will be that the lack of pre-defined and structured criteria in relation to the Committee's discretion could enable it to take into account random considerations, resulting in uncertainty for a company as to whether its export application will be approved. In addition, receipt of the Committee's approval does not constitute the end of a company's relationship with the OCS. In fact, a company which has received an export approval may be required to pay statutorily-mandated increased OCS sums, which are generally perceived as a financial 'penalty' for exporting outside of Israel Know-how which was funded by the OCS with the original intent (of both the company and the OCS) that it would be exploited by way of commercialization and manufacturing in Israel. The company will almost certainly be required to repay certain amounts to the OCS, in accordance with the manner in which the Know-how is exported, as follows:<sup>5</sup>

- (a) If the company wishes to remain incorporated in Israel but sell its Know-how to a foreign entity, it will be required to pay an amount equal to the ratio of the aggregate grants received by the company according

to the Law to the aggregate financial investments invested in executing the approved plan, multiplied by the sale price of the Know-how, provided that this amount (i) will not be less than the aggregate sum of all such grants, plus annual interest (certain amounts may be deducted from the outcome in accordance with the Law<sup>6</sup>), and (ii) will not exceed what is known as the 'Ceiling Sum' (see below);

- (b) In the case of a company 'Exit' (M&A) event – where the company wishes to export its Know-how outside of Israel as part of a sale of the company and as a result the approval recipient has ceased being a company incorporated in Israel. In this scenario, the company will be required to pay the OCS an amount equal to the ratio of the aggregate grants received by the approval recipient according to the Law to its 'Aggregate Research and Development Expenses' less certain financial assets, multiplied by the sale price of the company, provided that this amount (i) will not be less than the aggregate sum of all such grants, plus annual interest (certain amounts may be deducted from the outcome in accordance with the Law<sup>7</sup>); and (ii) will not exceed the 'Ceiling Sum' (see below);
- (c) If the company imports to Israel alternate know-how 'in exchange' for the exported Know-how, then provided that such imported know-how is expected to provide a significantly higher return than would the exported Know-how, the company may not be required to make any payment on account of

the export. However, it is important to note that such imported know-how will then become subject to all of the OCS restrictions, as if it were originally developed with OCS funds.

In accordance with the recently published Regulations for the Encouragement of Research and Development in Industry (The Maximum Amount Payable Pursuant on Account of a Transfer of Know-how Pursuant to Sections 19B(1) and (2) of the Law), 2012, the maximum amount that the OCS may require from companies for the export of their Know-how in accordance with (a) or (b) above, is six times the total OCS funding that

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the company received, plus interest – this is the 'Ceiling Sum'. This Ceiling Sum provides certainty with respect to the maximum exposure to OCS payments. Furthermore, the Ceiling Sum might be further reduced in cases where it can be shown that the company's research and development activity itself was not transferred outside of Israel (i.e., only the Know-how itself was exported).

#### **Export of Know-how: possible solutions**

The export restrictions imposed on OCS-funded Israeli companies reviewed in this article may appear to be, at first glance, a substantial obstacle and barrier to foreign investment in OCS-funded Israeli companies. However, that would be looking at the empty half of the glass: there are ways to lessen the impact of these restrictions which, based on our experience, may help turn 'lemons into lemonade'.

First, in the event that the company wishes only to transfer its Know-how, the Law permits the Committee to approve such a transfer without the payment of any additional amounts, provided that the transferee will grant the Israeli transferor an exclusive, perpetual, worldwide and irrevocable licence, for full use of the Know-how and any rights derived from it.<sup>10</sup> In this way, the OCS continues to benefit indirectly from the fruits of the exported Know-How.

Second, as discussed above, the

company may try to import alternative know-how.

Third, in our experience, it is possible to make specific requests to the Committee, seeking confirmation that certain types of quasi-transfers, or apparent transfers, of Know-how will nevertheless not be deemed or treated as such according to the Law. One common example is where a foreign purchaser (often an international brand company with worldwide goodwill and reputation) of an Israeli company is permitted, with the Committee's approval, to view the source code which was developed by the Israeli company using OCS funds, in order to perform integration with the purchaser's (and its subsidiaries') products.

The complexity of the question of what actually constitutes an export of Know-how outside of Israel may lead to different outcomes: we often encounter situations in which the OCS agrees, in writing, that certain activities will not be treated by it as a transfer of Know-how provided that certain OCS-dictated conditions are complied with.

#### **Conclusion**

When dealing with Israeli companies that have received OCS funding, and when a transfer outside of Israel of Know-how or manufacturing rights relating thereto is being contemplated, it is extremely important to conduct proper OCS-related due diligence, thoroughly understanding the relevant OCS rules and regulations and analyzing all possible scenarios in depth. Only in this way will a purchaser be able to propose and consider practical solutions regarding OCS requirements which can make all the difference in receiving the correct OCS approval or confirmation in a satisfactory manner.

Although the OCS export restrictions may appear at first glance both burdensome and severely restrictive to the operations of the OCS-funded companies, a closer look reveals that certain methods, if used properly, can be utilized to achieve a 'win-win' situation, for all parties involved.

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#### **Links and notes**

<sup>1</sup> The question as to what may be considered, de facto, an export of technological know-how outside of Israel is subject to different interpretations and beyond the scope of this article.

<sup>2</sup> Section 16 The law for The Encouragement of Research and Development in Industry, 1984 ('The Law')

<sup>3</sup> Section 17(a)-(a1) The Law

<sup>4</sup> Section 2 The Regulations for the Encouragement of Research and Development in Industry (Royalties Rate and rules of payment) – 1996 (the 'Royalties Regulations').

<sup>5</sup> Section 19b(b) The Law

<sup>6</sup> Section 19b(b)(1) and 19b(g) The Law

<sup>7</sup> Section 19b(b)(2) and 19b(g) The Law

<sup>8</sup> Section 2 The Royalties Regulations

<sup>9</sup> Sections 2 and 4 The Royalties Regulations

<sup>10</sup> Section 19b(c) The Law