Delaware vs. Israel: Where are the biggest and easiest exits?

Barry Levenfeld, Partner at the Israeli law firm of Yigal Arnon & Co., takes issue with those who oppose incorporating in Israel. He discusses how both tax and exit circumstances have changed in recent years, making company incorporation in Israel less problematic and – in some ways – more advantageous than ever before.

Conventional wisdom, blindly supported by many US and some Israel venture capital funds, holds that it is preferable to incorporate "Israeli" companies in Delaware, not Israel. We are told that exits from Delaware incorporations are easier, and that Delaware corporations attract more investors and higher valuations. The time has come to challenge the conventional wisdom.

The level playing field

At one time there were powerful legal and fiscal incentives to incorporate in Delaware, or rather, powerful *disincentives* to incorporating in Israel. However, one by one, these deterrents have fallen by the wayside, and the Israel/Delaware playing field is more level than ever before. Let's take a quick look:

Tax. Not long ago Israeli founders faced a 50 percent or higher tax on the gain from the sale of their shares by either initial public offering (IPO) or acquisition (M&A). Incorporating in Delaware opened up planning possibilities, some more legal and successful than others, but it at least gave hope to avoiding the 50 percent tax. Moreover, foreign VCs and other investors in Israeli companies risked exposure to Israeli capital gains tax that was anathema to limited partners, many of which were tax exempt institutions. Today, however, the situation has changed.

Founders are subject to Israeli capital gains tax at levels only somewhat greater than US tax rates, and recent legislation providing for taxation on global income of Israeli residents means that utilizing a Delaware corporation does not improve their lot. Non-Israeli investors, moreover, can benefit from zero capital gains taxes available through standard VC tax rulings, the exemption from capital gains tax available for investments in R&D companies, the current capital gains amnesty for gains made by most foreign investors in Israeli companies, and the availability of tax deferrals where acquirers use stock to purchase shares of target companies and for other types of reorganizations. Furthermore, the increasing sophistication of the Israeli tax authorities has led Delaware corporations to be viewed as "Israeli" for tax purposes if the Delaware corporation is managed and controlled from Israel, and to the imposition of Israeli capital gains tax on some foreign investors if the primary asset of the Delaware corporation is intellectual property located in Israel. Add to all that the low rate of corporate tax in Israel (27 percent on its way to 25 percent, with possible significant reductions for approved enterprise status), and the bottom line is clear: tax considerations no longer favor Delaware.

Corporate Law - IPOs. In this post-Enron, Sarbanes-Oxley world, an Israeli company – called a "foreign private issuer" in SEC parlance – enjoys significant benefits over its Delaware counterpart. To name just a few:

- Israeli companies can submit draft prospectuses to the SEC on a confidential basis – the so-called "silent filing" – thus maintaining confidentiality during the going public process until the company decides to actually go public.
- Short-swing profit restrictions that prevent corporate insiders from profiting on purchases and sales of company shares within a six-month window do not apply.
- Proxy statements and annual reports need not contain all the detailed disclosure, including the latest SEC invention – the Compensation Discussion and Analysis – required of US companies, and can be limited to matters dictated by Israeli law. Thus, there is no need for detailed disclosure of executive compensation.
- Israeli companies are not subject to recently expanded Form 8-K disclosure requirements that mandate prompt disclosure of material agreements, departures of directors or officers and compensation agreements.

There are minor complications stemming from being an Israeli company – dealing with external director compensation, and unclear regulations regarding notice periods for shareholder meetings, for example – but good lawyers can deal with them, and they pale in comparison to the advantages of being a foreign private issuer. In short, there is no doubt that from a corporate law perspective, it is better today to be an Israeli company on Wall Street.

Corporate Law – M&A. Before the Israeli Companies Law was completely revamped in 1999, it was indeed much easier to buy a Delaware corporation. Today, though, the same technique used to purchase public Delaware corporations can be used to purchase a public Israeli company – the reverse triangular merger in which a newly-established subsidiary of the acquiring firm merges with the target. In fact, in some ways, purchasing an Israeli company by reverse trian-

Continued on page 26

Barry Levenfeld

Delaware vs. Israel: Where are the biggest and easiest exits?

Continued from page 13

gular merger can be better than purchasing a Delaware corporation:

- Minority shareholders in Delaware corporations have dissenter's rights, and can apply to the court for an appraisal of their shares and get cashed out. Minority shareholders in Israeli companies cannot.
- Delaware law limits the extent to which a deal can be protected during the period – sometimes several months – between signing and closing. Various deal protection measures (voting agreements, break-up fees, no shop provisions) intended to make sure that the deal, once signed, will ultimately close, are restricted by "fiduciary out" doctrines that have developed in Delaware and which do not exist in Israel. This means that the purchase of an Israeli company can be made more certain at signing.

Israeli merger statutes do have some clumsy features, such as a forced waiting period of at least 50 days until closing, but, in general, purchasing an Israeli company today "looks and feels" like the purchase of a Delaware corporation.

Making the intangibles tangible

In the absence of any clear tax or legal reason to prefer Delaware corporations over Israeli corporations, why do so many serious investors and advisers still push Delaware as the preferred state of incorporation? It's the "intangibles," we are told: Delaware corporations get better valuations on exits than Israeli companies, simply because they are Delaware corporations. Investors prefer the familiar and who can deny, Delaware is more familiar to the US capital markets than Israel.

But is it so? We analyzed data provided by the IVC Research Center, and the results may surprise the chanters of the "Delaware" mantra. We examined 143 M&A deals for venture-backed companies for the period from 2005 through April, 2007. We excluded reverse mergers and ignored outer data points (two deals over $1 billion and several under $2 million). *The average transaction value for the Israeli companies was $240 million, whereas the average transaction value for the Delaware corporations was $196 million*.

We are not claiming that this means that Israeli companies will have significantly higher exit values than their Delaware cousins. We are simply saying that there is no empirical backing for the claim that Delaware corporations attract higher valuations. The claim may be based on emotion, prejudice or lack of familiarity with Israeli companies, but it is not based on fact.

Analyzing the data on IPOs was more difficult. In the same period, there were 53 IPOs of venture backed companies, of which 44 were Israeli companies and seven were US corporations (two were from other jurisdictions). Of those companies, 25 went public on the Tel Aviv Stock Exchange or AIM. Most of the TASE and AIM IPOs were essentially substitutes for venture financing, and cannot be considered "real" exits. Only seven of the companies went public on NASDAQ, of which just one was a Delaware corporation. That single Delaware corporation had a higher valuation for its IPO than the Israeli NASDAQ IPOs, so there is no statistical significance to the numbers.

Of more relevance is a study by Bruce Mann of Morrison & Foerster, who followed the performance of Israeli technology companies on NASDAQ as compared to their non-Israeli peers. He found that during the two years ended December 31, 2004, the average market price of the Israeli companies increased by over 100 percent, whereas the Dow Jones US Technology Index increased by only 45 percent. Again, we are not claiming that Israeli companies necessarily do better on Wall Street, we are simply saying that Delaware corporations do not necessarily attract higher valuations, and we are unaware of any empirical study that has substantiated this perception.

Bottom line: Exits for Israeli companies are just as big and just as easy as exits from Delaware corporations. In fact, they may be bigger and easier. ■

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