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**New Rules Published
by the Israeli
Innovation Authority**
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In May 2017, the Israeli Innovation Authority (the successor of the Office of Chief Scientist), a division of the Israeli Ministry of Economy and Industry (the "Innovation Authority"), issued new rules¹ becoming applicable to Israeli companies that receive grants from the Innovation Authority ("Funded Companies"). The rules, which become effective on July 1, 2017 (the "Effective Date"), relate to the know-how developed and obtained by Funded Companies using grants received from the Innovation Authority ("Funded IP").

In summary, the new rules focus on three significant issues:

- Licensing of Funded IP Outside Israel. The new rules establish a general framework for licensing of Funded IP outside Israel, a matter that was not clearly addressed in existing regulations. Under the new rules, following the Effective Date, the Innovation Authority will have the authority to permit a Funded Company to license Funded IP to a non-Israeli entity, without the license automatically being considered a transfer of Funded IP outside Israel and without subjecting the Funded Company to a one-time 'exit' payment required upon the transfer of Funded IP outside of Israel.
- Reduction of the Royalty Rates Payable to the Innovation Authority. Following the Effective Date, the royalty rate that a Funded Company is required to pay to the Innovation Authority from revenues that it generates out of the sale of products

¹ The Innovation Authority has not yet published several of the schedules referenced in the new rules; we do not expect, however, that these schedules, when published, will materially change the general description of the new guidelines set out in this memorandum.

incorporating Funded IP or licensing of Funded IP will be between 3% and 5% (rather than between 3.5% and 6% prior to the Effective Date). The royalty rate will be determined based on the Funded Company's income in the year preceding its filing of the grant application for the relevant Funded IP with the Innovation Authority. Certain types of Funded Companies will be entitled to a reduced royalty rate of 1.3%.

- *Changes to the Calculation of the Interest Rate*. Following the Effective Date, the annual interest rate accrued on the grants will be set at either: (i) the LIBOR rate, if the Funded Company's income in the year preceding the submission of its application to the Innovation Authority for the grant relating to the relevant Funded IP is up to US\$70,000,000, or (ii) the higher of (a) the LIBOR rate plus 1.5% or (b) 2.75%, if the Funded Company's income in that year is greater than US\$70,000,000.

A more comprehensive description of these rules is set out below.

1. Licensing of Funded IP Outside Israel

Until the adoption of the new rules, the Innovation Authority lacked the statutory authority to permit the licensing of Funded IP outside Israel, and therefore in practice companies that wished to license their Funded IP abroad had to apply to the Innovation Authority for a permit to transfer their Funded IP outside Israel.

The implication of a transfer of Funded IP outside Israel, once approved by the Innovation Authority, was the immediate repayment by the Funded Company of the grants received from the Innovation Authority in support of the development of the Funded IP plus an additional special one-time 'exit' payment, based on a formula set out in the Encouragement of Industrial Research and Development Law, 1984, which could result in a payment of up to six times the grants received.

The new rules provide the Innovation Authority with the authority to permit Funded Companies, subject to certain conditions detailed below, to license Funded IP to non-Israeli entities without having the license necessarily considered as a transfer of Funded IP outside Israel.

To obtain the Innovation Authority's approval of the license, the Funded Company must submit an application to the Research

Committee of the Innovation Authority. The Research Committee has the right to approve the application in its sole discretion, subject to the following conditions: (i) the licensed Funded IP may not be the full product developed pursuant to grant received from the Innovation Authority, (ii) the grant of license will **not preclude** the Funded Company from using the Funded IP that is being licensed, and (iii) the ownership of, and title to, the licensed Funded IP is not transferred to the licensee.

If the Innovation Authority approves the license, the licensor Funded Company will have to pay royalties to the Innovation Authority based on income it receives from the licensee in respect of the license (i.e., if the licensee pays a one-time fee with respect to the license of the Funded IP, then the royalties will be paid in one installment, and if the licensee pays license fees with respect to the Funded IP in installments, then the royalties will be payable in installments).² The Research Committee also may approve a Funded Company's application to license Funded IP to a non-Israeli entity in a manner that **precludes** the Funded Company from using the Funded IP if the Funded IP is not part of the product developed using grants received from the Innovation Authority and the ownership of, and title to, the licensed Funded IP is not transferred. If the Innovation Authority provides such an approval, the Funded Company is required to pay a one-time payment as if the Funded IP were transferred outside Israel.³

In cases where: (i) the consideration for the license includes non-monetary consideration, (ii) there is a "special relationship" between a Funded Company and the non-Israeli licensee of the Funded IP,⁴ or (iii) the Research Committee finds that the consideration does not reflect the fair market value of the licensed Funded IP, the Research Committee has the authority to calculate the value of the license based upon its economic valuation.

Additionally, under the new rules, the Research Committee may determine that a portion of the consideration received by the Funded

² The minimum royalty payable by the Funded Company is the grant amount and accrued interest, minus any royalties paid by the Funded Company.

³ See footnote 2 above for calculation.

⁴ A "special relationship" is defined as any of the following relations between the two parties: (i) companies that are affiliates of each other, (ii) a party to the transaction is an office holder of the other party, (iii) the parties are business associates, (iv) the parties have an employment relationship, (v) both parties, directly or indirectly, have the same controlling shareholder, (vi) one party, directly or indirectly, controls the other party, (vii) both parties are, directly or indirectly, controlled by the same third party, (viii) both parties together, directly or indirectly, control a third party, (ix) each party is a family member of the other, or (x) one party is an exclusive distributor or agent or exclusive licensee of the other party.

Company in a licensing transaction, including consideration that is expected to be received by the Funded Company more than seven years following the Research Committee's approval of the licensing transaction, will not be considered as part of the aggregate consideration received by the Funded Company for purposes of determining the royalties payable to the Innovation Authority.

As in the case of a transfer of Funded IP or manufacturing rights outside Israel, the Research Committee has the authority to allow an exchange of rights to use (i.e., cross-license of Funded IP in exchange for a right to use other intellectual property), without the payment of royalties, if the Research Committee finds that by such exchange, the Funded Company will earn greater yield than it would have earned without the exchange.

If the Innovation Authority issues the license permit, the Funded Company will be required to provide an annual statement, certified by an accountant, in accordance with the instructions of the Innovation Authority.

2. Reduction of the Royalty Rates Payable to the Innovation Authority

Until the adoption of the new rules, the royalty rate payable by a Funded Company to the Innovation Authority was set at a rate of between 3.5% and 6% of the Funded Company's income from the sale of products using Funded IP.

Under the new rules, the royalty rate payable by a Funded Company to the Innovation Authority, from income derived by the Funded Company from licensing Funded IP or from selling products incorporating Funded IP, will be (i) 3%, if the Funded Company's income in the year preceding the submission of its application to the Innovation Authority for a grant for the relevant Funded IP is up to US\$70,000,000; and (ii) 5%, if the Funded Company's income for that year exceeds US\$70,000,000. In addition, a reduced royalty rate of 1.3% will apply with respect to certain companies in traditional technology industries.⁵

⁵ The 1.3% royalty rate would apply to companies whose primary business is classified by the Research Committee as a traditional technology industry, and whose research and development expenses in the year preceding the submission of the application do not exceed 7% of sales volume (unless the company's sales volume during that year is less than NIS 10,000,000) and whose income in that year does not exceed US\$70,000,000).

3. Changes to the Calculation of the Interest Rate

Until the adoption of the new rules, when the Innovation Authority authorized a new grant, it also set the interest rate that would apply to repayments of the grant; the interest rate was fixed and not subject to further changes or revisions.

Under the new rule, however, the annual interest rate applicable to a grant will be variable and linked to 12-month LIBOR,⁶ and will update annually. The interest rate will be either: (i) the LIBOR rate, if the Funded Company's income in the year preceding the submission of its application to the Innovation Authority for the grant relating to the relevant Funded IP is up to US\$70,000,000, or (ii) the higher of (a) the LIBOR rate plus 1.5% or (b) 2.75%, if the Funded Company's income in that year is greater than US\$70,000,000.

Certain types of Funded Companies⁷ will be required, prior to receiving the grant, to elect the interest rate applicable to the grant, which will be either the LIBOR rate or the Bank of Israel interest rate.⁸

We would be happy to answer any questions that you might have.

Sincerely,

Hi-Tech, Technology & Venture Capital Practice

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⁶ The applicable LIBOR rate is the annual LIBOR rate for US Dollar deposits, on the first trading day of each year.

⁷ See footnote 5.

⁸ A rate determined by the Bank of Israel as the nominal interest on the first trading day of each year, as published on the official website of the Bank of Israel.