

A PRACTICAL GUIDE
AND
AN OVERVIEW OF THE ISRAELI COMPANIES LAW
AS TO PRIVATELY HELD COMPANIES¹

The following article is intended to provide a practical guide and an overview to the Israeli Companies Law, 1999 as it relates to the establishment and governance of limited liability companies.

A. Background:

In the period preceding the declaration of the independence of the State of Israel (in 1948), the territory was governed by the British Mandate, hence a strong British, common law influence was manifest in the laws relating to companies in Israel.

The companies law underwent a major overhaul in 1999 with the adoption of the Companies Law-1999 (the "Companies Law"), which adopted many new approaches into the Law bringing the law closer to the Delaware law of corporations. Some of these changes were accepted with favor by the legal and business communities and some of which, as shall be detailed below, came under sever criticism and were later amended.

Registration of privately held companies, and supervision over the conduct of their affairs, fall under the responsibility of the office of the Companies Registrar which is a sub-division of the Ministry of Justice.

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This Article is updated as of February, 2010.

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Note: The above should not be considered as legal advice, and can not be relied upon as such.

B. Establishment of a Limited Liability Company:

A limited liability company is established by one or more promoters who are required to sign and file the following forms:

1. Required Filing Information:
 - 1.1. An application for the establishment of a new corporation shall include information regarding the names, addresses and identification numbers of the applicant/s; information as to what shall be the registered office of the Company; a declaration that the applicant is not limited by any law (debt Execution Law, Bankruptcy Law) from establishing a company; a declaration as to the aims of the Company; the capital of the Company and the scope of liability which shall attach to its members.
 - 1.2. Unlike some states in the U.S., an Israeli company need not have a registered agent. Official notices to the Company need to be sent to its registered address.
 - 1.3. The fees payable for the establishment of an Israeli company do not depend upon its initially registered capital but are fixed today at a sum of 2,435 NIS (linked on an on-going basis to the Consumer Price Index) (approximately \$650 as of the date of this article).
 - 1.4. The signature upon the documents which are filed for the establishment of a new company must be authenticated by an Israeli attorney, or if signed overseas, by the Israeli consul.
 - 1.5. The name of a company must be approved by the Companies Registrar, who may reject a proposed name only on reasonable grounds (a company, or a trademark, are already registered with such name, or is very similar to such name; the name is intended to deceive the public, or is contrary to public policy, etc.).
2. The Articles of the Company.

- 2.1. The Companies Law allows wide latitude in the drafting of the Articles and only matters which are expressly prohibited or mandated by the Companies Law need be included or omitted from the Articles.
- 2.2. The general concept underlying the Companies Law is that the Articles are a contract between the company and its shareholders and a contract amongst the shareholders.
- 2.3. The Articles must include particulars as to the name of the Company, the aims of the company, details as to the registered and initially issued share capital and details as to the limitation of liability.
- 2.4. The aims of the Company may be stated to be one of the following: (i) any activity permitted by law; (ii) any activity permitted by law, other than the activities set forth in its Articles; (iii) only the activities fixed in its Articles; (iv) public purposes only, and in such a case the Company may not distribute any profits. The doctrine of *ultra vires* (beyond legal capacity) is no longer applicable in Israel.
- 2.5. The capital of the Company may be composed of shares of a certain par value, or of shares of no par value, and of only one type of the above (i.e. the Company may not have some shares with par value and some without). The Company may have various classes of shares, such as preferred shares (e.g. with preferential voting, dividend and liquidation rights), management shares (which grant the right to appoint directors), etc. It is to be noted that an increase to the registered capital of a company has been recently exempted from stamp duty (1%) which used to be assessed on such increase, thus bringing about significant savings to companies. Most companies are registered with Ordinary Shares which grant their holders an equal right to cast one vote per share in any shareholder's meeting, to receive a proportionate part of any dividend which is distributed and the right to receive a proportionate share of any assets remaining upon liquidation after all debts to creditors have been satisfied.

- 2.6. There are no limitations as to the maximum holding by foreign residents of shares in an Israeli company (on the contrary, as shall be presented in a future article there are quite significant tax and government incentives provided for companies which have a high rate of foreign holding and which are active in one of Israel's approved development zones).
- 2.7. If shares are issued to any foreign residents then, if the proposed shareholder is an individual, a photocopy of his passport must be filed (which may be authenticated, among other ways, by a notary qualified to practice in the country where the passport was issued or a notary qualified to practice in the country of residence of the foreign resident), and if the proposed foreign shareholder is a corporation, then its certificate of incorporation or registration must be filed, together with a certification as to its existence at such date, both authenticated in the manner fixed in the regulations and translated into Hebrew or English, which translation must be authenticated by a notary.
- 2.8. Liability of the shareholders may be limited by shares, that is to say that the liability of the shareholders shall be limited to the sum agreed to be paid by each of them in consideration for the shares issued to them by the Company, as countersigned by them in the Articles of the Company. The liability of the shareholders may also be unlimited, as is the case for example with a professional corporation of lawyers, certified public accountants, private investigators and some other types of special companies.
- 2.9. There are no minimum equity investment requirements into an Israeli company.
- 2.10. A company may decide to file specially drafted articles, or it may decide to merely provide the basic required details as set forth in Section 2.3 above, and other than that adopt no other provisions as to its governance. In that case the general provisions of the Companies Law, which are quite comprehensive, shall apply to the governance of the Company, until amended by the shareholders. Examples of provisions which are

commonly found in the Articles of privately held companies and which are not included in the Companies Law are the granting of a right of first refusal upon the sale of shares by a shareholder, 'tag-along' and 'bring-along' rights and others.

- 2.11. The initial Articles of a company must be filed in Hebrew, although after establishment, the Companies Registrar will also accept Articles drafted in English.
- 2.12. Unless otherwise stated in the Articles, the Articles of a Company may be amended upon a simple majority vote of the shareholders in a general shareholders assembly. The Articles may also state that certain provisions shall require a special voting majority in order to be amended.
- 2.13. No amendment may be made to the Articles which would require a shareholder to purchase additional shares, or to increase his liability, absent his approval to such change.
- 2.14. If the capital of the company is divided into various classes, no change may be made in the Articles as to the rights of such class, without the approval of a majority of such class, unless it has been fixed otherwise in the Articles.
- 2.15. The Articles shall be signed by the first shareholder/s and shall indicate, alongside his name, his address, identification number, and the number of shares allotted to him. The Articles must be signed before an attorney (or Israeli consul abroad) in order to authenticate the identity of those signing.

3. Consent of Initial Directors:

- 3.1. A third form which must be signed and filed at the time of establishment of a new company is that of the consent to act by the initial directors. The form must include the particulars of those persons who have agreed to act as the initial directors of the Company. The tenure of the initial

directors shall end upon the closing of the first shareholders assembly, unless fixed otherwise in the Articles.

- 3.2. A corporation may act a director, while naming the person who shall act as its representative.
- 3.3. A privately held Israeli company must have at least one director.
- 3.4. If it is desired to appoint a non-Israeli resident as a director in an Israeli company, then, if the proposed director is an individual, a photocopy of his passport must be filed (which may be authenticated, among other ways, by a notary qualified to practice in the country where the passport was issued or a notary qualified to practice in the country of residence of the foreign resident), and if the proposed directors is a corporation, then its certificate of incorporation or registration must be filed, together with a certification as to its existence at such date, both authenticated in the manner fixed in the regulations and translated into Hebrew or English, which translation must be authenticated by a notary.
- 3.5. If the documents are filed properly, then the registration of the new company is performed by the Registrar "on the spot". Name changes, if required may also be performed.

C. Corporate Governance.

4. The general philosophy underlying the Companies Law, is that a company is governed by three different organs: the general shareholders assembly; the board of directors; the general manager and the active management. The shareholder assembly may be likened to a legislative body, the board of directors to a general policy making and supervisory body and the general manager and active management to an executive body.
5. The Companies Law creates a system of checks and balances between the organs. While each organ is autonomous to act in its own sphere, and must exercise independent discretion as to its obligations, the Companies Law fixes various mechanisms allowing one of the organs to supervise the actions of

another. Thus, the shareholders may dismiss the directors, and the directors may dismiss the general managers. The shareholders may also amend the Articles and in that fashion change the "rules of the game" altogether.

6. The General Shareholders Assembly:

- 6.1. A General Shareholders Assembly (GSA) must be held by the Company every year, and in any event no later than 15 months from the last GSA. A privately held company may make a provision in its Articles that it shall not be obligated to hold a GSA, other than for appointing an auditor for the company.
- 6.2. A director, or any shareholder/s, holding effectively more than 10% of the issued capital and/or of the more than 10% voting power of the company can compel the Board to convene a GSA.
- 6.3. A notice as to a GSA must be sent to all shareholders at least 7 days prior to the date of the GSA.
- 6.4. A proper quorum for the purposes of holding a GSA requires the presence, within half an hour of the time fixed for the GSA, of at least two shareholders holding at least 25% of the voting rights in the Company.
- 6.5. A written resolution of the shareholders may be adopted, provided that the resolution is approved by all shareholders who are entitled to vote at a GSA.
- 6.6. Unless the Articles provide otherwise, a GSA may be held by means of telecommunication, provided that all the shareholders are able to hear each other simultaneously.

7. The Board of Directors:

- 7.1. The Board of Directors is charged with setting the general operating policy of the company and with supervising the actions of active management.

- 7.2. The Board must furnish a report to the shareholders assembly at its annual meeting as to the status of the company and of its operating results.
 - 7.3. The Board is responsible for the preparation of the financial reports of the company and of their filing with the responsible authorities.
 - 7.4. Advance notice as to a Board meeting shall be given to all the directors a reasonable time in advance.
 - 7.5. Unless the Articles provide otherwise, a quorum for the purposes of holding a Board meeting requires the presence of a majority of the directors.
 - 7.6. Unless the Articles provide otherwise, a written resolution of the Board may be adopted, provided that the all the members of the Board, who are entitled to participate in such meeting and vote on the relevant subject have agreed not to convene as to such matter.
 - 7.7. Unless the Articles provide otherwise, a Board meeting may be held by means of telecommunication, provided that all the directors are able to hear each other simultaneously.
8. Active Management:
- 8.1. A privately held company, may, but is not required to appoint a general manager.
 - 8.2. The general manager is appointed and dismissed by the Board.
 - 8.3. The general manager is responsible for the daily operations of the company, which are to be performed in accordance with the general policy fixed by the Board and subject to its instructions. The general manager reports to the Board.
9. The Audit Committee.

- 9.1. A privately held company, may, but is not required to appoint an audit committee.
10. Independent Directors.
- 10.1. There is no obligation to appoint independent directors in a privately held company.
11. Fiduciary Duties and the Duty of Care.
- 11.1. All officers of the company owe a fiduciary duty and a duty of care to the company. An "officer" of a company includes the following: (i) a director; (ii) a general manager; (iii) general business manager; (iv) vice general manager; (v) Assistant general manager; (vi) Any person who fills one of the above roles in the company, even if his title is different; (vi) Any other manager who reports directly to the general manger.
- 11.2. The duty of care is judged by reference to the principles of negligence enunciated in the Torts Ordinance, and the Companies Law states further states that an "officer" must exercise the same level of competency which a reasonable officer would have used in the same position and in the same circumstances.
- 11.3. The fiduciary duty which is placed upon an officer requires him to act in good faith and for the good of the company. The basic principle which must guide the officer is that he may not use his special position in the company in order to make a personal gain or obtain other personal advantages. The Companies Law does not prohibit the entry of the company into transactions with 'interested parties', but places a duty of disclosure and fixes a set of approvals which must be obtained for such transactions.
12. Transactions With 'Interested Parties'.
- 12.1. The provisions of the Companies Law dealing with transactions between the company and "interested parties" are quite extensive and detailed. This article which is limited in scope is not intended to detail all such

provisions, and we shall therefore describe only the general principles of same.

12.2. The overriding principle stated in the Companies Law requires any officer of the company who knows that he has a personal interest in any transaction to be concluded with the company, to disclose without delay his personal interest in same.

12.3. Depending upon the nature of the transaction. a transaction between the company and an officer must obtain the approval of one or more of the following organs of the company: the board of directors, the audit committee (if the company has one) and the general shareholders assembly. In addition, and foremost, the transaction must be one which is not to the detriment of the company.

13. Pre-Emptive Rights.

13.1. The Companies Law mandates that in a privately held company which has only one class of issued shares, all the shareholders of a company are entitled to a pre-emptive right to purchase any future issuances of shares, proportionately to their holdings in the Company. The Board of Directors may offer to third parties any unsubscribed shares. A company may however, fix different provisions as these issues in its Articles.

14. Distribution of Dividends.

14.1. A company may distribute dividends out of "profits", provided that: **"there does not exist a reasonable concern that the distribution will prevent the company from its ability to meet its existing and expected obligations, when the time comes for meeting same."**

14.2. The term "profits" has been defined in the law, and the Board may distribute a dividend only if a 'profit' exists and only based upon financial reports prepared in accordance with generally accepted accounting principles, the effective date of which is no earlier than 6 months prior to the date of distribution.

14.3. A dividend distribution which is made not in accordance with the above stated criteria (a "Prohibited Distribution") may obligate the shareholders to return funds to the company and furthermore may expose the directors to personal liability toward creditors.

15. Exemption, Insurance and Indemnification.

15.1. A company may exempt an officer of the company from liability arising from a breach of his duty of care to the company, if a provision to such effect is fixed in advance in the Articles. A company may not exempt an officer from his fiduciary duty to the company and the acceptance by an officer of such an undertaking from the company is in itself a breach of fiduciary duty.

15.2. Two types of indemnification are allowed: before and after the fact. In order to provide an undertaking as to indemnification before the fact, such a provision must be included in the Articles of the company. This type of indemnification is limited to those instances which in the opinion of the Board can be anticipated in advance at the time of giving the undertakings, and to a sum which the Board fixes as being reasonable in the circumstances. In order to indemnify an officer post ipso facto, a provision to this effect must be included in the Articles.

15.3. If a company includes an appropriate provision in its Articles, then the company may obtain insurance for an officer, in order to insure him against liability which may be placed upon him due to actions taken as an office holder of the Company, in any one of the following circumstances:

15.3.1. The breach of the duty of care toward the company or toward a third person.

15.3.2. The breach of the fiduciary duty toward the company, provided that:

15.3.2.1. The officer acted in good faith;

- 15.3.2.2. He had a reasonable basis for believing that his action will not be to the detriment of the company.
 - 15.3.3. A financial liability placed upon an officer in favor of a third person.
- 15.4. A company may also indemnify an office holder for his reasonable legal costs, provided that the office holder is not accused of a criminal offense, or unless he is acquitted of such offense, or if convicted it is a type of offense which does not require scienter. A company may also give an office holder an advance undertaking to indemnify him for his reasonable legal costs, but this too must be set forth in the Articles of the Company.
- 15.5. No effect shall be given to any provision in the Articles or to any undertaking as to indemnification as to any one of the following:
 - 15.5.1. A breach of fiduciary duty (other than as relating to indemnification and insurance due to a breach of a fiduciary duty in which the office holder acted in good faith and had a reasonable basis for believing that his action will not be to the detriment of the company);
 - 15.5.2. A breach of the duty of care which was performed intentionally or with carelessness, other than if committed solely negligently;
 - 15.5.3. An action taken with an intent to make an illegal personal gain;
 - 15.5.4. A fine, or plea-bargain fine placed upon him.
- 16. Reporting Requirements:

Privately held Israeli companies are required to file reports with the Companies Registrar as to the following:

- 16.1. Amendments to its Articles, including as to the amendment of its name, the increase or decrease of its registered capital. A change to its registered address
 - 16.2. A notice stating that the company does not have an auditor, if no other auditor has been appointed in his stead.
 - 16.3. Changes made to the board of directors.
 - 16.4. The issuance and transfer of shares. (It is important to note that when stamp duty tax was abolished in Israel the issuance of shares by a company also became exempt from tax which used to be collected at 1% of the value of the issuance.)
 - 16.5. A merger.
17. Duty to Appoint an Auditor.
- 17.1. A privately held Israeli company must appoint a certified public accountant as an auditor, unless its annual income does not exceed 500,000 NIS (amount linked to the C.P.I.) and the shareholders' assembly in a vote of at least 90.1% of the voting power present decides not to appoint an auditor.
 - 17.2. The auditor is appointed (and may be dismissed) by the General Shareholder's Assembly and normally his appointment is effective until the next annual general shareholders meeting. The term of the appointment may, subject to certain conditions, be extended by provisions to that effect in the Articles.
18. Financial Reports:
- A privately held Israel company must prepare annual financial reports to December 31 of each year, as well as a balance sheet and a profit and loss statement, and any other report mandated by generally accepted accounting principles. The reports must be audited by a certified public accountant and

signed by the directors, and must then be brought to the approval of the general shareholders' assembly.

19. The Filing of an Annual Report with the Company's Registrar.

19.1. Every privately held company must file an annual report with the Company's Registrar. Intense debate took place in the Knesset (the Israeli parliament), as to whether a private company should be required to file its balance sheet with Company's Registrar, which would make such report accessible to the public, with those opposing such obligation raising the argument that such public filing harms basic rights of incorporation and privacy. The political compromise that was reached has resulted in the Law exempting a privately held company from filing its balance sheet, unless **one** of the following exists:

19.1.1. The Articles do not place any limitation on the right to transfer shares.

19.1.2. The Articles do not prohibit the offering of its shares or debentures to the public.

19.1.3. The Articles do not limit the number of its shareholders to 50.

As a result of the above, most privately held companies have been exempted from filing their balance sheet with the Company's Registrar.

19.2. The information which does need to be filed annually with the Company's Registrar is the following:

19.2.1. Date of last annual shareholders' assembly.

19.2.2. Division of shares and names and particulars of shareholders.

19.2.3. Names of acting directors and names of directors who are no longer acting.

19.2.4. Whether or not the company has an auditor and if it does his particulars.

19.2.5. Name and particulars of general manager.

The annual report must be signed by the chairman of the board or by a director who has been authorized to sign the report.

It should be noted that many private Israeli companies fail to adhere to the obligation to file an annual report, although the Companies Registrar has been empowered by law to assess quite heavy fines against defaulting companies.

D. Important Amendments to the Law.

In March 2005, a series of amendments were passed to the Law, dealing with various technical matters which required correction since the Law was passed in 1999, but more importantly revising or deleting some substantive provisions which had come under criticism by legal experts and by the courts.

We shall summarize below just a few of the most pertinent provisions as they relate to privately held companies:

20. Lifting the Corporate Veil.

20.1. One very major criticism which was leveled against the Law when enacted was with regard to the extremely strict and interventionist approach taken by the Law in placing personal liability upon shareholders and even directors and officers, by allowing a court to 'lift the corporate veil' with relative ease. The effect of this strict approach was that a multitude of claims were filed with the courts seeking compensation from shareholders and directors and officers for various grievances suffered by the claimants. Apparently foreign residents were also deterred from serving on the boards of Israeli companies, and in a country which is highly dependent on investments into hi-tech companies, and which seeks the personal involvement of foreign experts in such boardrooms this was a painful result of the Law as enacted.

20.2. This was drastically revised. Firstly, the provision allowing the lifting of the corporate veil against directors and officers has been deleted (which does not mean however that directors and officers can not be held

personally liable for breach of fiduciary duties, breach of the duty of care, or based on other legal principles applicable to their conduct).

20.3. In addition, a court will be allowed to lift the corporate veil only in the following circumstances:

20.4. If the court finds that, in the circumstances, it is just and proper to do so, in those exceptional legal circumstances when the use of the separate legal entity was performed in one of the following:

20.4.1. In a manner which would have the effect of defrauding a person or depriving a creditor;

20.4.2. In a manner which harms the purpose of the company and while taking an unreasonable risk with regard to its ability to settle its debts,

And, provided that that the shareholder was aware of the aforesaid use, and while taking into consideration the size of the holdings of the shareholder in the Company and the performance of his duties toward the company (duty to act in good faith and by a controlling shareholder to act with fairness) and while taking consideration the ability of the company to settle its debts. A shareholder will be deemed as having been aware, also if he suspected such conduct or the possibility of the existence of such circumstances which led to such use, but avoided inquiring as to same, but mere negligence shall not suffice to place liability upon him.

21. The amendment was aimed not only to place additional hurdles in the way of lifting the corporate veil as to all shareholders, but to specifically reduce the exposure of passive shareholders, who are not actively involved in the decision making of the Company, so that they shall not be exposed to personal liability for the actions taken by the Company and/or by its officers or by controlling shareholders.

22. A shareholder upon whom personal liability is placed will also suffer suspension of any debt owed by the company to him, until the company has paid off all its other creditors.

23. As we can see, after this amendment a claimant seeking to lift the corporate veil will have to overcome many obstacles before a court will accede to such a petition.