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Bankruptcy and Intellectual Property Rights: Can They Live Side by Side Under Israeli Law?

A court ruling by the Tel-Aviv District court on December 7, 2005, discussed the legality and enforceability of intellectual property assignment clauses following bankruptcy of the licensor.

The court ruling related to two agreements which Commodio Ltd. ("Commodio") signed with two different parties, Genesis System House Ltd. and Super Bonus Ltd. (together, the "Licensees") regarding the use, development and transfer of Commodio's intellectual property. Unfortunately, after signing the agreements with the Licensees', Commodio entered into liquidation proceedings and an official liquidator was appointed over Commodio's assets. There was no dispute between the parties regarding interpretation of the assignment and use provisions in the agreements between them, but rather a complex legal dispute regarding the legal ability of the parties to perform in accordance with those agreements because of the subsequent liquidation.

Upon entering into liquidation, Commodio and all its assets became subject to the bankruptcy laws which impose serious limitations on the conduct of business by a company, including its ability to waive its rights, make conditional its rights or liabilities or modify existing rights and liabilities. In general, contractual undertakings which give priority to one of the parties, over company creditors, which would not have been given to such party by way of law, will not be enforceable and will have no validity towards an appointed liquidator, unless such party has protected its rights and such rights have been given to it according to the specifications and limitations enforced by the bankruptcy laws (registration of lien, etc.).

Commodio signed with the Licensees use, development and transfer agreements regarding its software product. The parties had agreed that all ownership rights relating to the licensed product, would remain with Commodio at all times. Each of the Licensees were given specific rights of use or development in connection with such products and specifically not given any title or ownership rights.

Software products are customarily based on a source code, which stands behind and operates the product's object code. As customary in this field, the license is given for the use of the product itself (operation of the object code) and no direct rights (title, ownership, etc.) are given with regards to the source code itself.

However, in light of the liquidation of Commodio, the Licensees were concerned that they would not be able to use or develop the licensed products if they did not have the source code for the products.

The case examined the scope of the license, including with regards to the source code and question of ownership of such whether the Licensees would be entitled to ownership rights in the source code, as well as right to receive receipt of continued licensed rights

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or ownership rights in with regards to the products themselves (operation of the object code), directly or by way of right of first refusal, after liquidation of Commodio.

License for use of rights

Judge Elsheich in her ruling compared the Commodio case (a case dealing with the "intangible world" of intellectual property) to other known cases in the "tangible world". The situation, according to her point of view, is similar to where the liquidator finds out that a liquidated company has rented its real estate facilities under a long term rental agreement to a third party during its ordinary course of business. In such a case, the liquidator cannot require the tenant to immediately leave the facilities upon issuance of a dissolution order for the landlord; the tenant cannot be adequately compensated by filing a claim as a debtor, rather the tenant seeks specific performance of the lease agreement.

Both a lease of real estate facilities and a license to software involve limited and partial transfer of rights, and as such, the partial transfer of rights shall be effective also following a dissolution order. A tenant would pay rent to the liquidator, rather than to the original lesser. Similarly, in the Commodio case, the Licensees use licenses will continue to be in force following the liquidation proceedings, but now the Licensees will be obliged toward the liquidator, rather than to Commodio.

Judge Elsheich in her ruling stated that while Commodio was solvent (the time when the transaction took place) Commodio transferred to the Licensees limited property rights in the manner of rights of use, which, de facto, have been extracted from the property rights of Commodio with regards to such products.

"Source code" ownership

When examining the question of ownership of the source code which stands behind the licensed product, it was Judge Elsheich's position that since the source code is a material part of the product, and a key tool for the use of the product itself, the ownership rights in the source code remain with Commodio and the liquidator, and are not transferable or assignable under pre-agreed contractual undertakings.

Notwithstanding this, the "physical" transfer or entrusting of such source code with the Licensees for use of the product, without transfer of ownership or title rights, does not stand in contradiction with the bankruptcy laws de facto, but rather should be regarded as an integral part necessary for the fulfillment of the legitimate contractual agreements between the parties, as long as such transfer of rights does not involve substantial expenses to the liquidated company and as long as ownership and title of such intellectual property rights remains unchanged.

Transfer of ownership

The court noted that the result would be different if the contracts had provided in advance for the transfer of ownership of the intellectual property to the Licensees, should Commodio be liquidated. Such an undertaking would be contrary to the bankruptcy laws, which seek to retain assets in the bankruptcy estate in order to protect the company's ordinary creditors from having assets of the company transferred out of the company's asset inventory. Any such contractual undertakings would have been regarded as illegal and unlawful and the appointed liquidator of the court or creditors would not have been correct to take actions to nullify such undertakings to transfer the ownership of the intellectual property upon liquidation of Commodio.

Right of first refusal

Judge Elsheich also examined the legality of a "Right of First Refusal" clause dealing with the transfer of intellectual property following bankruptcy of the owners of such intellectual property. Past rulings have clearly stated that a right of first refusal legally acted upon with due consideration prior to the beginning of the liquidation proceedings, will be regarded to as a legal transfer of rights which will not be reversed due to the subsequent bankruptcy of the owner. Contrary to veto rights, refusal rights cannot prevent the offering for sale of company assets but rather gives effective means for ensuring the receipt of the highest possible offer applicable in such a situation. Such refusal rights are materially different than veto rights given to one party or another with regard to the transfer of intellectual property since refusal rights do not eliminate the sale of the assets but rather give the Licensee the chance to purchase the assets from the owners at a price identical to or higher than the highest offer received. In light of this maximization of value of the assets sold to third parties, the bankruptcy laws and court find that rights of first refusal are valid and enforceable.

Conclusion

Judge Elsheich ruled that contractual undertakings regarding licensed rights of use of intellectual property (including royalty payment and terms of use, where applicable) will remain in effect following liquidation of the owner of such intellectual property.

On the contrary, contractual undertakings calling for the transfer of ownership rights in the intellectual property (including technology, source code, etc.) arising as a result of the bankruptcy proceedings, contradict the bankruptcy laws and therefore are void and unenforceable. ■

Thanks to Einat Meisel of Gross, Kleinhendler, Hodak, Berkman and Co., for preparing this article for Cooley's audience.

Duty to 'Act Fairly' Under Israeli Companies Law

U.S. investors should be aware that the Israeli Companies Law imposes on shareholders of Israeli companies certain duties and obligations that are not familiar to U.S. investors and which may limit the power of such shareholders to exercise their rights. The Companies Law imposes a duty on every shareholder toward the other shareholders and the company, to act "with good faith and in a customary manner," and "… avoid abusing its power in the company… in exercising its rights and fulfilling its duties …" In addition, the Companies Law imposes a supplementary duty on holders of preferred shares that confer special corporate governance rights such as veto rights, and holders of a majority interest in a class of preferred shares, to "act fairly" toward the company.

Commentators believe that the duty to "act fairly" imposes a higher standard than the duty to act "in good faith". These commentators place the duty to "act fairly" as an intermediate standard between the "lower" good faith standard (to which all shareholders are subject to) and the "higher" fiduciary duties standard (to which officers and directors are subject to). The duty to "act fairly" does not require the shareholder to act selflessly and ignore such person's interests for the benefit of the company, which may be required of directors and officers under their fiduciary duties. A shareholder may act for the betterment of his or her own interests as a shareholder or controlling person of the company, however, such person must balance such self-interest with the interests of the other shareholders taken as a whole. ■

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Reverse Triangular Mergers and Mergers of Public Companies under Israeli Law: New Ruling by the Tel-Aviv District Court

A ruling by the Tel-Aviv District Court (the "Court") in the matter of *Naftali Shani vs. Malam Maarachot*[1] (the "Malam Ruling") looked at the enforceability under Israeli law of two common acquisition structures—reverse triangular mergers, and one-step mergers involving Israeli public company targets. In its ruling, the Court rejected claims that: (i) an acquisition of a public company must be accomplished through a tender offer and cannot be effected through a one-step merger; and (ii) the Israeli Companies Law—1999 (the "Companies Law") does not allow a deal to be structured as a reverse triangular merger.

The plaintiff in the Malam Ruling, Naftali Shani (the "Plaintiff"), requested the Court to issue an injunction to prevent a reverse triangular merger between Malam Maarachot, Ltd. ("Malam"), a public company traded on the Tel-Aviv Stock Exchange, and Tim Maarachot Mahashvim, Ltd. ("Tim"), also traded on the Tel-Aviv Stock Exchange and a holder of 66% of the outstanding shares of Malam. Pursuant to the terms of the proposed merger, Tim, the acquirer, would form a subsidiary ("Merger Sub") to merge with and into Malam, leaving Malam as the surviving entity and a wholly-owned subsidiary of Tim (the "Proposed Merger"). It should be noted that the Proposed Merger was approved by the shareholders of both of the two merging entities, Malam and Merger Sub.[2] This Commentary will discuss only two of the arguments raised by the Plaintiff.

Acquisition of a public company

The Court considered whether the acquisition of a public company could be structured as a merger, or whether the only structure to effect an acquisition of a public company in Israel is through a tender offer. The Plaintiff claimed that the Companies Law mandates that an acquisition of a public company must be effected through a tender offer, and thus structuring such a deal as a merger is not legally viable. It should be noted that the Companies Law imposes unique requirements in effecting a tender offer, including a version of a 'bring-along" right, which provides that when a purchaser offers to acquire more than 90% of the outstanding shares of a public company, and holders of more than 50% of the outstanding shares accept such an offer, the acquirer can force *all* shareholders in the company to sell their shares (whether or not they tendered their shares in the tender offer).[3] Thus, a purchaser can force the acquisition of all the outstanding shares of a public company under Israel's tender offer rules, so long as holders of more than 50% of the outstanding shares tender their shares.

The Honorable Judge Dr. Michael Agmon-Gonen rejected the Plaintiff's claim and held that the acquisition of a public company could be structured under Israeli law as a merger. The Court explained that the rationale for the tender offer requirement is the protection of minority shareholders that would be left following an acquisition of a majority (but not all) of the shares. Such shareholders may lose the liquidity of their shares due to delisting of the target company's shares. Such a concern, the Court found, does not exist in a merger in which the acquirer purchases all the shares of the target company. Judge Agmon-Gonen further ruled that a tender offer and a merger of a public company are alternative legally viable structures and that parties may chose either structure so long as all relevant corporate approvals are obtained.

Reverse triangular merger

The Plaintiff further claimed that even if a merger of a public company is a legally viable structure in Israel, only a regular merger is recognized by the Companies Law, and a

reverse triangular merger cannot be effected under the Companies Law.

What is a reverse triangular merger? A reverse triangular merger is a common structure to effect an acquisition, and is accomplished when a subsidiary of the acquirer (formed specifically for the purpose of the acquisition) is merged with and into the target company, leaving the target company as the surviving corporation and a subsidiary of the acquirer. Structuring an acquisition as a reverse triangular merger requires approval of the shareholders of the two merging entities (the newly formed subsidiary and the target), but in most cases does not require the approval of the shareholders of the acquirer.[4] An additional benefit of structuring an acquisition as a reverse triangular merger is the procedural benefit of having the target company survive the merger, avoiding in certain cases the necessity of obtaining consents from third-parties with which the target company has existing contractual arrangements.

Judge Agmon-Gonen reviewed the economic benefits of a reverse triangular merger and quoted the opinion of several prominent corporate scholars in Israel, based on which she rejected the Plaintiff's claim and ruled that despite the literal reading of the regulations issued pursuant to the Companies Law, the correct reading of the Companies Law allows the structuring of an acquisition as a reverse triangular merger.

Although the Malam Ruling was rendered in response to a request for an injunction to prevent the completion of the Proposed Merger, the Court discussed the substantive legal claims involved and determined that an acquisition via both a tender offer and a reverse triangular merger can be effected under the Companies Law.

Although practitioners in Israel have structured acquisitions of public companies as reverse triangular mergers, they often advise clients that the structure involves some uncertainty. The Malam Ruling increases the certainty of practice under the Companies Law by validating one of the most popular structures in today's international M&A market.

Please note that careful planning and consideration of many business and legal issues is required when structuring the acquisition of an Israeli company. Appropriate legal advisers should be consulted to determine the appropriate structure in any particular case.

Notes

[1] HP 000786/07.

[2] Section 320(b) of the Companies Law requires a merger to be approved by a majority of each of the series of shares.

[3] The acquirer may force the shareholders to sell all the shares that are subject to the tender offer. Assuming the tender offer was made to purchase all the shares of the target company, the acquirer may force all the shareholders to sell their shares. Section 338(a) of the Companies Law provides the shareholders in such context with appraisal rights for their shares.

[4] Although usually neither the Companies Law nor the Delaware General Corporate Law requires approval of the acquirer's shareholders, in situations where a portion of the consideration is paid in the acquirer's stock, such approvals may be required by the rules of the exchange on which the acquirer's stock is traded. Such approval may also be required under the merger statutes of other jurisdictions.