Israel

Negotiated M&A Guide 2022

Corporate and M&A Law Committee

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1. INTRODUCTION TO THE M&A FIELD IN ISRAEL

With its rapidly advancing technological and engineering expertise, as well as an amply demonstrated innovative spirit, Israel has for many years attracted investors to its market, creating abundant M&A opportunities and earning Israel its global nickname of 'Start-up Nation'. With a population of approximately 9.5 million, Israel boasts one of the highest number of venture capital firms and start-ups per capita in the world, contributing greatly to the rich, entrepreneurial ecosystem that has given Israel its powerful high-tech reputation. The Israeli government further fosters the national M&A market, supporting the high-tech industry through the establishment of the Israeli Innovation Authority (the IIA, formerly known as the Office of the Chief Scientist). Formed under the Ministry of Economy, the IIA supports research and development activities of start-up companies in variety of fields and more advanced enterprises, which was intended to fuel the vibrant Israeli entrepreneurial culture. This atmosphere created an influx of wealth leading to both inbound and eventually also outbound M&A activity, the majority of which centres around the high-tech sector.[1] Despite a brief reduction of M&A activity during the first few months of the Covid-19 pandemic, the global shift to digitalisation in light of travel restrictions and bans spurred a record increase in investments in and sales of Israeli companies and a shift from early exits for nascent start-ups to larger, more complex and more varied liquidity events for more established companies.

In the past decade, Israel's M&A market has been affected by economic and political developments, as well as other local legislative developments such as the enactment of the Law for Promotion of Competition and Reduction of Concentration (the Centralisation Law) in 2013. This law aimed to improve economic competition by reducing the size of existing large Israeli conglomerates organised in pyramidal holding structures; separating holdings in substantial financial enterprises from holdings in substantial non-financial enterprises; establishing enhanced regulatory scrutiny in respect of any additional acquisitions by or grant of rights to substantial nonfinancial or financial groups; and preventing new pyramids from being formed. The passing of such legislation was intended to dilute the concentration of corporate power in Israel. Key measures under the law included limiting the number of layers permitted in a pyramid-type holding company and a ban on the formation of new pyramids; and requiring controlling groups holding both substantial financial units (such as banks or insurance companies) with assets exceeding ILS 40bn and non-financial units (such as retail chains, construction companies, and mobile operators) with more than ILS 6bn of revenue or credit to divest one of the two classes of substantial assets by the end of 2019. This process, alongside other laws and processes in major sectors (such as telecommunications and banking), resulted in a considerable number of transactions driven by these requirements.

The thriving capital markets around the world, particularly the US capital markets, during 2019 through the first half of 2021, has dramatically increased the valuations of leading Israeli high-tech companies, turning many of them into 'unicorns' (ie, companies valued at US$1bn

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[1] Jordan Yerman, 'A Startup Nation: Why Israel Has Become The New Silicon Valley' (APEX, 22 May 2019), see https://apex.aero/articles/startup-nation-israel-become-silicon-valley; Mathilde Frot, 'How Israel Became the Startup Nation of the World'(Top MBA, 11 March 2021), see www.topmba.com/where-to-study/asia/israel/how-israel-became-startup-nation-world; 'What made Israel a startup nation' (Embassy of Israel in Vietnam, 2 November 2017), see https://embassies.gov.il/hanoi/opinions/Pages/What-made-Israel-a-startup-nation.aspx; Simon Griver, 'Israel transforms into scale-up nation', (*Globes*, 29 November 2020), see https://en.globes.co.il/en/article-israel-transforms-into-scaleup-nation-1001351180.

or more – many of which started trading on the US stock market, either through the traditional IPO process or via a de-SPAC (special purpose acquisition company) transaction. As in other parts of the world, the SPAC trend seems to be slowing as a result of a number of factors, including the difficulties in raising private investment in public equity (PIPE), justifying high valuations and the cooling down of the capital markets. This has also adversely affected the number of IPOs since the second half of 2021. However, the substantial increase in the number of Israeli unicorns in the last few years has had a positive effect on the number of outbound M&A deals in 2021.[2] The Israeli unicorns, now equipped with ample amount of cash to spend (and the ability to pay with their traded securities), are buying smaller companies, both in and (mainly) out of Israel, with the purpose of continuing showing growth and justifying their valuations.

The Israeli M&A market has been heavily influenced by the US M&A market for several reasons, including the fact that the many of the significant buyers in Israel have been US multinationals (or buyers with at least some of their major activities in the US), particularly noticeable in the technology sector. For instance, when buyers such as Apple, Google, Microsoft, Facebook, IBM, Intel and similar giants acquire Israeli companies, they search for similar terms and conditions to their other acquisitions. However, this does not necessarily mean that all deals are buyer-friendly. In instances where the market is competitive, such buyers are willing to compromise on deal terms that are more seller-friendly to edge out any competition. Even so, Israel is usually regarded as a more buyer-friendly jurisdiction, and in this regard more similar to the US than Europe.

2. THE LEGAL LANDSCAPE

2.1 Relevant statutes

In general, private M&A transactions are governed by several main statutes, regulations and additional laws applicable to specific sectors – such as banking, insurance, privacy, gas, electricity, and water – which vary and are dependent on the nature of the deal and assets involved in the transaction and which require permits and approvals from specific governmental bodies and regulators. Some of the main statutes governing private M&A transactions include:

a) the Companies Law, 5759-1999 (the Companies Law, which governs all transactions involving companies incorporated in Israel);
b) the Contracts Law (the General Part), 1973 and Contracts Remedies Law, 1970 (the General Contracts Law and Contracts Remedies Law, respectively, and together the Contracts Law);
c) the Securities Law, 5728-1968 (the Securities Law), in specific contexts;
d) the Economic Competition Law, 5748-1988 (the Competition Law), which governs all competition-related matters, including mergers, antitrust, and restrictive arrangements (as briefly outlined above); and
e) the Income Tax Ordinance (New Version), 5721-1961 (the Income Tax Law).

Some of the primary regulatory bodies with respect to private M&A transactions are as follows:[3]

[2] Sophie Shulmam, 'No longer a damsel in distress: Israeli startups have transformed from sellers to buyers' (CTech, 14 September 2021), see www.calcalistech.com/ctech/articles/0,7340,L-3917844,00.html
[3] For further details on relevant regulatory regimes see section 6.2 below.

a) the Israeli Competition Authority;
b) the Israeli Tax Authority (ITA); and
c) the Israeli Registrar of Companies (the Registrar).

In addition, public M&A transactions are also subject to the supervision of the Israel Securities Authority; certain transactions may also be subject to other sectoral regulators.[4]

2.2 Foreign investment policy and considerations for foreign acquirers

In general, the Israeli legal system makes the M&A market easily accessible to foreign buyers. There are very limited general restrictions or impediments on acquisitions of Israeli companies by foreign individuals and companies or on foreigners serving on a board of directors or holding a controlling interest, except in certain sectors as further detailed below.

Moreover, in terms of foreign direct investment (FDI) oversight, Israel is generally a country which is open to, and encouraging of, foreign investment. Israel has neither a formal FDI oversight regime nor comprehensive controls like in various other jurisdictions that cut across all sectors of the economy (and allow for the review and potential blocking of foreign investment). Instead, it relies on sector-specific FDI oversight rules in line with each sector's regulatory environment (for instance, communications, defence, finance/banking, real estate, insurance, etc.). The result has been an incongruous mixture of sector-specific restrictions that diverge from one another based on specific public policy considerations and the needs of each sector's regulators.[5]

Although the Israeli M&A market possesses many advantages for foreign investment, Israel has a number of sensitive sectors and regulators, of which parties to an M&A transaction should be aware. Some of these include the following.

Israeli Innovation Authority

Israeli companies that have received research and development grants and funding from the IIA face certain restrictions on production outside of Israel as well as transfer of IIA-funded know-how, for which they must obtain the IIA's approval and pay a transfer fee. Certain requirements also apply in the event that there are certain changes in the shareholding of such companies, including when non-Israeli shareholders attain certain ownership levels. Similar restrictions and requirements apply to companies benefitting from the tax incentives of the Israel Investment Center (IIC).

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[4] Such as the Supervisor of Capital Markets, Insurance and Savings in the Israeli Ministry of Finance where financial corporations are involved.

[5] In December 2019, the Israeli government established an advisory committee (the Committee) with the authority to advise certain specified regulators on the policy considerations of national security under certain circumstances (including at the discretion of the advising regulator). The primary expertise of this Committee is in defence and national security matters, but it also includes stakeholders that represent broader economic interests and the interests of Israeli industry. The practical advice the Committee provides regulators about evaluating foreign investment in specific situations may include: assessing whether or not to issue or revoke licences, provide conditional licences, impose additional reporting requirements, etc. The Committee does not have any direct contact with companies nor does it have independent powers, and ultimately the authority to make decisions remains with the regulators. That said, if the Committee decides that a transaction poses a national security risk, the relevant regulator is more than likely to uphold this decision. In this context, the country of origin and identity of the potential investor will be a crucial factor taken into consideration by the Committee and regulators.

Export controls

Israel has an extensive export control regime that regulates the export of certain goods and services and affects all sectors of the Israeli economy, including those in which foreign investors may have particular interest, such as artificial intelligence, semiconductor technologies (eg lasers, sensors and chip development), smart mobility, drones and cyber technologies. The export control regime is administered by the Ministry of Defense (MOD) (with respect to certain defence-related exports) and the Ministry of Economy and Industry (with respect to dual-use exports). Israeli export controls are list-based and generally adopt the international export control lists promulgated by the Missile Technology Control Regime, Wassenaar Arrangement, Australia Group, Nuclear Suppliers Group and the Chemical Weapons Convention (in some cases subject to certain unique Israeli amendments/additions).

Encryption controls

In Israel, encryption technology is regulated primarily under a legal framework that is distinct from the Israeli export control regimes. These encryption controls are broad and regulate nearly all types of encryption-related activity, including development, production, modification, integration, purchase, use, possession, transfer, importation, distribution, sale, negotiations concerning exportation, and actual exportation of any means of encryption (hardware and software). As a rule, engaging in any of these means of encryption requires licensing by the MOD, subject to certain licensing exemptions.

Defence corporations

A number of specific defence sector corporations that are sensitive from a national security perspective have been classified as regulated 'defence corporations' and are subject to additional regulation by the MOD, including with respect to foreign investment and transfers of shareholdings. A company can be classified as a 'defence corporation' by a joint order of the Prime Minister, MOD and Minister of Economy and Industry, but the legal basis upon which such a classification is made is confidential.

Additional sectors

Further sector-specific approvals include those that may apply to financial institutions (such as pension funds, insurance companies, and banks); telecommunications companies; and natural resources and essential services (such as in the privatisation of government-owned companies), with regard to which the Israeli government retains certain veto rights. The Israeli Defense Export Controls Agency (DECA) requires that the exportation of certain regulated products, technology, and services be formally registered and licensed. Changes in control must be reported to the DECA and they may refuse to renew any licences resulting from a change in control which may be deemed to undermine Israel's national security.

Israel Lands Authority

Over 90 per cent of the real property in Israel is held by the state, via the Israel Lands Authority (the ILA). Companies and individuals that 'own' property in Israel in many cases actually hold either development agreements or long-term leases with the ILA. In most cases, a change in control of the rights holder, or a transfer of the rights themselves, must be approved by the ILA. Where the rights holder is or has become a non-Israeli, the ILA must also give its approval. Such approval is usually given, although can take quite a long time.[6] Where the target company is engaged in certain sensitive operations or the land is located in a strategic area, approval can be further delayed, while in instances where the potential buyer or investor is organised or resident in certain countries, principally those without diplomatic relations with Israel, the approval may be denied altogether.

3. TRANSACTION STRUCTURES

3.1 Brief overview of M&A structures

Under Israeli law, parties to M&A transactions generally enjoy the benefit of being able to elect the structure best suited to their particular deal, and therefore the decision is often based on factors that apply in many other jurisdictions, such as tax, business strategies, appetite for acquiring certain liabilities, ability to obtain required board and shareholders approvals, requirements for third-party consents, and regulatory approvals. While the following acquisition processes and their respective structures are largely applicable to both public and private M&A transactions, differences arise in relation to the internal approval processes and disclosure requirements of a publicly traded Israeli company. Parties may choose among the following structures in M&A transactions:

(a) *Share purchase:* under a share purchase agreement, shares are contractually purchased from the existing shareholders of the company.

(b) *Asset purchase:* under an asset purchase agreement, the acquirer purchases all or some of the assets or activities of the target company.

(c) *Merger and reverse triangular merger:* under a straight merger, the Israeli acquirer and Israeli target entity combine and form a new shareholding structure. The Company Law restricts the straight merger of an Israeli entity with a non-Israeli one, so parties typically resort to the reverse triangular merger structure, whereby a foreign acquirer incorporates a wholly owned Israeli subsidiary that merges with the Israeli target, with the shareholders of the target receiving cash or shares of the foreign acquirer as consideration.

Additional structures available under Israeli law include:[7]

(d) *Tender offer:* tender offers are only relevant to the acquisitions of shares of publicly traded companies. Although a tender offer provides a quick route for acquisition, there is a high approval threshold, so it is only likely to be used in the event that a statutory merger is not possible due to opposition of the board.

(e) *Scheme of arrangement:* another less common way to purchase the entire share capital of a company is a court-approved scheme of arrangement. Originally, this mechanism was intended to address reorganisations with the goal of avoiding the insolvency of the company in question. However, until the enactment of the Companies Law, in the absence of a statutory merger procedure, this mechanism was also used for mergers. Following the enactment of the Companies Law and the introduction of the statutory merger procedure as described above, the question has arisen as to whether the scheme

[6] As such, it is uncommon in the market for the parties to include ILA consent to be a condition precedent in closing M&A transactions.

[7] As this guide intends to provide a high-level overview of the most common structures for private transactions, we did not expand upon the following two approaches.

of arrangement mechanism is still available for transactions unrelated to insolvency. In a recent court ruling, the Tel Aviv District Court ruled that a court-approved scheme of arrangement may only be used as a means to carry out a corporate transaction where no other alternative method is available.

3.2 Considerations affecting the structure

The ultimate structure of a transaction is dependent on deal-specific matters. Some of the more significant considerations that may ultimately drive the structuring decisions of parties to an M&A transaction include:

Tax

The structuring of a transaction often turns principally on the tax treatment. Generally put, there is only one layer of taxation in a share purchase: the shareholders (other than, generally, non-Israelis) are taxed on the disposition of their shares, at the capital gains rate.[8] By contrast, an asset purchase is essentially taxed twice: first, the seller company pays capital gains on the disposition of the sold assets, and second, the shareholders are taxed on the distributions received from the company following the sale. A reverse triangular merger is generally treated as a share purchase, and where the consideration for the target shareholders' shares is shares in the buyer, the parties can usually apply for a ruling from the ITA allowing the target's shareholders to postpone the assessment of tax until they have a true exit (ie, receipt of cash for their shares). Shareholders of a target company, therefore, generally prefer to avoid an asset purchase structure (or will need to be incentivised to accept the structure via, eg, an increased valuation). Buyers, on the other hand, often prefer an asset transaction because this structure allows the buyer to take a new cost basis in the assets, and such costs can be depreciated over time as an expense that is offset against the buyer's taxable income. In a share purchase, the buyer acquires the company 'as is', including with its existing cost basis in its assets. It may be possible to recognise the cost of the shares and offset this against the tax on their future sale, but, as noted previously, this is generally not applicable to foreign buyers, who are generally exempt from capital gains tax on the sale of securities in Israeli companies.

Timing.

Both share and asset purchases can move fairly quickly, subject to approval by the relevant stakeholders. In a share purchase, however, the process may be prolonged if shareholders have concerns about the transaction terms. In that case, a contractual (by way of the articles of association of the company or other shareholder agreements) or statutory drag along/bring along provision can be triggered, which may add several more weeks to the transaction timeline. Under the Companies Law, the merger timeline is at least a month and a half from the board approval of a transaction to the issuance of the merger certificate signifying the closing of the transaction. In each type of structure, additional issues such as requirements for regulatory approval and third-party consents can add weeks, if not months, to the parties' targeted schedule.

Liability

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[8] In Israel, the purchaser is obligated to withhold and remit this tax. It is routine for the purchaser to engage a local paying agent to take on this responsibility.

An additional consideration in choosing a structure is the degree to which the buyer is willing to assume liabilities and obligations of the target. In an asset purchase agreement, the buyer is able to select the assets, rights, and liabilities that it desires to take on; as a general rule, liabilities of the selling company remain with it unless expressly agreed otherwise. In a share purchase, the buyer will essentially assume all of the rights and obligations, as they remain with the target (subject to limitations, representations, warranties, and indemnification). Mergers are treated like share purchases in this respect.[9] Under an asset purchase agreement, the tax liabilities of the selling company remain with it and the buyer is not exposed to such liabilities unless they have been explicitly included as acquired liabilities. The same applies to other liabilities.

Consent thresholds

Consent requirements may also affect the structures parties elect to adopt for their M&A transactions. Because share purchases typically require the approval of all or a supermajority of shareholders, the structure is less likely to be chosen where a target company has a large number of shareholders or a known block of opposing shareholders.[10] An asset purchase, on the other hand, may only require the approval of a majority of the shareholders or a specific subclass of preferred shareholders, as dictated by the target company's articles of association and shareholder agreements.[11] The merger structure is likely to be preferable in situations where there are a large number of shareholders; therefore, their consent is both impractical to obtain and difficult to predict. For this reason, many public M&A deals adopt the merger structure. As mentioned above, the parties may need to use a reverse triangular merger if one party is not Israeli, but they may also choose it to maintain the separate corporate structures of the two entities and to shield the acquirer and entities above it in the corporate structure from the liabilities of the acquired entity.

In terms of other third-party consents, under a share purchase agreement the buyer must be aware of any change in control provisions that may be triggered by the share purchase

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[9] This consideration can be illustrated by a scenario in which a buyer wishes to 'acquire' (ie offer employment to) the employees of the target company. The buyer may choose either to assume the liabilities of the previous employer (the target company), such that the employment of employees can be considered as continuing from that of the target, or to undertake a 'fire and re-hire' in order to leave the liabilities connected with the employees prior to closing remain with the target company. In contrast, in a share purchase agreement, all of the target company's liabilities are taken on by the buyer, so prior non-payment of wages or social benefits, for example, become the buyer's responsibility (again, subject to indemnification obligations of the sellers that are negotiated in the agreement).

[10] If the parties decide to proceed with a share purchase but one or more shareholders of the target company is unwilling or unavailable to approve the transaction, the buyer and the willing sellers can typically rely on a drag-along/bring-along mechanism that is usually found in the target's articles of association. While such provisions vary in their complexity and length, the usual concept is that, if a certain supermajority of the voting power of the target (sometimes including certain classes of preferred shares) has approved a share sale, the remaining minority can be required to sell their shares on the terms approved by the majority. These provisions often include additional protections for the minority, such as stating that the bring-along mechanism does not apply where the transaction proceeds will not be distributed according to the liquidation preference set out in the articles. In addition to this contractual bring-along mechanism, the Companies Law provides for a similar 'squeeze out' mechanism in which the buyer can force the purchase of the shares of minority shareholders who have refused such sale if the holders of at least 80 per cent (or 90 per cent, with respect to a company incorporated prior to 1 February 2000) of the shares to which the offer relates have accepted the offer, subject to any different majority threshold that may be prescribed in the company's articles of association. Some buyers are reluctant, however, to enforce such drag-along/bring-along provisions, in part due to issues that may arise in the ambiguity in the statutory drag provisions and accordingly potential questions relating to the enforceability of such provisions under Israel law. Consequently, in instances where the transaction has not been approved by all shareholders, the dissenting shareholders are essentially granted a veto right, which, although it may be overcome, may further extend the process.

[11] Under the law, such a transaction may not require shareholder consent at all, but due to rules regarding related-party transactions and arrangements between shareholders (either through governing documents or otherwise), it is likely some shareholder approval would need to be sought.

agreement. Leases, in particular, often contain provisions allowing the landlord to terminate upon a change of control of the tenant. Under an asset purchase agreement, the process is more cumbersome because many assets being purchased will be transferred via assignment, which frequently requires consent from applicable third parties (such as, eg, suppliers and customers).

3.3 Main agreements and typical key clauses

3.3.1 Share purchase

Israeli share purchase agreements typically follow a 'US-style' transaction: purchase on a net debt basis, with a post-closing purchase price adjustment for amounts by which the cash, debt and working capital were over or underestimated by the sellers immediately prior to closing. The main documents typically required in a share purchase transaction are:

- the share purchase agreement;
- an escrow agreement to govern the release of any amounts placed in escrow to ensure the indemnification claims by the buyer (if any), or post-closing purchase price adjustments;
- retention agreements, if certain shareholders or key employees are to be retained following completion of the transaction;
- non-compete/non-solicitation agreements for certain shareholders and key employees;
- a paying agent agreement, in transactions where a trustee withholds and remits tax to the ITA and distributes consideration to sellers (and, frequently to, holders of cashed-out options or a trustee on their behalf);
- a shareholders' agreement, in transactions where less than 100 per cent of the shares of the target company are sold, or if certain shareholders are rolling over significant equity and require protections from the entity issuing the new equity; and
- various other principal documents, such as revised articles of association (particularly where the acquirer will not hold 100 per cent of the issued share capital post-closing), a shareholder register reflecting the transfer of the purchased shares, share transfer deeds, notices to the Israeli Companies Registrar, appropriate board and shareholder resolutions, consents, waivers, and legal opinions.

Some of the main clauses in a share purchase agreement may include:

- provisions relating to the sale and purchase of the securities, including the consideration to be paid, payment terms, treatment of options and other convertible securities and responsibility for taxes associated with the acquisition, as well as provisions relating to holdbacks, escrows and earn-outs;
- representations and warranties by the target company with respect a range of matters related to it (such as capitalisation, corporate structure, authorisation, non-contravention, tax, contracts, employees, intellectual property, privacy, disputes, no brokers, and so on);
- representations and warranties by the sellers with regard to their holdings and ownership, as well as authorisation and non-contravention;
- fundamental representations by the buyer;
- covenants of parties (and principally the sellers and target company) for the interim period between signing and closing;
- closing deliverables and conditions;
- indemnification by shareholders for breach of representations, either by the target

company or the shareholders, subject to certain limitations (these may include certain caps and thresholds, as well as deadlines after which claims may not be brought);

- post-closing obligations of the parties;
- waiver of rights and release of claims; and
- various other clauses, including with regard to dispute resolution.

3.3.2 Merger agreement

While merger agreements require specific provisions unique to Israeli corporate law, the overall provisions in the agreement other than those pertaining to structure will be quite similar to those in a share purchase agreement, as detailed above.

3.3.3 Asset purchase

Some of the main documents required in an asset purchase transaction include:

- the asset purchase agreement;
- employment agreements for those employees whose employment is terminated with the target company and who are rehired by the buyer;
- an escrow agreement, to govern the release of any amounts placed in escrow to ensure the indemnification claims by the buyer (if any);
- non-compete/non-solicitation agreements;
- transition service agreements for facilities and assets that remain with the target company but are necessary for the operation of the business acquired by the buyer during the interim period following the completion of the transaction; and
- various other principal documents, such as consents to assignment, deeds of assignment, appropriate board and shareholder resolutions, waivers, and legal opinions.

Some of the main clauses in an asset purchase transaction may include:

- provisions detailing the assets and liabilities to be acquired by the buyer and those that will remain with the target/seller company;
- representations and warranties provided by the target company, principally in relation to the assets acquired, as well as non-contravention and authority to enter into the agreement;
- fundamental representations by the buyer;
- covenants applicable during the interim period between signing and closing, principally with respect to maintenance of the assets and liabilities to be transferred;
- closing deliverables and conditions;
- indemnification by the target company for breach of representations provided by the target;
- post-closing obligations by the parties; and
- various other clauses, including with regard to dispute resolution.

Some additional colour on more notable aspects of the key terms and clauses in Israeli transactions is set out below:

Drafting process

It is customary for the buyer to prepare and provide the first drafts of the main documents.

An exception to this is in an auction scenario, where the sellers will provide the first draft of the main agreements to the principal contenders and their initial markup is considered as part of their bid package.

Consideration arrangements.

Israeli M&A agreements often include provisions allowing for portions of the consideration to be paid at a later time, if at all. The most common of these mechanisms is one or more escrows of a portion of the purchase price, typically to cover the sellers' indemnification obligations and sometimes to provide a source for payment of a purchase price adjustment in the sellers' favour. Indemnity escrows in Israeli deals are typically released to the sellers (if not subject to claims) within two to four years after closing, in parallel to the survival period for business warranties (see below), while purchase price adjustment escrows are released after finalisation of the purchase price adjustment. The indemnity escrow amount (subject to any specific indemnity arrangements that may apply) is usually 10–30 per cent of the purchase price (matching the cap for business warranties – see below), unless representation and warranty insurance is used, in which case the escrow typically matches the policy deductible.

Another consideration structuring element sometimes implemented is an earn-out, which parties might use in order to compromise on the valuation where sellers have high expectations and buyers feel that the company may not have proved itself or may have recent impressive gains that are likely to plateau after closing. This mechanism may be particularly common in Israel, where much of the M&A centres on hi-tech companies that have proven products but limited revenue or have yet to enter promising new verticals and geographic markets. The inclusion of an earn-out also necessitates negotiation of the management and operation of the target during the earn-out period: the buyer will prefer complete control of its subsidiary, with the ability to direct business strategies and deploy budgets in a way that maximises long-term gains and harmonises with the buyer's own plans. The sellers, by contrast, will want to ensure that existing management will be able to remain with the target and to direct the target's activities in a manner to ensure achievement of the performance indicators that will be used to measure achievement of the earn out. Consistent with other jurisdictions, we would advise that earn-out provisions be drafted as meticulously as possible, with reference to specific, easily identifiable and measurable outcomes, to avoid disputes about whether, and to what extent, a deferred payment has been earned.

Finally, in some cases, the parties will negotiate to hold back some of the consideration due. This may be as an alternative to an escrow, for coverage of indemnification provisions, but more commonly it is used for the consideration due to founders and senior management that hold shares in the target. Rather than employ bonus and equity incentive schemes to entice these key personnel to stay with the company, a buyer can instead seek to withhold consideration due to them for their shares and agree to release it only after a period of a year or two. We note that this mechanism can have tax implications, because the held-back consideration can be viewed as at least partially work income, and therefore be subject to income tax rates rather than capital gains.

Representations and warranties

In a share purchase agreement, it is common for each seller to provide warranties as to the ownership and title of shares, the authorisation and corporate power to enter into such a transaction and the absence of any conflict with governing documents, court orders/decisions, licences, and other agreements. It is then customary for each seller to provide indemnification in the event of breach of both its own warranties and those of the target company. By contrast, in an asset purchase agreement, shareholders do not provide representations regarding their share ownership and title. The scope of the representations provided under an asset purchase agreement will tend to focus on the assets and liabilities being acquired by the buyer.

It is also common to see representations regarding: title to assets, material contracts, compliance with applicable law (including specific areas of law, such as anti-bribery, sanctions,[12] encryption, export control, environmental and other regulations and sector-specific areas), ownership and non-infringement of intellectual property, data privacy and security, existence and validity of permits and licences, disputes and claims, related-party transactions, insurance, tax, and major customers and suppliers. More particular and important in Israeli tech deals are representations that the target company has received no funding from the IIA or other governmental grants or benefits which have been used to further the development of the company's intellectual property (and, in an asset purchase, with respect to the intellectual property being acquired), subject to any grants that the seller(s) may disclose to the buyer, in which case there would typically be representations on compliance with any requirements resulting therefrom. Israeli labour representations are typically more robust because employees in Israel have a substantial body of rights that are protected by employee-friendly courts, and employers who run afoul of such legislation can face both civil and criminal sanctions. Israeli transactions routinely involve targets whose employees have been granted options under the beneficial capital gains route under the Israeli Tax Ordinance (generally referred to as the Section 102 route), which entitles such grantees to be taxed at the capital gains rate so long as the company has complied with the rigorous prerequisites. Non-compliance results in a substantially higher tax burden for the grantee, who may then seek to be made whole by the company; therefore, most share purchase agreements include representations regarding the company's compliance with the Section 102 requirements. In addition, especially where tech companies are involved, robust representations pertaining to intellectual property are included and buyers will want to specifically ensure that these cover all aspects of assignment of intellectual property from employees and founders to the company and absence of any rights in respect thereof.

The buyer will also be required to give certain fundamental representations, such as with respect to its organisation and authority, non-contravention, and availability of funds (particularly where the buyer is an SPV (special purpose vehicle) or the transaction will be debt-financed). In a transaction where part or all of the consideration consists of shares of the buyer and the buyer is not a public entity, the sellers will require a full suite of representations about the buyer and its share capital, as well. Note that in some cases the sellers will also ask to carry out some level of diligence on the buyer.

The sellers' and company's representations are often rather vigorously negotiated: foreign buyers with M&A experience in other jurisdictions may be surprised by the extent to which Israeli sellers do so. This is one reason why representations and warranties insurance may be

[12] Israel has in place comprehensive sanctions against Iran, Syria and Lebanon. Its sanctions against Lebanon are unique from other jurisdictions, which makes it important to refer to this country specifically when doing diligence on a target's (possible) business with embargoed countries/territories (eg, North Korea, Iran, Syria, Crimea, etc.). We note that as of the date hereof Israel has not been part of the countries issuing sanctions against Russian (and Belarus) persons, banks, companies and sectors, however sanctions in other jurisdictions can affect Israeli companies and Israeli-related transactions. As a result, and noting the general dynamic reality of current global events, specific advice should be sought.

particularly suited to the Israeli market.

As mentioned above, Israeli transactions tend to follow the US style, with representations being qualified by a disclosure schedule, rather than by reference to the entire data room of documents and information disclosed by the company. In general, if a fact or circumstance is stated on a disclosure schedule and not qualified as being for informational purposes only, the buyer will be barred from bringing a claim against the sellers for breach of representation on the basis of that fact or circumstance. We note that, even if not disclosed on the disclosure schedule, a buyer may have trouble succeeding on an indemnity claim where the defendants demonstrate that the buyer was aware of the relevant fact or circumstance before closing – so-called ‘sandbagging’. In order to counteract an unfavourable reception from an Israeli court, a buyer may seek to include ‘pro-sandbagging’ language in the purchase agreement, although more often than not the sellers will adamantly refuse and, unless the buyer’s bargaining power far outstrips the sellers’, the final agreement will be silent on the matter.

Indemnification

The buyer’s right to be indemnified for losses arising from a breach of warranties may be limited in several ways.

First, it is standard for there to be some time limit for bringing the indemnification claims. ‘Fundamental’ warranties (such as capitalisation, organisation and authorisation) typically survive until the end of the statutory limitations period (this period is seven years for most types of claims). Regular business warranties like those regarding material agreements, financial statements, and general compliance with law typically survive for at least two years, and sometimes three or four. Higher-risk warranties, such as tax and IP, can fall in between these two ranges or even survive until the end of the statutorily dictated period. Like fundamental warranties, the survival period for specifically identified exposures that the sellers have agreed to indemnify against (‘specific indemnities’) is typically that set out by statute.

Second, indemnification rights may be limited in amount. The parties to a share purchase agreement are likely to set a maximum amount for which the target company or its shareholders may be liable. Again, there tend to be different limits depending on the type of claim, with fundamental warranty claims being capped at the purchase price (occasionally with a tax gross-up), business warranties being capped at 10–30 per cent of the purchase price, and specific indemnities being capped at their highest estimated amount.

Indemnification rights may also be limited by so-called baskets and thresholds – ie, minimum monetary thresholds that must be exceeded before the buyer may claim any indemnification from the target company or its shareholders. Under a ‘tipping basket’, once the threshold is reached, the buyer is able to recover all of its losses from the first dollar. Under a true deductible basket, on the other hand, the buyer is only entitled to recover any losses to the extent they exceed the threshold. In Israeli transactions, tipping baskets are more common.

Representation and warranty insurance has become increasingly common in Israeli M&A over the last few years, although it is still not used with as much frequency as in certain other jurisdictions. Policies for Israeli deals tend to be more like US policies than European ones – there is no disclosure against the data room or diligence reports – while the price tends to be higher than a European policy but lower than a US policy. The premium may be either paid by the buyer or split between the parties. Representation and warranty insurance in other jurisdictions, notably in the US, has obviated the need for substantial negotiation of the representations and warranties.

The limitations set out above typically do not apply to claims involving fraud and intentional misconduct, and may not apply to breaches of certain covenants. Israeli contract law, similar to other jurisdictions, provides default terms in the event of breach, including various remedies (eg, specific performance, restitution and damages) as well as mechanisms for implementation thereof (such as terms pertaining to setoff rights). Thus, the transaction documents should be reviewed with an eye to any defaults that may apply in the absence of express contractual stipulations.

Restrictive covenants

A specific block exemption issued for restraints ancillary to mergers (Antitrust Rules (Block Exemption for Restraints Ancillary to Mergers)), 2009 (the Block Exemption) provides that under certain conditions, including having 50 per cent or lower market shares in the relevant market or an adjacent market, safe harbours exist for some restraints that would otherwise be restricted under anti-trust rules, including:

- non-compete commitments for sellers of shares, for a period of up to four years starting from the earlier of (1) the moment when the seller's share of the acquired business decreases below 20 per cent; or (2) the seller no longer has the right to appoint at least one board member; or, if the seller is to be employed with the acquired business, for a period of up to two years from the end of their employment; and
- commitments to continued supply under the same terms (for up to three years).

Governing law

Parties to Israeli M&A agreements may choose Israeli law to govern the interpretation of the documents, but very frequently they will choose a source of law that is either more familiar to the buyer – often Delaware for American buyers, and England and Wales for buyers from the UK and countries whose legal systems grew out of the English system. Regardless of the governing law provision, however, the Israeli Companies Law will apply to internal corporate matters since the target company is Israeli. For example, the proof of share ownership following a share purchase will follow Israeli law, which provides that the shareholder register is the *prima facie* evidence of a company's shareholdings. Even more significant, in a merger agreement the entire merger process will be carried out under Israeli law. The parties' choice of law is also not generally relevant to regulatory issues. For the sake of clarity, therefore, in transactions in which documents state that they are governed by foreign law, it is advisable to add that Israeli law is applicable to internal corporate matters.

Dispute resolution

Israeli companies and sellers will typically prefer that any disputes arising out of the transaction will be heard in Israel. Because of their central location and the recognised competence of their judges, the parties often further specify the courts sitting in Tel Aviv. This is a point for negotiation, however, and a buyer with significant bargaining power may be able to stipulate a different forum.

Foreign litigants are not disadvantaged in the Israeli legal system, and where the governing law is Israeli, the outcome of a case being heard by an Israeli judge interpreting local law is likely to be more predictable. Litigation will be carried out principally in Hebrew, although court filings and testimony can typically be submitted in English where there is a demonstrated need to do so.

As a substitute for litigation – or at least as a precursor to the courts – some parties to Israeli deals will opt to arbitrate their disputes either in Israel or in other jurisdictions. Although Israeli law includes default arbitration rules, the parties may also contractually determine a variety of arbitration parameters, such as identity and number of the arbitrator(s), language of the arbitration, and who pays the arbitration fees. All of these details, and the choice of arbitration itself, should be stated in the main transaction document.

4. PRELIMINARY AGREEMENTS

From a legal perspective, and although not required under law, the first step in an M&A transaction in Israel is typically the execution of a letter of intent (LOI) and a non-disclosure agreement (NDA). Before the lawyers are heavily involved, however, the interested buyer will often have sent a non-binding indication of interest. This is particularly true in an auction process, where the prospective buyers are invited to send an initial non-binding indication of interest, and only those prospective buyers whose initial proposal is worthy of consideration by the sellers will move on to a second phase. At the end of this second phase, prospective buyers submit a binding proposal and the winning bidder signs the binding letter of intent with the sellers.

A letter of intent – also known as a term sheet, memorandum of understanding, heads of terms and like titles – will elaborate on the deal terms set out in the non-binding indication of interest, going into more depth with respect to points such as treatment of employee options, management retention, any escrow or holdback, a high-level description of earn-out terms (where applicable), liability and indemnification (particularly any survival, caps and thresholds), and will set out an exclusivity (no-shop) period during which the sellers and the company agree not to entertain or solicit any offers to carry out any share or asset transfers or to provide any information about the company for that purpose. Exclusivity provisions are enforceable under Israeli law and parties may agree on remedies for a breach, including indemnification, injunctions, and reasonable breakup fees.

NDAs are commonly executed prior or in parallel to the execution of LOIs and, in particular, before the target will provide any non-public information as part of the due diligence process. NDAs will typically cover all information provided by the target company to the buyer, subject to customary exceptions such as information that is in the public domain or which the buyer received from a third party who was not in breach of a confidentiality obligation toward the company. The buyer will agree to protect the confidential information from disclosure and not use it for any purpose other than the contemplated transaction, provided that the buyer may share confidential information as required by court order or other legal process. NDAs also stipulate that the information received by the buyer can only be shared with certain employees, agents and representatives who are bound by confidentiality obligations at least as protective as the buyer has agreed to, and subject to the buyer remaining liable for any breach by such recipients. It is customary for the NDAs to contain remedy provisions in the event of breach which may include injunctive and monetary relief for damages incurred as a result of the breach in confidentiality.

5. DUE DILIGENCE

In a share purchase transaction or a merger, the buyer will usually conduct due diligence with regard to the business, financial, legal and tax matters of the target company, including any important corporate matters. For an asset purchase, the diligence will focus on the assets and liabilities that fall within the deal parameters. Therefore, the corporate matters of the selling company are less relevant, although it would be required to identify any consent requirements or other arrangements among shareholders that may be relevant to the transaction. The main objective of the diligence is to identify risks and exposures in the target company or the target assets and liabilities, to enable the buyer to manage them and negotiate for an acceptable allocation of risk in the material agreements.

The due diligence process typically commences with the buyer's requests for information and documents as outlined in due diligence requests lists, usually drafted by the buyer's advisers and internal deal teams.[13] The initial legal due diligence list will contain questions and requests covering a wide range of matters, including corporate history and structure; capitalisation; major agreements, including debt and guarantees; major suppliers and customers; employees, contractors and other service providers; employee stock options; regulatory matters, including anti-bribery and anti-corruption, export control, licensing and other areas relevant to the company's field of activity; intellectual property matters; privacy; and personal and real property.

External lawyers will often want to review very high-level financial matters as well, such as the most recent audited financial statements.

Several matters to be cognisant of during the due diligence process relate to sector-specific concerns, many of which were outlined in this guide (eg, intellectual property rights, IIA funding, employment matters, economic sanctions, export controls, MOD work, employment stock option plans and adherence to requirements for the purposes of classification under the capital gains tax route for options).

6. TYPICAL CONDITIONS TO CLOSING AND RELEVANT REGULATORY REGIME

6.1 Conditions to closing

There are several conditions to closing that are often seen in Israeli M&A deals, including antitrust approvals under the Israeli Competition Law, approval of the Israeli Companies Registrar (in the case of a merger), IIA approval, receipt of certain tax rulings (which may be interim or pre-rulings), entrance into employment and retention agreements with key personnel, and obtaining third-party consents for major contracts. These are in addition to the internal corporate approvals required (as described above) and the standard buyer protection conditions, such as the accuracy of representations and warranties, the performance of all covenants, the lack of a material adverse effect before closing, and the delivery of duly executed ancillary documents. Where the transaction is being financed by debt, a buyer may

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[13] In an auction process, the diligence usually begins with the review of a confidential information memorandum, which may be prepared by the seller's advisors, including the banker, followed by a limited review of certain high-level documents provided in an online data room. Once a buyer moves forward in the process, it may provide diligence request lists to the target.

attempt to include the financing as a condition to closing.[14] Many times sellers with leverage will object to such a condition and rather agree to cooperate to a reasonable extent, and at the buyer's expense, with any diligence required by potential financing parties and other reasonable requests made by buyer after signing in order to secure the required funds.

6.2 Relevant regulatory regime

Some of the main relevant regulatory regimes relevant in Israeli M&A transactions are set out below.

Antitrust

The applicable law in this area is the Competition Law, which is designed to regulate restrictive trade practices including M&A. Parties to a transaction should note that the definition of a 'merger' under the Competition Law is open and fairly broad and includes the acquisition of the principal assets of a company by another entity or the acquisition of shares by another entity following which the acquiring company holds one of the following:

- more than 25 per cent of the nominal value of the issued share capital or of the voting power of the acquired company;
- the power to appoint more than 25 per cent of the directors; or
- participation in more than 25 per cent of the profits of the acquired company.

In the event that the acquisition is a 'merger' within the definition of the Competition Law and at least one of the following conditions applies to it, the parties are required to obtain the approval of the Competition Commissioner if:

- the cumulative turnover of the merging entities in Israel, in the fiscal year preceding the merger, exceeded ILS 367.930m and the revenues of one of the merging parties was at least ILS 20m;
- as a result of the merger, the market share of the merging companies in Israel, in the production, sale, marketing or purchase of the relevant product or the provision of the particular service, exceeds or would exceed 50 per cent; or
- one of the merging companies (this includes any direct or indirect subsidiary, parent or sister company of the buyer and target), has a market share exceeding 50 per cent in any market in Israel.

Once the parties have filed for antitrust approval, they are prohibited from taking any further acts to consummate the transaction or otherwise consolidate their activities until the Commissioner's approval is provided or the mandatory waiting period (30 days, which may be extended depending on the circumstances) has passed. Therefore, a transaction cannot be completed before this approval is obtained and parties must refrain from any 'gun jumping' in the interim period. Parties in breach of this prohibition may be subject to criminal, administrative, and civil sanctions and fines which can be very large, depending on the value of the transaction.

Israeli companies registrar

In a merger transaction, both parties to the transaction must file a 'merger proposal' to the

[14] See further descriptions below with regard to financial assistance aspects of Israeli law.

Israeli Companies Registrar. The merger will be considered to be consummated once the Registrar issues a merger certificate, which can only be done following the lapse of (1) 30 days from the shareholders' approval of the merger; and (2) 50 days from the filing of the merger proposal with the Registrar. In a share purchase transaction, the transfer of the shares, change in articles and change in directors should be registered with the Registrar within two weeks after closing; however, this notice is declarative and the validity of the transaction is not affected by a delay.

FDI oversight

As mentioned above, FDI oversight in Israel is sector-specific. Therefore, the necessity of any regulatory filings will depend upon the target's business and whether it falls within a sector which is specifically regulated. What is required for such filings will vary depending upon the relevant sector's legislation and regulatory requirements.

Business licences

Most licences required to conduct business will stipulate that any direct or indirect change in control of the licenceholder will necessitate either a notification to the relevant licensing authority or the issuance of a new licence. In certain cases, this may give the licensing authority an opportunity to impose additional fees and conditions on the licenceholder.

Export controls

If the target is a regulated exporter, then changes to shareholdings (or any other key amendment to the target's original registration) must be updated to the MOD within 30 days after the change has taken place. While not a legal requirement, some regulated exporter companies may choose to notify the MOD before closing in order to receive an indication about the MOD's position with regard to a particular future transaction, as a negative result could ultimately result in the MOD choosing to revoke existing licences, to not provide licences requested or to add onerous conditions to existing licences.

Encryption controls

There is no formal requirement to update the MOD Encryption Department following an asset sale or change in ownership of an entity that holds an encryption licence. That said, such an update is usually done by simply 'renewing' the existing license and explaining about the relevant ownership change via the MOD's online renewal page. In certain circumstances, the regulator may suggest applying for a new encryption licence – which is also a simple and quick procedure.

IMOD supplier status

If a company is deemed a recognised MOD supplier (meaning they provide either products or services to the MOD as a client),[15] the relevant guidelines require that the MOD be updated upon any significant change of ownership or control.

The definition of 'ownership' and 'control' that triggers the requirement (both for purposes of the MOD and the other notifications and consents mentioned in this section) vary based

[15] Some companies may also work with other MOD departments, such as the MOD's Cyber Bureau or 'Mafaat' (the 'Administration for Research, Arms Development and Technological Infrastructure' of the MOD).

on the situation, so Israeli counsel should analyse the relevant facts to determine how to proceed.[16]

7. CLOSING AND POST-CLOSING ACTIONS

Following the signing of the main transaction documents and the fulfilment of the conditions to closing, the parties will typically carry out a number of steps and execute certain documentation at the closing. Although not an exhaustive list, these may include the following:

7.1.1 Share purchase

- shareholders' consent;
- share transfer deeds;
- updated company share register;
- any relevant resolutions (eg, signatory rights resolutions);
- director appointment/resignation letters;
- certificates bringing down the representations to closing and confirming the fulfilment of the conditions to closing; and
- ancillary agreements and undertakings.

7.1.2 Asset purchase

- shareholders' consent;
- transfer deeds; and
- assignment of relevant agreements.

Certain other actions are typically taken shortly after closing, such as:

- notification of the Israeli Companies Registrar;
- notification to various third parties, including creditors, customers and governmental entities such as the IIA and MOD.

In addition, certain tax rulings related to the transaction (whether in respect of tax withholding aspects or treatment of option holders who benefit under the Israeli capital gains route) are provided in an interim form approved by the tax authority prior to the closing of the transaction, and will require a final ruling after the closing. in some instances, the sellers will insist that the final ruling be obtained before closing, to give them comfort regarding the tax treatment of the transaction.

8. FINANCIAL ASSISTANCE

In the context of a financed transaction, a lender may require certain guarantees be given by entities within the target's corporate structure. Any asset, including a guarantee, given by an

[16] In addition, if a company has foreign shareholders or partners, both the Israeli company and each foreign shareholder or partner will have to sign standard declarations that classified and sensitive information will not be passed to the non-Israeli person or entity. The same applies to any foreign members of the company's board of directors. The company will be able to continue its work for the MOD, but it will be prevented from transferring any such classified information to non-Israelis and, in some circumstances, even Israelis who have not received a certain level of security clearance or been specifically approved by the MOD.

Israeli company to its shareholders solely by virtue of its rights as such is considered a distribution. This kind of financial assistance is not prohibited under Israeli law but is rather must comply with the distribution tests under the Israeli Companies Law.[17] These tests are as follows:

(a) *Profits test:* the company must have sufficient distributable profits;[18] and
(b) *Solvency test:* the company must be able to meet its debts at the time of their repayment.[19]

Although Israeli law is not entirely clear on this point, there is an argument that both tests should be met at the time of creation of the guarantee as well as at the time of any enforcement. Oftentimes, a target company will not have sufficient distributable profits at the time of the closing of an acquisition and, absent any such profits, an Israeli company cannot provide financial assistance or upstream guarantees, posing a structuring challenge.

One possible solution, although this may not be preferred by the lenders, is a court-approved distribution whereby the company is only required to meet the solvency test. Although this route provides certainty, parties will often see this as an impractical solution due to the length of time needed to obtain court approvals.

9. CONCLUSION

As demonstrated throughout, the Israeli M&A market conditions and Israeli legal system make the Israeli M&A market easily accessible to foreign buyers. The bargaining power of the parties and the particular deal specifics will ultimately govern and dictate the type of M&A structure adopted by the parties and the terms of such an agreement. Parties should be aware of sector-specific regulations and approvals and of the required internal corporate approvals required in order to bring about the successful consummation of their particular transaction. Naturally, all transactions are tailored to their circumstances and specific laws and regulations that may apply (or may be updated from time to time); where an Israeli target is involved (either directly or indirectly through as a member of a target group) it is highly advisable to consult Israeli local counsel at the early stages of a transaction, preferably at the time of negotiating the basic deal terms, involving an Israeli target or target group member.

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[17] In addition, any such deemed distribution would have tax implications that must also be explored.

[18] Dividends may be distributed only out of the greater of: (i) the balance of accumulated reserves; and (ii) reserves/profits accumulated over the two most recent fiscal years based on the company's most recent financial statements (audited or reviewed). For the purposes of the calculations, the aggregate amount of all previous distributions are deducted (other than distributions which were already subtracted from the company's retained earnings as reported in its financial statements). The date of the distribution may not exceed six months from the end of the period to which such financial statements relate.

[19] A distribution may only be effected provided that there is no reasonable suspicion that the distribution will result in the company being unable to meet its current or future obligations when due. This subjective determination as to whether or not the company satisfies the Solvency Test is made by the company's board of directors.