



## NEW R&D REGULATIONS AFFECT REDEMPTION FEES PAYABLE TO THE OFFICE OF THE CHIEF SCIENTIST

Companies that have received funding from the Office of the Chief Scientist of the Israeli Ministry of Industry, Trade and Labor (the "**OCS**") operate under rigorous restrictions with respect to the transfer of know-how developed as a result of such funding. Most notably, the transfer of know-how to entities outside of Israel is subject to OCS approval and, further, requires the OCS-supported company to pay a so-called "redemption fee" to the OCS. The redemption fee is calculated according to a complex statutory formula and had not been limited. Consequently, OCS-supported companies seeking to transfer rights in their intellectual property – whether the deal involved only specific IP rights or was an M&A transaction – faced disquieting uncertainty, as a major expense arising from such a transfer was not capped, and could not be easily assessed. In addition, foreign companies were often wary about purchasing OCS-supported companies, since typically they would have to cover this potentially disproportionate expense.

To address these issues, the Knesset Finance Committee recently approved regulations that place an upper limit on the redemption fee payable by an OCS-supported company in the event of a transfer of its know-how, capping the total fee. In addition, a number of other changes to the redemption fee calculation method have gone into effect which, along with the new regulations, may affect the financial strategies of OCS-supported companies.

If you have any questions regarding the matters in this legal update, please contact the following attorneys or call your regular Meitar contact.

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### The Transfer of Know-How under the R&D Law

The OCS was established under the Encouragement of Industrial Research and Development Law 5744-1984 (the "**R&D Law**"). The R&D Law sets forth the procedure for obtaining OCS funding for industrial R&D and the obligations of companies that receive such funding. In particular, the R&D Law places restrictions on the transfer of know-how that was developed by the company within the framework of an OCS-funded program: an OCS-supported company must obtain OCS approval for such a transfer and, to the extent the transfer is approved, must pay a redemption fee. Section 19B of the R&D Law sets forth two alternatives for calculating the fees payable to the OCS in the event of an overseas transfer of know-how – one for the transfer of know-how alone, and one for the transfer of know-how as part of a sale of the company's assets or a merger. In either case, the fee is a function of the proceeds from the sale, the amount of OCS grants and the amounts invested by the company itself. The R&D Law also sets a minimum fee equal to the aggregate amount of OCS grants, plus annual interest. Depreciation and any royalties already paid by the company are deducted from the redemption fee. In practice, the actual fee payable is not easily calculable, creating a situation where a company on the verge of a transaction encounters what can be a serious obstacle to closing the deal.

Until now, the R&D Law did not set a maximum redemption fee. The 2011-2012 Economic Arrangements Law (the "**Arrangements Law**"), however, authorized the Minister of Finance and the Minister for Industry, Trade and Labor, with the approval of the Knesset Finance Committee, to enact regulations setting a maximum amount.

On May 14, 2012, the Finance Committee unanimously approved the Regulations for the Encouragement of Industrial Research and Development (Maximum Amount Payable for a Transfer of Know-How Under Sections 19B(b)(1) and (2) of the Law), 5772-2012 (the "**Regulations**") In addition to placing a cap on redemption fees, the Regulations have another significant effect: as a result of their adoption, a previous amendment to the R&D Law, which changes the formula for determining the total redemption fee in an M&A transaction which results in the company ceasing to be a corporation incorporated in Israel (a "**Foreign-Based M&A**"), enters into force. This revised formula will generally lead to a higher redemption fee in the case of a Foreign-Based M&A.

### The Regulations

#### **Cap on Redemption Fees**

The Regulations place a limit on the redemption fee payable both in a transaction involving the transfer of know-how only and in a more comprehensive Foreign-Based M&A. In the former type of transaction, the maximum redemption fee is an amount **six times** the total OCS grants relating to the know-how being transferred, plus annual interest. Where the transfer of know-how is part of a sale of assets or a merger, the maximum redemption fee is an amount **six times** the total of any OCS grants received by the company, plus annual interest.

Nevertheless, the Regulations set a lower cap where the overseas transferee provides assurances that at least 75% of the R&D positions in the company will remain in Israel for a period of three years from the date of payment of the redemption fee. In this case, the maximum would be only **three times** the applicable grant amount plus interest. Thus the Regulations distinguish between the maximum redemption fee in a transfer of the company's intellectual property and the maximum fee in a transfer of the company's actual R&D operations.

The maximum redemption fees in each scenario are summarized in the table below:

	<b>Sale of know-how alone (Section 19B(b)(1) of the R&amp;D Law)</b>	<b>Sale of know-how as part of a Foreign-Based M&amp;A (Section 19B(b)(2) of the R&amp;D Law)</b>
<b>At least 75% of R&amp;D positions remain in Israel</b>	<u>Three</u> times the total OCS grants in connection with the know-how, plus interest	<u>Three</u> times the total OCS grants to the company, plus interest
<b>Less than 75% of R&amp;D positions remain in Israel</b>	<u>Six</u> times the total OCS grants in connection with the know-how, plus interest	<u>Six</u> times the total OCS grants to the company, plus interest

The limits on redemption fees set by the Regulations still leave the OCS room to maneuver in determining the final redemption fee, but they also provide significant comfort since there is a clearly defined cap on this liability.

#### **Modification of Redemption Fee Formula for Foreign-Based M&A**

The Arrangements Law, which was published in January 2011, set forth certain amendments to the R&D Law, which were conditioned on the enactment of the Regulations. Now that the Regulations are in force, these amendments have likewise come into force. An amendment that is likely to have a substantial effect on the redemption fee amount is the modification of Section 19B(b)(2) of the R&D Law, which sets forth the formula for calculating the redemption fee for a transfer of know-how as part of a Foreign-Based M&A. Previously, this fee had been the amount resulting from the ratio between the total amount of OCS grants received by the company and the *overall* financial investments in the company, multiplied by the sale price of the company. Following the enactment of the Regulations, this formula is revised, such that it takes into account the ratio between the total OCS grants and the financial investments in *the company's R&D*. Since the investment in R&D operations alone is always less than the overall investment in a company, the denominator in this formula is smaller, and thus the resulting amount is greater.

The change in the redemption fee calculation is summarized in the following table:

	<b>Sale of know-how alone (Section 19B(b)(1) of the R&amp;D Law)</b>	<b>Sale of know-how as part of a Foreign-Based M&amp;A (Section 19B(b) (2) of the R&amp;D Law)</b>
<b>Previous Formula</b>	$\frac{\text{total OCS grants}}{\text{total investment in the applicable OCS-funded program}} \times \text{sale price of know-how}$	$\frac{\text{total OCS grants}}{\text{total investment in company}} \times \text{sale price of company}$
<b>Formula following enactment of Regulations</b>	(No change)	$\frac{\text{total OCS grants}}{\text{total investment in company's R\&D}} \times \text{sale price of company}$

In short, the new cap on redemption fees notwithstanding, this change in the redemption fee formula is

likely to increase the fee amount in a Foreign-Based M&A.

### **Conclusion**

Needless to say, the entire redemption fee arrangement aims to discourage OCS-supported companies from liquidating or even significantly reducing their R&D operations in Israel. Indeed, an overseas transfer of R&D conflicts with one of the main objectives of the OCS as set out in the R&D Law: "the creation of places of employment in industry and the absorption therein of scientific and technological manpower." While this is unquestionably a noble goal, over the years the OCS has come to realize that restrictions under the R&D Law aimed at promoting industry can, in the end, backfire by hampering the rewards of international business.

With this in mind, the Regulations offer up to a 50% redemption fee "discount" where a transfer of know-how preserves the places of employment for Israel's scientific and technological manpower. The Regulations aim, first of all, to allow OCS-supported companies to better predict the redemption fee amount that they will be expected to pay in the event of a transfer of know-how. At the same time, they reflect the delicate balance between the recognition that cross-border transactions are a necessary and positive part of a modern economy, and the fundamental mandate of the OCS – bolstering the local R&D sector and the people who are part of it.

Should you have any questions about how the Regulations could impact your company, please feel free to contact us.

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