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Israeli Law Alert

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- **Amendment 16 to the Israeli Companies Law, 1999**

On March 7, 2011, the Knesset adopted Amendment No. 16 (the **"Amendment"**) to the Israeli Companies Law, 1999 (the **"Law"**) which became effective on May 14, 2011. The Amendment puts particular emphasis on the principles of independence of directors and external directors, strengthening the status of institutional investors and minority shareholders in public companies and the appointment of external directors in order to better balance the power of the controlling shareholders to influence the management of the company.

Summary of Main Amendments:

- Transactions in which the controlling shareholder has a personal interest will now require the approval of a majority (compared to the former requirement of 1/3) of the votes of the company›s shareholders who do not have a personal interest in the approval of the transaction.
- The initial election of an external director will require the approval of a majority (compared to the former requirement of 1/3) of the votes of the company›s shareholders who do not have a personal interest in the approval of the election.
- The maximum term of service of an external director has been extended from six to nine years for all Israeli public companies. Renewal of an external director›s term every 3 years requires the approval of the majority of the votes of the shareholders who are not controlling shareholders.
- A requirement that each director implement his independent judgment (as opposed to the controlling shareholder's judgment).
- The prohibition of a chief executive officer (the **"CEO"**) to serve as chairman of the board of directors (the **"Chairman"**) has been expanded to include close relatives of the CEO.
- Any person who, directly or indirectly, is subordinate to the CEO may not serve as the Chairman, and the Chairman may not be assigned responsibilities that are given to a person subordinate to the CEO.
- A corporation can no longer serve as a director in a public company.
- A majority of the members of the audit committee (the **"Audit Committee"**) must be independent directors, as described below. The chairman of the Audit Committee must be an external director. The quorum of the Audit Committee requires a majority of the Audit Committee's members, so long as a majority of those present are independent and at least one is an external director.
- The Israel Securities Authority (the **"ISA"**) may impose monetary sanctions on an individual or a corporation for violation of the provisions of Section 363A of the Law (such as if the company does not have a CEO or internal auditor, or the CEO or his relative serves as Chairman).
- The Amendment strengthens the Audit Committee's independence and expands its authority. In this context, the Audit Committee will determine when a transaction will be deemed to be an "Extraordinary Transaction" with respect to transactions between a company and its controlling shareholders.

I. Main Provisions Regarding Directors and their Independence

Cancellation of the term "De Facto Director"

Prior to the Amendment, the Law stated that a director is any person who was nominated to be a director, and any person who functioned in such a capacity de facto, even if not formally appointed to the position. The Amendment deletes the latter part of the definition (regarding a person who functions as a director albeit never being properly elected as a director by law), and provides instead a twofold prohibition: first, that a person may not fulfill a duty of the duties of a director if such person was not appointed to the role of director in accordance to the law, and second, that a person who violates this provision will bear all of the responsibilities and liabilities which apply to a director under law.

Independent judgment

The Amendment prohibits any person from influencing the independent judgment of a director.

A corporation as a director of a public company

The Amendment provides that a corporation is no longer permitted to serve as the director of a public company. A corporation may continue to serve as a director in a private company, unless prohibited by the company's articles of association.

Double appointment of the Chairman and the CEO

Prior to the Amendment, a person was permitted to serve jointly as Chairman and CEO of a public company for a period of three years, subject to approval by a majority of the votes of shareholders at a general shareholders meeting, the majority of which included at least 2/3 of the votes of shareholders that are not controlling shareholders or their representatives who are present, while the total of the dissenting votes did not exceed 1% of the voting rights in the company. The Amendment provides the following additional limitations:

a. A person who, directly or indirectly, is subordinate to the CEO may not be elected to the position of Chairman;
b. The prohibition that a CEO not be elected to the position of Chairman applies also to a relative of the CEO;
c. The Chairman or his relative shall not be assigned any of the duties of the CEO, except in accordance to Section 121(c) of the Law (which limits the period of such assignment to three years and requires either the approval of 2/3 of the votes of shareholders who are not controlling shareholders and do not have a personal interest in the approval of the decision, or that the sum total of dissenting votes does not exceed 2% of the total voting rights in the company); and
d. The Chairman shall not be granted duties of a person directly or indirectly subordinate to the CEO.

Gender equality on the Board of Directors

The Amendment specifies that if at the time of the appointment of an external director all of the current directors that are not controlling shareholders in the company or their relatives are of one gender, the external director must be of the opposite gender. Previously, the Law required that an external director of a specific gender be appointed only if all of the other current directors are of the opposite gender.

II. External Director

Initial nomination of an external director

Under the Law, Israeli public companies must have at least two external directors who are appointed by a general meeting of shareholders. The Amendment increases the number of votes required at the general shareholders meeting for the initial election of an external director to a majority (compared to the former requirement of 1/3) of the votes of company's shareholders who are

not controlling shareholders and do not have a personal interest in the approval of the election. In addition, the Amendment requires that the sum total of dissenting votes not be more than 2% of the shares held by non-controlling shareholders (compared to the former 1% threshold).

Term of service and its approval[1]

The maximum term of service of an external director has been extended from six years, which consisted of two terms of three years each, to a maximum term of nine years, which consists of three terms of three years each, with the goal of utilizing the experience gained by the external director and his or her familiarity with the company.

A company can limit the term of an external director's service to a maximum of six years by providing for such in the company's articles of association, so long as the initial nomination is after the Amendment comes into effect. Extension of the external director's term every three years requires the approval of the majority of the shares held by shareholders who are not controlling shareholders (no controlling shareholder approval is required).

Independence

The Amendment provides that a relative of a controlling shareholder may not be elected as an external director. In addition, an employment or business affiliation between an individual and the Chairman, the CEO, a significant shareholder or the chief financial officer of the company will disqualify such person as an external director.

Furthermore, the Amendment broadens the limitations on a company and its controlling shareholder to employ an external director following the completion of service of the external director.

III. General provisions regarding the Audit Committee

The composition of the Audit Committee

Below are the new composition requirements of the Audit Committee of a public company following the Amendment:

- A majority of the members of the Audit Committee must be independent directors.[2]
- The chairman of the Audit Committee must be an external director.
- A quorum shall be a majority of the members of the Audit Committee, so long as a majority of those present are independent directors and at least one of those present is an external director.
- A person who is not a member of the Audit Committee may not be present at the meetings unless authorized by the chairman of the Audit Committee and only if present during the discussions but not during the voting (the corporate counsel and company secretary may be present at the meeting during the voting as well).

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[1] Note that prior to the Amendment, companies listed on the New York Stock Exchange, Nasdaq Select Market, Nasdaq Global Market and NYSE Amex Equities (formerly American Stock Exchange) were already permitted to appoint their external directors for an additional term if, among other things, the audit committee and board of directors find that, due to the external director's expertise and special contribution to the board of directors and its committees, the appointment for an additional term is for the benefit of the company.

[2] This is some sort of hybrid between an external director and a "regular" director. The nomination of such a director must comply with most of the qualification requirements for the nomination of an external director, including the prohibition of affiliation with a controlling shareholder and holding the position for a term longer than nine years, but is not required to comply with the provisions in the law regarding compensation for external directors.

- The following persons will not be appointed as members of the Audit Committee:

  - Chairman of the board;
  - A director employed by the company, the controlling shareholder or a corporation under his control;
  - A director who renders services to the company, its controlling shareholder or to a corporation under his control on a regular basis; and
  - A director for whom the bulk of his livelihood is provided by the controlling shareholder.

The Audit Committee of a private company:

In a private company, the board may appoint an Audit Committee and the aforementioned limitations will not apply, although a director employed by the company or who provides services to the company on a regular basis may not serve on the Audit Committee, and the controlling shareholder or his relative may not serve as chairman of the Audit Committee.

Broadening of the Audit Committee's role

- The Audit Committee should determine whether transactions with a director, CEO, 5% shareholder or someone with authority to appoint a director or the CEO are "Extraordinary Transactions". The Audit Committee may make such a determination with regard to a type of action or transaction (as opposed to a specific action or transaction), in accordance with guidelines that it determines annually, in advance.

- The Audit Committee shall examine deficiencies in the business management of the company, including by consulting with the company's external auditor or internal auditor.

- If the Audit Committee finds a material defect, it must hold at least one meeting on the matter in the presence of the company's internal auditor or external auditor, (according to the circumstances). Other officers of the company who are not members of the Audit Committee may not be present.

- The Audit Committee shall examine the internal auditor's work plan, to the extent brought before the board for approval, and propose changes to it as needed.

- The Audit Committee shall examine the internal auditor's performance and if he has sufficient resources to fulfill his duties.

- The Audit Committee shall examine the scope of the external auditor's work and the fees paid to him.

- The Audit Committee shall determine procedures for the handling of complaints on the part of employees in regard to shortcomings in the business management of the company and for the protection of employees who have made such complaints.

IV. Transactions in which the controlling shareholder has a personal interest

Who determines what is "Extraordinary"?

The Law provides that an Extraordinary Transaction is "a transaction that is not in the regular course of the company's business, a transaction that is not on market terms or a transaction that may materially affect the profitability, property or obligations of the company". The Amendment requires the Audit Committee to determine which transactions fall within the definition of an "Extraordinary Transaction.

Definition of personal interest

The definition of "personal interest" has been broadened such that when voting is done via proxy, the proxy holder will be considered to have a personal interest if he personally has a personal interest or if the person he is representing has a personal interest.

Shareholder vote required for transaction with controlling shareholder

The Amendment increases the number of votes required to approve an Extraordinary Transaction with a controlling shareholder or in which a controlling shareholder has a personal interest, from 1/3 of the votes of shareholders who do not have a personal interest in the matter (so long as the sum of the votes of the dissenting shareholders is less than 1% of the total voting rights in the company), to a majority of the votes of the aforementioned shareholders, so long as the sum of the votes of the dissenting shareholders is less than 2% of the total voting rights in the company.

An Extraordinary Transaction with a controlling shareholder or in which a controlling shareholder has a personal interest, as well as a transaction of a company with its controlling shareholder or his relative with regard to terms of service and employment for a period that exceeds three years will need to be approved again every three years in the aforementioned manner. With regard to a transaction that does not relate to terms of service or employment – the transaction may be approved for a longer period of time if the Audit Committee agrees that engagement in a such transaction for the desired period of time is reasonable under the circumstances.

Transaction with an officer who is not a director regarding terms of service and employment

Prior to the Amendment, a transaction with an officer who is not a director regarding terms of service and employment required the approval of the board, and only if the transaction was "Extraordinary" did the transaction require the additional approval of the Audit Committee. The Amendment requires that any such transaction with regard to an officer's terms of service or employment must receive the approval of the Audit Committee. Alternatively, the Amendment permits a special committee of the board for compensation (**"Compensation Committee"**) to approve such transactions if all of the provisions that apply to the Audit Committee apply to the Compensation Committee (e.g., composition of the committee and those permitted to take part in its proceedings).

To alter an existing transaction with an officer who is not a director with regard to terms of service or employment, only the approval of the Audit Committee is required (without need for approval by the board) if the Audit Committee establishes that the alteration is not material in relation to the existing transaction.

V. Tender Offer

Special Tender Offer[3]

The votes of those who have a personal interest in the acceptance of the Special Tender Offer will not be taken into account when calculating the majority needed to approve the offer (even if they are not controlling shareholders in the company). Prior to the Amendment, only the votes of the controlling shareholder of the offeror, a holder of 25% or more of voting power in the company, or any person acting on their behalf, were not taken into account.

Full Tender Offer

The Law provides that a person may not acquire a public company's shares or voting rights or a class of such company's shares, which will result in the purchaser's holdings in the company's shares or class of shares exceeding 90% unless such person effects a "Full Tender Offer". Section 337 of the Law requires approval of over 95% of all the (classes of) shareholders of the company in order to approve a Full Tender Offer. The Amendment requires that such majority must include half of the offerees who do not have a

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[3]A special tender offer is required under the Companies Law in connection with a purchase of a public company›s shares which will result in a person becoming the holder of 25% or more of the voting power in the company in which there is no current holder of such voting power, or which will result in a person›s holdings in the company exceeding 45% of the voting power, in a company in which there is no current shareholder who holds more than 45% of the voting power.

personal interest in the acceptance of the offer. These requirements (approval of over 95% of the shareholders, as well as half of those who do not have a personal interest) will not apply if the holdings of the offerees that do not reply to the offer is less than 2% of the issued share capital of the company or of the issued share capital of the specific class of shares for which the offer is being made.

The Amendment extends the period of time during which an offeree may sue for appraisal rights for the shares' fair value to six months (from three months). In addition, the Amendment enables the offeror to determine in its Full Tender Offer that only an offerree who refused to accept the Full Tender Offer can petition the courts to receive these appraisal rights.

VI. Imposition of monetary sanctions by the ISA

The Amendment states that in addition to the monetary sanctions that the companies' registrar may impose on a company that violates the provisions of the Law, the ISA has the authority to impose monetary sanctions on an individual or corporation for violation of the provisions of Section 363A of the Law.

Examples of violations which will enable the ISA to impose sanctions are the following:

- The company does not have a CEO or internal auditor;
- The CEO, or a relative of the CEO, serves as the Chairman;
- The Chairman holds another position in the company or a company under its control; or
- The company did not nominate the minimum number of directors with expert knowledge in accounting and finance required by the Law.

The amount of the monetary fine that can be imposed on a corporation is adjusted based on the capital of the corporation, with the largest amount currently NIS 500,000. In regard to an individual, the monetary sanction stated is NIS 6,000. The Amendment does not specify if the amounts are the maximum or set amounts.

VII. Recommended corporate governance directives

The Amendment sets forth a number of recommended corporate governance directives which companies may adopt into their articles of associations.

- Determination of the number of independent directors in a company depending on whether there is a controlling shareholder in the company.

- Diversity in the composition of the board, taking into consideration the gender of the nominee, his experience and the special needs of the company.

- Persons who are directly or indirectly subordinate to the CEO will not be nominated as directors.

- Programs for the training of new and serving directors.

- Appointment of a person to be responsible for the implementation of the corporate governance directives in the company.

- Holding board meetings (at least once a year) regarding the business management of the company by the CEO and his or her subordinates, not in their presence.

- Holding Audit Committee meetings (at least once a year) regarding defects in the business management of the company, in the presence of the internal auditor and the external auditor of the company.

- Appointment of external directors is by a majority vote of the general shareholders meeting and does not take into account the votes of controlling shareholders or votes of shareholders who have a personal interest in the approval of the appointment, except for a personal interest which does not result from a connection with the controlling shareholder, as well as the votes of those that abstain. In addition, the aggregate number of votes for the approval of the appointment from those that are not controlling shareholders or shareholders who have a personal interest in the approval of the nomination increased to 2% of the overall voting rights in the company.

- Voting in the general shareholders meeting via a voting instrument - also by internet.

VIII. The practical implications on the running of the corporation

The Amendment has significant implications on Israeli corporations, their officers and their employees. Public companies should review the Law and take the appropriate steps to prevent, as much as possible, violation of the Law and the imposition of severe administrative actions against the company, its officers or its employees, as described above.

This memo does not entirely cover all the matters included in the Amendment or the full details of the Amendments that have been addressed above. In regard to any specific issues, the provisions of the Law should be examined in full detail.

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