

COMMENTS

THE PROMISED LAND: AN EXAMINATION OF THE ISRAELI HIGH-TECH INDUSTRY

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“Moses didn’t have a geographical positioning system . . . so when he led us to the promised land, instead of taking us to a nice country like Switzerland, he left us in the middle of the desert.”¹

1. INTRODUCTION

The State of Israel declared its independence on May 14, 1948, one day before the official end of the British Mandate.² Minutes after the British Mandate expired on May 15, the United States and the Soviet Union recognized Israel as a nation, as the armies of

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¹ Peter Kruger, *Milk and Honey Are Not Enough*, COMM. INT’L, June 1, 2001, 2001 WL 11534749 (quoting Amiram Shore, chairman of the Israeli Association of Software Houses).

² ARNOLD BLUMBERG, *THE HISTORY OF ISRAEL* 77 (1998). In a letter to Lord Rothschild of the Board of Deputies of British Jews dated November 2, 1917, Lord Arthur James Balfour, the British secretary of state for foreign affairs, wrote, “His Majesty’s Government view with favor the establishment in Palestine of a national home for the Jewish people, and will use their best endeavors the facilitate the achievement of that object” On February 18, 1947, Great Britain repudiated its Mandate for Palestine, effectively renounced the Balfour Declaration, and submitted the problem of a Jewish state to the United Nations (“UN”). *Id.* at 41, 71.

Egypt, Iraq, Jordan, and Syria joined the Arab Liberation Army in an attack on Israel.³

Israel's subsequent War for Independence was only the beginning of a long series of conflicts, official and unofficial, with its neighboring countries. Due to these continued hostilities, most of the attention focused on Israel has been on its seemingly constant military entanglements. However, Israel has now partially shifted the spotlight to its emerging role as a leader in the market for high technology. This Comment seeks to analyze the rise of the Israeli high-tech industry and examine the likelihood of its continued success.

Section 2 of this Comment traces the development of Israel's economy from one of agriculture and armaments to one focused, and potentially dependent, upon high-technology. This Section focuses on the various factors that have spurred the growth of the Israeli high-tech industry. In particular, the Section will concentrate on the role of the Israeli military, which has served as both an incubator of technological development and personnel training, as well as the government, which has played a key role in creating programs to encourage start-ups and external investment. Section 3 analyzes the current and potential problems that Israel faces in sustaining this newly-developed industry. These problems include not only those peculiar to Israel's isolation—an isolation both self-imposed and geographically proscribed—but also those inherent to the development of a high-tech industry in an economy without a legal structure ready to foster and support it. Preeminent examples of such problems include a labor shortage of managers and salespeople, and a body of corporation law that does not encourage businesses to incorporate in Israel. This Section examines the implications of the recent reemergence of sustained violence between Israel and Palestinians, as well as the Nasdaq's rapid decline in value in 2000 and 2001. Section 4 examines Israel's competition with the United States over incorporation and physical location. While Delaware is Israel's mightiest competitor with respect to incorporation, various other states actively encourage Israeli high-tech companies to relocate offices and manufacturing plants to the United States. Finally, Section 5 offers possible solutions to the difficulties faced by Israel as it adapts to its new industry, and exam-

³ *Id.* at 78. Israel had actually been at war with the Arab Liberation Army since November 29, 1947, the day the UN voted to accept the partition. *Id.*

ines the question of whether Israel can truly develop a mature high technology industry.

2. THE RISE OF THE ISRAELI HIGH-TECH INDUSTRY

From October 1999 through October 2000, Israel experienced a growth in its electronics and computer industry of nearly 140%.⁴ Manufacturing and software accounted for seventy-three percent of Israel's exports in 1999, making high technology the largest export in a country which, thirty years ago, depended on oranges for more than half of its export earnings.⁵ Agriculture as a whole now makes up only three percent of Israeli exports, and citrus foods account for less than 0.5%.⁶

This Section summarizes the Israeli economy as it stood in the 1980s and analyzes the factors that led the country into its high-tech revolution.

2.1. *In the Beginning*

In the early 1980s, Israel's economy was focused on agriculture and armaments, with little money spent in the private high-tech sector. Inflation surpassed 500% a year, its foreign debt of \$21 billion was the largest debt per capita in the world, and government expenses, which primarily consisted of military and welfare expenditures, required seventy-two percent of its gross national product ("GNP").⁷

It was in this atmosphere that two brothers, Zohar and Yehuda Zisapel, created RAD Data Communications in 1982. RAD started out by exporting simple communications products, such as modems.⁸ Although the company succeeded, the brothers had a larger vision for their company, fostered by their contact with markets outside of Israel.⁹ That vision became Lannet, a supplier

⁴ See MINISTRY OF FINANCE, A GRAPHIC PRESENTATION OF THE ISRAELI ECONOMY IN RECENT YEARS 1, at <http://www.mof.gov.il/hachnasot/matsav.pdf> (last visited Feb. 18, 2002) [hereinafter MINISTRY OF FINANCE].

⁵ *Id.* at 9; Jenny Sinclair, *Israel Hits the Switch*, AGE, June 27, 2000, 2000 WL 21653895.

⁶ See Sinclair, *supra* note 5, at 6.

⁷ See Michael A. Hiltzik, *Israel's High Tech Shifts Into High Gear*, L.A. TIMES, Aug. 13, 2000, at A1 [hereinafter Hiltzik, *High Gear*]; Shira Levine, *The Jewel in the Desert*, AM.'S NETWORK, Feb. 1, 2000, 2000 WL 10794692.

⁸ See Levine, *supra* note 7.

⁹ See *id.*

of Ethernet and asynchronous transfer mode switching solutions for local area networks.¹⁰ One of Israel's first high-tech start-ups, Lannet went public in 1991 with a \$100 million market valuation. Israel, and the Zisapel brothers, have not looked back since.¹¹

2.2. *Various Factors Behind Israel's High-Tech Industry*

Despite the appearance that Israel sprang onto the high-tech scene from nowhere, many factors have slowly melded together to create an environment in which the creation of high technology has begun to thrive.

2.2.1. *The Israeli Government*

The government has played the dominant role in the development of the high-tech industry, both intentionally and inadvertently. The driving force behind the creation of the technology requisite for a high-tech industry came from an inadvertent, though not surprising, source—the conversion of telecommunications technology created for the military into products for civilian use.¹² As mentioned above, Israel has a long history of spending a large percentage of its GNP on its military.¹³ Even today, Israel spends ten to fifteen percent of its GDP on defense, most of which goes to state-of-the-art communications technology.¹⁴ Thus, the atmosphere was ripe for a military-industrial complex, where technology created for the army could be used for the benefit of civilians.¹⁵

However, the military has done more than just supply some of the technology needed for such products; it also plays an important role in labor supply, training Israeli citizens, all of whom are required to serve in one of the most technologically advanced ar-

¹⁰ See *id.*

¹¹ Lannet was later purchased in 1998 by Lucent Technologies for \$117 million. *Id.* RAD Data Communications now has fourteen sister companies guided by the RAD Group, a holding company. Seven of the companies under the RAD Group umbrella are currently traded on Nasdaq. See The RAD Group, RAD Group Homepage, at <http://www.rad.com/radgroup/group.htm> (last visited Feb. 25, 2001) (homepage for the RAD Group).

¹² *Japan, US, Israel Investors Plan Fund for Israeli Firms*, ASIA PULSE, July 12, 1999, 1999 WL 18764286.

¹³ See *supra* note 7 and accompanying text.

¹⁴ See Levine, *supra* note 7.

¹⁵ Michael A. Hiltzik, *Israel's High-Tech Boot Camp: The Army*, L.A. TIMES, Aug. 23, 2000, at C13 [hereinafter Hiltzik, *Boot Camp*].

mies in the world.¹⁶ Through the army, Israeli citizens can get technological training not only in how to fly jet fighters, but also as managers of multibillion-dollar research and procurement programs.¹⁷ Due to the mandatory service requirement, the Israeli army can hand-pick the best and brightest students to work in its high-tech operations.¹⁸ These students, intelligent to begin with, and now trained in the complex areas of telecommunications and software, leave the army after their service is completed and put their newly-acquired knowledge to use in the capital market.

It seems a natural progression that a country that supplies a large number of its citizens with mandatory technological training would develop a high-tech industry. Former soldiers have become the crux of Israel's high-tech work force, and many have become entrepreneurs.¹⁹ However, despite the military's impact on the Israeli high-tech industry, a formal alliance between the two entities does not exist. Instead, engineers, who put their skills to civilian use after leaving military service, or contractors, who are employed in both arenas, conduct this transfer of knowledge between the two sectors.²⁰

Moreover, Israel's government plays a direct role in the growth of its high-tech sector, providing substantial support for start-up companies.²¹ Since 1991, the Ministry of Trade and Industry has invested in start-ups through its incubator program.²² Through the Office of Chief Scientist ("OCS"), the Ministry runs a system of twenty-four incubation centers that partially fund accepted entrepreneurial ideas.²³ To be accepted, ideas for business and requests for money must be based in research and development ("R&D"), technologically focused, and adaptable to the export market.²⁴ Once a business is accepted, the OCS provides a significant portion

¹⁶ See Levine, *supra* note 7; Emma-Kate Symons, *New Technology Reinventing Israel*, GLOBAL FIN., May 1, 2000, at 41; Eric Hausman, *Israel: High Tech's Promised Land*, COMPUTER RESELLER NEWS, May 8, 2000, 2000 WL 2162702.

¹⁷ See Hiltzik, *Boot Camp*, *supra* note 15, at C13.

¹⁸ See Hausman, *supra* note 16.

¹⁹ See *id.*; Symons, *supra* note 16, at 41.

²⁰ Kruger, *supra* note 1.

²¹ See *Land of Milk and Telephony*, BUS. & FIN., June 29, 2000, 2000 WL 9643516.

²² See Levine, *supra* note 7.

²³ See *id.*; *Land of Milk and Telephony*, *supra* note 21.

²⁴ See *Land of Milk and Telephony*, *supra* note 21.

of the money needed for the business to get started.²⁵ The government also helps with the more mundane tasks of starting a business, such as an R&D plan, administrative counseling, secretarial services, and legal and accounting advice.²⁶ If the project succeeds, the government receives a percentage of the profits from the enterprise; in the event of failure, however, they do not require repayment.²⁷ Out of the 592 projects that were started through the incubator program, 308 are still going, 225 found venture capital funding, and 83 were still negotiating for venture funding.²⁸

The government also plays a large role in encouraging external investment and attracting potential customers. Its first major step came with a program called Yozma.²⁹ Yozma aimed to aid Israel's own venture capital community by enticing foreign venture capital with partially matching government funds.³⁰ If a foreign venture capital firm agreed to commit money in a partnership with an Israeli investment group, the Israeli government would match a significant portion of the venture capital.³¹ The joint partnership could then buy out the government's portion at a nicely discounted purchase price if the partnership prospered.³² Yozma succeeded in achieving its goals: not only did Yozma create ten funds, nine of which exercised their option to buy out the government, several of these funds are now among Israel's leading investment groups and are given much of the credit for the development of the high-tech sector.³³ The Israeli government has also set up U.S. offices, which promote trade and investment between the two countries.³⁴

The Israeli government further seeks to aid its new industry by placing an emphasis on "pre-competitive" technologies and by en-

²⁵ *Id.*; Levine, *supra* note 7. The individuals whose ideas are being funded must also contribute a portion of start-up capital. Levine, *supra* note 7.

²⁶ Levine, *supra* note 7.

²⁷ *Id.*

²⁸ See *Land of Milk and Telephony*, *supra* note 21 (paraphrasing Leon Sfar, chief executive of the Jerusalem-based Har-Hozvim incubator).

²⁹ See Hiltzik, *High Gear*, *supra* note 7, at A9. "Yozma" is Hebrew for "initiative." *Id.*

³⁰ *Id.*

³¹ See *id.*

³² See *id.*

³³ See *id.*

³⁴ See Brenda Sandburg, *Silicon Valley Looks to Israel*, RECORDER, May 27, 1998, at 1.

couraging links to academia.³⁵ By focusing on pre-competitive technologies, the government hopes that Israeli development will shape the market instead of following the trends developed elsewhere.³⁶ Furthermore, the government bolsters academic peer review of commercial research to evaluate a project or idea and strengthen the ties between industry and the academy.³⁷

2.2.2. *Israel's Culture and Immigrant Nature*

Another factor that contributed to the growth of Israel's high-tech sector is the Israelis themselves. A high-tech industry has been deemed a good "fit" for Israel, a country lacking in natural resources but abundant in the resource of knowledge.³⁸ Israeli workers have a reputation for being innovative, competitive, committed, and hard-working.³⁹ This may be explained by how seriously Israel takes education. Israel's commitment to a learned population is demonstrated by the statistics: the country invests over nine percent of its annual GDP in education.⁴⁰ Israel ranks first in the world for engineers as a percentage of the workforce and third in the world for percentage of residents with a college degree.⁴¹ In patents per capita, Israel ranks behind only the United States and Japan.⁴² Furthermore, although Hebrew is the first language of Israelis, English, the "first language of technology," is readily spoken.⁴³

³⁵ Jenny Sinclair, "Government, Get Involved!", AGE, Feb. 15, 2000, 2000 WL 2314266.

³⁶ See *id.* As an example, the government began advocating research into wave division multiplexing for broadband communications three years ago. *Id.*

³⁷ *Id.*

³⁸ See Hausman, *supra* note 16.

³⁹ See Nicholas Booth, *Power of the Promised Land*, TIMES (London), Sept. 30, 1998, at 14; Larry Kaplow, *Brainpower Draws U.S. Chip Makers to Israel*, PALM BEACH POST, June 18, 2000, at 3F [hereinafter Kaplow, *Brainpower*]. It has also been colorfully noted that Israelis have the uncanny ability to "find[] a niche and doggedly exploit[] it." Booth, *supra* at 14.

⁴⁰ See Levine, *supra* note 7. By comparison, the United States invests less than seven percent of its GDP in education. *Id.*

⁴¹ See MINISTRY OF FINANCE, *supra* note 4. Israel has 135 engineers per 10,000 employees. The United States and Japan, which rank second and third, have seventy and sixty-five engineers per one thousand workers respectively. *Id.* Twenty percent of Israeli citizens have undergraduate degrees, behind only the United States and the Netherlands. *Id.*

⁴² See Hiltzik, *High Gear*, *supra* note 7, at A8.

⁴³ See Kaplow, *Brainpower*, *supra* note 39, at 3F.

The wave of highly educated Russian immigrants that fled to Israel following the collapse of the Soviet Union in 1989 also dramatically enhanced Israel's labor market.⁴⁴ About one million immigrants from the former Soviet Union, including a large number of mathematicians, chemists, material scientists, and engineers, have come to Israel over the past decade and now constitute a major part of the technical workforce.⁴⁵ This influx of one million immigrants to a country with a population of only five million could have been hazardous to a country whose economy was at first unable to support them; for a time, former college professors were forced to sweep the streets of Tel Aviv.⁴⁶ The Israeli government then implemented the aforementioned incubator programs, due in part to this wave of educated Russian immigrants.⁴⁷ Since the economy could not otherwise absorb these immigrants, they worked for the start-up companies developed in the incubator program, thus giving Israel an "entrepreneurial edge."⁴⁸

Many also credit Israel's geography for the rise of its high-tech industry. Israel's lack of natural resources has forced its inhabitants to create an industry that provides for a more stable economy.⁴⁹ Commonly referred to as the Silicon Wadi, Israel is often compared to California's Silicon Valley, not only in terms of production, but also geographic location.⁵⁰ Like the claustrophobic location of Silicon Valley, a piece of land with bodies of water on both sides and cities (San Francisco and San Jose) on either end, Israel is bordered by the Mediterranean Sea and pressed between several countries.⁵¹ A small and isolated country, Israel's geography naturally lends itself to networking and idea-sharing. Israel's precarious military situation, stemming from its location in the

⁴⁴ See Hiltzik, *High Gear*, *supra* note 7; Japan, US, Israel Investors Plan Fund for Israeli Firms, *supra* note 12; Kaplow, *Brainpower*, *supra* note 39, at 3F; Eric Lai, *Israel Earns 'Silicon Valley of the Desert' Tag*, S. CHINA MORNING POST, Apr. 14, 1998, 1998 WL 2975079; Sinclair, *supra* note 5.

⁴⁵ See Hiltzik, *High Gear*, *supra* note 7, at A8.

⁴⁶ Kruger, *supra* note 1.

⁴⁷ *Id.*; see *supra* Section 2.2.1.

⁴⁸ Kruger, *supra* note 1.

⁴⁹ *Id.* Israel does have a strong mineral sector. For a complete analysis of the current industry, see Peter Harben, *Mining Annual Review: Israel*, MINING J., Oct. 1999, LEXIS Publications File.

⁵⁰ See Hiltzik, *High Gear*, *supra* note 7, at A8; Sandburg, *supra* note 34, at 1. "Wadi" means "oasis" or "valley" in Arabic. *Id.*

⁵¹ See Hiltzik, *High Gear*, *supra* note 7, at A8.

midst of hostile neighbors, also prepared the population for the high-risk nature of technology start-ups. Again, because of the required military service, young Israelis are practically trained to mesh responsibility with risk.⁵² Further, a history of boycotts and embargoes by the surrounding Arab countries has forced Israelis to be self-reliant.⁵³

2.2.3. *Foreign Investment*

In the early 1990s, venture capital in Israel was practically non-existent. In 1991 there was one venture capital firm in Israel, Athena Venture Partners Fund.⁵⁴ In 1994, foreign investments in Israel accounted for only \$26 million.⁵⁵ Soon after, Israeli companies caught the attention of the venture capital world for two reasons. First, Israeli companies became the darlings of the Nasdaq. Israel ranks third in the world for the number of Nasdaq-listed companies, with eighty-eight.⁵⁶ Second, Israeli companies are popular targets for buyouts by other companies.⁵⁷

While initial investments came from Europe, the past few years have been dominated by American cash flows.⁵⁸ In just the past few years, venture capital investments in Israeli companies have gone from \$429 million in 1997, to \$568 million in 1998, \$1 billion in 1999 and \$3.1 billion in 2000.⁵⁹ Israel now ranks second only to the

⁵² See Levine, *supra* note 7. See also *supra* Section 2.2.1 (giving information regarding required military service).

⁵³ See Hiltzik, *High Gear*, *supra* note 7, at A8.

⁵⁴ See Seth Kenvin, *Birth of a VC Nation*, RED HERRING, May, 1996, available at <http://www.redherring.com> (last visited Feb. 18, 2002).

⁵⁵ See Levine, *supra* note 7.

⁵⁶ See NASDAQ, Nasdaq Homepage, at http://www.nasdaq.com/reference/Israel_companies.stm (last visited Feb. 19, 2002). Israel ranks behind only the United States and Canada in the number of Nasdaq-listed companies. Nasdaq, *List of Non-U.S. Companies*, at http://www.nasdaq.com/about/non_us_companies_010831.csv (last visited Mar. 16, 2002).

⁵⁷ For example, Lucent bought Lannet, a supplier of Ethernet and asynchronous transfer mode switching solutions for local area networks, in 1998 for \$117 million; VerticalNet Inc. acquired Tradeum Inc., a company that powers business-to-business exchanges, for \$475 million in stock in 2000; AOL acquired Mirabilis, an instant messenger system, for more than \$400 million in 1998; BMC Software acquired New Dimension Software for nearly \$700 million; and SunGuard Data Systems bought Oshap Technologies for \$210 million. Hausman, *supra* note 16; Levine, *supra* note 7; *Silicon Wadi For Sale*, JERUSALEM REP., Apr. 12, 1999, at 42.

⁵⁸ See Levine, *supra* note 7. From 1997 to 1998, U.S. investment in Israeli industries increased by forty-eight percent. *Id.*

⁵⁹ See MINISTRY OF FINANCE, *supra* note 4.

United States in the amount of venture capital raised for its high-tech industry. Nevertheless, increased tensions in the Middle East, coupled with a sagging world economy, have dramatically impacted the amount of venture capital available for Israeli high-tech companies.⁶⁰

3. ISRAEL'S PROBLEMS IN SUSTAINING ITS HIGH-TECH INDUSTRY

Although Israel continues to have tremendous success in the high-tech sector, the past few years of achievement, expansion, and prosperity have begun to take its toll on the country. A labor shortage of technical workers and an utterly inadequate supply of the managers, marketers, and salespeople needed to sustain a mature industry threatens to plague the country. A fear that the high-tech sell-outs that put Israel on the map and attracted the needed venture capital are fostering an incentive to build in order to sell pervades the news. Additionally, the geography of Israel that many credit for giving its citizens the proper combination of responsibility and risk assumption for the high-tech field also endangers the stability and peace that cultivates development and investment. Furthermore, Israeli intellectual property ("IP"), corporation, and tax laws have not been updated to sustain a mature high-tech industry. Finally, the dependency of the industry on venture capital funding and its shortage over the past year has resulted in a significant setback for the industry.

3.1. *The Labor Shortage*

Israel's expected labor shortage has several components. Israel's major source of high-tech training, the military, may become a victim of its own success. As mentioned in Section 2.2.1, the military helped to fuel the nation's high-tech revolution by providing training to its soldiers and officers, who in turn applied that training to civilian use. However, as an increasing number of officers leave the military to pursue more lucrative careers in the private sector, "Israel's high-tech progeny is consuming its patriarch."⁶¹ This problem has become so pervasive that in September 2000 the navy refused to call reservists to duty because too many of

⁶⁰ See *infra* Section 3.5 for further discussion of this topic.

⁶¹ See Stephen J. Glain, *Retires Officers Return to Recruit Programmers*, WALL ST. J. EUR., Oct. 4, 2000, 2000 WL-WSJE 27823491.

them used their time trying to lure away officers.⁶² Although the military has tried to reverse this trend by offering its high-tech officers increased pay, better housing, new cars, and other perks, the real problem lies in the inevitable conclusion that if the computer experts do not stay in the military, then it becomes very difficult to justify the expense of training them.⁶³ This is a dangerous proposition to an industry that depends upon the military to supply its high-tech workforce.

Second, the supply of engineers and programmers, considered the backbone of a high-tech industry, is becoming dangerously inadequate to meet the demand for such workers. The shortage was staved off for several years by the influx of Russian immigrants starting in 1989, but that wave has stopped, and no one knows for certain from where the next group of skilled high-tech workers will come.⁶⁴ Israel's strict immigration laws make it nearly impossible for non-Jews to even get work visas.⁶⁵ The industry even offered the Israeli government money in exchange for admitting foreign workers on temporary visas, but the idea floundered in the fear that such a move would bring too many non-Jewish immigrants to Israel.⁶⁶

The shortage of high-tech employees in 2000 and 2001, estimated to number anywhere from 5000 to 25,000, has other sources as well.⁶⁷ Many Israeli engineers are moving to the United States in search of higher salaries.⁶⁸ Despite the fact that engineers located in Israel are paid almost eighty percent of their U.S. counterparts, rising salaries in the United States often prove too tempting to turn down.⁶⁹ Another bottleneck in the supply of engineers and programmers is the low number of computer scientists graduating from universities.⁷⁰ Acceptance into a university's computer science program is extremely difficult; only eight percent of high

⁶² See *id.*

⁶³ See *id.*

⁶⁴ See Hiltzik, *High Gear*, *supra* note 7, at C13; Lai, *supra* note 44.

⁶⁵ See *Land of Milk and Telephony*, *supra* note 21.

⁶⁶ See Kaplow, *Brainpower*, *supra* note 39, at 3F.

⁶⁷ See *id.*; *Land of Milk and Telephony*, *supra* note 21.

⁶⁸ See Kaplow, *Brainpower*, *supra* note 39, at 3F.

⁶⁹ See *id.*

⁷⁰ See Michele Gershberg, *Israeli High-Tech Leader Sees Industries Tripling in 10 Years*, DOW JONES INT'L NEWS, Dec. 15, 1999, 12/15/99 WL DJINS 03:00:00.

school seniors get a high enough grade on the math matriculation exam required to enter such programs.⁷¹

While the threat of a shortage in engineers and programmers is not as intense a problem in the current economic climate,⁷² the other segment of the labor shortage—the lack of executives, managers, marketers, salespeople, and other support professionals required to sustain a mature industry—threatens to further destabilize an already vulnerable economy by harming the infrastructures of companies otherwise able to withstand an economic downturn.⁷³ Israeli entrepreneurs readily admit that despite their skills in developing and producing technology, their sales, marketing and management abilities need help.⁷⁴

Perhaps the most significant gap in the Israeli corporate structure is the lack of managers; several components seem to exacerbate this dilemma. First is a lack of experience.⁷⁵ The high-tech industry is so new that there are not enough people who have seen the various stages a company goes through as it progresses from start-up to established company who can share that experience with entrepreneurs.⁷⁶ Second, some blame lies with how Israeli companies are formed.⁷⁷ Since many engineers and entrepreneurs come from the military, there is a greenhouse effect of isolation, where engineers develop a product that may be the best in the world, and only after completion do they check if a market exists for this new product.⁷⁸ Another source of the problem is likely to

⁷¹ See Gwen Ackerman, *Low Tide for Hi-Tech*, JERUSALEM POST, Sept. 29, 2000, Rosh Hashana Supp., at 18 [hereinafter Ackerman, *Low Tide*].

⁷² Some indicators lead to the conclusion that the labor shortage is now a labor surplus. See *All Things Considered: Decline of Israel's High-Tech Industry* (NPR radio broadcast, May 10, 2001) (interviewing recently laid-off employees of Versiware Israel); *Demand for High-Tech Workers Drops 83%*, JERUSALEM POST, Dec. 11, 2001, at 3 (noting that a survey of want-ads in Israeli newspapers shows a demand drop for high-tech workers).

⁷³ Nicky Blackburn, *Desperately Seeking Israel's First Nokia*, JERUSALEM POST, June 20, 1999, (Hi-Tech Supp.), at 10.

⁷⁴ See Levine, *supra* note 7. One entrepreneur, Izhak Tamir Zizapel of Orkit Communications, notes that Israeli problems in marketing and sales are due to the difference in social customs from Americans. "Every American," he notes, "was born in front of the television. Americans are much better at positioning their companies, doing marketing, building up their image." *Id.*

⁷⁵ See Blackburn, *supra* note 73, at 16.

⁷⁶ See *id.*

⁷⁷ See *id.*

⁷⁸ See *id.*

be common in any start-up around the world—not knowing when to create a formal management structure. Entrepreneurs begin a company with their fingers on every pulse; at some point, however, they must delegate some of their responsibilities to grow their companies effectively.⁷⁹ The quandary is knowing when that point comes.

3.2. High-Tech “Sell-outs”

Israeli companies bought out by larger non-Israeli companies, predominantly American, have forced the world to stand up and take notice of the nation’s high-tech industry.⁸⁰ Such high-tech “sell-outs” have brought money and interest into the once fledgling economy. However, both foreign money and interest are feared to have negative ramifications for the Israeli industry in the long run.

As more of the money behind Israeli projects comes from the United States, some fear that the country’s high-tech industry will lose its unique traits and become “Americanized.”⁸¹ The primary concern, however, is that as Israeli companies are bought up by the likes of Intel and Motorola, Israel loses out on having an Intel or Motorola of its own.⁸² Instead, the Israeli company becomes an R&D subsidiary of a larger company, technology ownership is diffused, and profits and IP flow out of Israel and directly into the United States.⁸³ Moreover, by selling at an early stage, Israelis have no means with which to learn the management, sales, and marketing skills needed to sustain a fully-developed industry.

These arguments against the wave of “sell-outs” are hotly contended. Critics argue that the examples of successful “sell-outs” fueled the start-up craze in the first place.⁸⁴ Further, opponents maintain that foreign venture capital is critical to the continued growth of existing companies, and necessary to the ability of new start-ups to “hit the ground running.”⁸⁵ Critics also argue that as long as American buyers keep the Israeli operations going and

⁷⁹ See *id.*

⁸⁰ See Gershberg, *supra* note 70.

⁸¹ Levine, *supra* note 7.

⁸² See *Silicon Wadi for Sale*, *supra* note 57, at 42.

⁸³ See Levine, *supra* note 7; *Silicon Wadi For Sale*, *supra* note 57, at 42. See also *supra* note 57 for examples of companies acquired by American companies.

⁸⁴ See Levine, *supra* note 7.

⁸⁵ See *id.*

build them up, then Israelis only benefit from having such technology giants in their backyard.⁸⁶ Finally, commentators note that young entrepreneurs who sell their companies for millions do not usually stay on as employees of the new owner or retire. Instead, they go back out into the market and start a new company even better than the first.⁸⁷

3.3. Problems with Israel's Geographic Location

Israel has several problems associated with its geographic location. The first problem is with the lack of available markets. Israel is a small country with an inadequate domestic market to sustain its burgeoning high-tech industry, and few markets available in the surrounding countries due to small economies, political hostilities, or a combination of both.⁸⁸ Israel must consistently look at and deal with major markets that are thousands of miles away.

Israel's relations with its neighbors have always been a drawback for potential investors, but the recent eruption of violence between Israel and Palestinians clearly impacted the economy for the fourth quarter of 2000 and all of 2001. Israel's economy is vulnerable to nervous investors, since it exports almost all of its software, chips, and electronics and relies extensively on the United States and Europe for its capital.⁸⁹ Despite assurances that the situation is not nearly as bad as it is portrayed on television, and that few companies are located near problem areas, investors have decided to stay in a holding pattern as they wait and see how events turn out.⁹⁰ Foreign investors have cancelled or postponed trips to the region, and numerous technological conferences have also been cancelled.⁹¹ These cancellations could seriously hurt Israeli companies, since high-tech investors often insist on meeting the managers of the companies in which they are considering investing in order to gauge ability and form a close working relationship.⁹² Newer companies will be most hurt by delayed invest-

⁸⁶ See *id.*

⁸⁷ See *Silicon Wadi for Sale*, *supra* note 57, at 42.

⁸⁸ See Kaplow, *Brainpower*, *supra* note 39, at 3F.

⁸⁹ See David Rosenberg, *Palestinian Unrest Takes Toll on Israeli High Tech*, DOW JONES INT'L NEWS, Nov. 1, 2000, 11/1/00 WL DJINS 03:35:00.

⁹⁰ See *id.*

⁹¹ See *id.*

⁹² See *id.*

ments, since they are less likely to have the capital to make it through dry periods.⁹³

Particularly problematic for Israel's economy is the susceptibility of chip fabrication ("fab") plants to sabotage. Intel, a U.S. company with two such fab plants in Israel, could be a target in the event of a protracted war against terrorism by the United States, given its U.S. origins and its location in Israel.⁹⁴ Fab plants are especially vulnerable to attack, because all it takes to ruin the entire chip-making process is opening a dust-filled bag in a clean room.

3.4. Problems with Israeli Laws

Although Israeli laws are problematic in several areas, predominantly in IP, tax, and corporation law, almost all issues stem from the same source. Israeli law has simply not adapted rapidly enough to the needs of its advancing high-tech industry.

3.4.1. IP Law

A running joke in Israel is that whenever the United States markets a software program, all of Israel buys just one copy.⁹⁵ The matter is not so funny to software developers in the United States, because it represents a larger problem with Israeli IP law. It is estimated that illegal copies make up seventy percent of the software used in Israel.⁹⁶ The problem is not just one that upsets American software companies; it upsets Israeli ones as well, since copyright infringement is estimated to cost legitimate Israeli software companies at least \$57 million per year. As a reaction to the problem, software giant Microsoft maintains a very limited presence in Israel, and Bill Gates has stated that he will not step foot in the country until the country takes better measures to protect IP rights.⁹⁷

This is not to say that Israel does not have laws that protect copyrights and patents. In 1988, the Knesset amended the copy-

⁹³ See *id.*

⁹⁴ Matthew Yi, *Expensive Assets*, S.F. CHRON., Sept 22, 2001, at C1. Still, it is highly unlikely that Intel will relocate its two Israeli fab plants, due to the difficulty of moving a fab plant as well as the depressed chip market, which would make selling the plant harder. *Id.*

⁹⁵ See Lawrence J. Siskind, *The Holy Land Comes of Age*, RECORDER, May 27, 1998, LEXIS Publications File.

⁹⁶ See *id.*

⁹⁷ See *id.*

right law to treat software the same as it treats literary works.⁹⁸ Similar to U.S. law, remedies for infringement include injunctive relief and damages. Israeli laws even go a step further, allowing ex parte orders which permit the plaintiff's attorney or court appointed representative to enter the defendant's property and seize the illegal software and the computers used to make it.⁹⁹ Israel's patent law also protects software. Following the decision in the U.S. case *Diamond v. Diehr*,¹⁰⁰ Israeli law allows software programmers to apply for patent protection.¹⁰¹ The Knesset also approved the Patent Cooperation Law in 1996, which allows a patent applicant to file in eighty signatory countries simultaneously.¹⁰²

Thus, the problem is not just in the law itself, but also in its lax enforcement and application. Despite the fact that Israel has one of the highest per capita lawyer populations, few lawyers litigate IP cases.¹⁰³ Moreover, Israel's Supreme Court has not been protective of IP rights. In one example, the Court held in *Saggi v. Estate of Abraham Ninio*¹⁰⁴ that illegal reproduction of a copyrighted work by the same individual, counts as only one copyright infringement, regardless of how many times it has been reproduced.

3.4.2. *Incorporation Elsewhere*

Israel's problems with IP protection are commonly viewed as being associated with IP's coming of age; many believe that the law will adapt quickly enough to prevent any permanent damage.¹⁰⁵ However, Israeli tax and corporation laws have led to potentially irreparable damage, as more than ninety percent of its high-tech start-ups have chosen to incorporate not in Israel, but in Delaware.¹⁰⁶

⁹⁸ See *id.* The Knesset is Israel's legislature—a 120-seat unicameral body whose members are elected by proportional representation for no more than four years.

⁹⁹ See *id.*

¹⁰⁰ *Diamond v. Diehr*, 450 U.S. 175 (1981) (finding patent protection for a method of implementing a mathematical formula).

¹⁰¹ See Siskind, *supra* note 95.

¹⁰² See *id.*

¹⁰³ See *id.*

¹⁰⁴ See *id.* (citing case about copyright right infringement).

¹⁰⁵ See *id.*

¹⁰⁶ See Ackerman, *Low Tide*, *supra* note 71, at 18; Hiltzik, *High Gear*, *supra* note 7.

What causes ninety percent of Israeli start-ups to incorporate outside of Israel? The advice of their venture capital funds.¹⁰⁷ These funds know that when it comes to taxes and merger and acquisition ("M&A") laws, incorporating in Israel is not an option. First, Israel has a capital gains tax of fifty percent. By comparison, the United States taxes capital gains at twenty percent.¹⁰⁸ Second, the capital gains tax is partnered with Israel's corporate tax rate of thirty-six percent.¹⁰⁹ When countries like Singapore tax similar entities at a zero to ten percent rate, and Ireland taxes such businesses at a 12.5% rate, Israel cannot compete.¹¹⁰ Skewed Israeli M&A laws impose taxes even when a merger involves only a transfer of shares,¹¹¹ and new corporate regulations impose shareholder responsibility on CEOs.¹¹² Finally, the Israeli government intentionally fails to grant e-commerce start-ups "approved enterprise" status, which would qualify them for tax breaks.¹¹³

Such laws not only force businesses to incorporate elsewhere; the laws drive them to do business elsewhere as well.¹¹⁴

3.5. Venture Capital Dry-Up

In 2000, investors placed a record-breaking \$3.1 billion into Israeli high-tech start-ups;¹¹⁵ during 2001, investors put only \$1.5 million into such businesses.¹¹⁶ While investments in existing companies remained steady during the first two quarters of 2001, seed investments, or first investments, declined fifty percent be-

¹⁰⁷ See Ackerman, *Low Tide*, *supra* note 71, at 19.

¹⁰⁸ See *id.*

¹⁰⁹ See *id.*

¹¹⁰ See *id.* Ireland's current tax rate is twenty-four percent, dropping to 12.5% in 2003. *Id.*

¹¹¹ See Ackerman, *Low Tide*, *supra* note 71, at 19.

¹¹² See *id.*

¹¹³ See *id.*

¹¹⁴ See *id.*

¹¹⁵ Neal Sandler, *As If the Intifada Weren't Enough. . .*, BUS. WK., June 18, 2001, at 48.

¹¹⁶ PricewaterhouseCoopers, *Moneytree Survey: Q3 2001 Results*, at <http://www.pwcglobal.com/il/eng/ins-sol/survey-rep/moneytreeQ401.pdf> (last visited Mar. 19, 2002). The IVC Research Center of Tel Aviv found that high-tech companies overall raised \$1.15 billion in the first half of 2001, a forty-four percent decline compared to the same time period in 2000. Buzzy Gordon, *Hi-Tech Investment Continues to Plummet*, JERUSALEM POST, Aug. 6, 2001, at 16.

tween the first and second quarters.¹¹⁷ The hardest hit within the high-tech sector was the Internet sector, where investment in the second quarter declined eighty-nine percent from first-quarter levels.¹¹⁸

The third quarter of 2001 was even bleaker for Israeli companies with regard to venture capital. Local and foreign venture capital firms raised \$330 million for Israeli start-ups, a twenty-one percent decline from the second quarter and a sixty-eight percent drop from the third quarter of 2000.¹¹⁹ Seed investment also declined fifty-two percent from the second quarter.¹²⁰ Companies raising capital declined from 137 in the second quarter to 117 in the third quarter and the average financing per round fell from \$3.7 million to \$3.2 million.¹²¹

This decrease in venture capital funding is extremely harmful to the Israeli economy, which depends much more on venture capital than does the U.S. economy. While the United States receives more venture capital in total amounts, venture capital investment makes up three percent of Israel's gross domestic product ("GDP") and only one percent of U.S. GDP.¹²²

4. INCORPORATION IN THE UNITED STATES

A brief history of the recent background of the economic relationship begins with the U.S.-Israeli Free Trade Agreement ("FTA"), which became effective July 1, 1985.¹²³ The FTA was an agreement to eliminate substantially all tariffs between the United

¹¹⁷ See Gordon, *supra* note 116; Neal Sandler, *Survey: Israeli VC Investments Plunge*, DAILY DEAL, July 30, 2001, available at 2001 WL 25881197.

¹¹⁸ See Gordon, *supra* note 116.

¹¹⁹ See PricewaterhouseCoopers, *supra* note 116. See also Neil Sandler, *Israeli Venture Deals Drop, Life Sciences Up*, DAILY DEAL, Nov. 5, 2001, available at 2001 WL 25884179 (noting the declining funds by Israeli high-tech companies for the fourth consecutive quarter).

¹²⁰ PricewaterhouseCoopers, *supra* note 116.

¹²¹ *Israeli High Tech Suffers*, EUR. VENT. CAP. J., Dec. 1, 2001, 2001 WL 13627333.

¹²² Yasmine Chinwala, *Israel Turns to Europe for Capital*, FIN. NEWS, Sept. 3, 2001, 2001 WL 12507573.

¹²³ See Free Trade Area Agreement, Apr. 22, 1985, U.S.-Isr., 99 Stat. 61 [hereinafter FTA]. For a complete discussion of the FTA and its legality under the General Agreement on Tariffs and Trade ("GATT"), see Sandra Ward, Note, *The U.S.-Israel Free Trade Area: Is GATT Legal?*, 19 GEO. WASH. J. INT'L L. & ECON. 199 (1985).

States and Israel by 1995.¹²⁴ The FTA also restricts several non-tariff barriers such as import licenses, percentages for exports, and buy-local requirements.¹²⁵ The FTA also provides safeguard provisions. An example of such a provision is the rules of origin clause, which limits the benefit of the agreement by mandating that only goods produced or substantially changed in the exporting country to be covered.¹²⁶ The FTA also calls for the implementation of temporary trade measures if there is a balance of payments problem in either country.¹²⁷

More recently, the United States and Israel have forged an even closer, though unofficial, economic relationship through Israel's high-tech sector. Intel provides an illustrative example of this closer tie between the two nations. Intel's link to Israel began with Dov Frohman, an American-educated Israeli who created the EPROM semiconductors for Intel.¹²⁸ When Frohman wanted to return to Israel, Intel reportedly appeased him by sending him to open the company's first design center overseas in Haifa.¹²⁹ In 1994, the Israeli government, under the late Yitzhak Rabin, made a deal with Intel for a manufacturing plant in Kiryat Gat, a town with little industry and a high unemployment rate.¹³⁰ The plant, which opened in 1999, complements the Haifa R&D center and the Jerusalem fabrication plant and received a \$600 million government construction incentive.¹³¹ From January through August of 2000, Intel exported \$1.2 billion of high-tech products from its Israeli operations.¹³² Furthermore, Intel has committed itself to being a positive social influence in Israel. It has a local employment policy and actively encourages its employees to live near their respective plants.¹³³ Intel has also partnered with local communities to

¹²⁴ FTA, *supra* note 123, art. 10.

¹²⁵ *Id.* art. 12 § 1, 13.

¹²⁶ *Id.* annex 3.

¹²⁷ *Id.* art. 11 § 1.

¹²⁸ See Larry Kaplow, *Intel's Roots in Israel Mature*, PORTLAND OREGONIAN, May 30, 2000, 2000 WL 5405789 [hereinafter Kaplow, *Intel's Roots*]. EPROM semiconductors allow computers to store information even when they are turned off. *Id.*

¹²⁹ See *id.*

¹³⁰ See *id.*

¹³¹ See *id.*

¹³² See *Intel Does Good Things for Israel*, ISR. BUS. TODAY, Sept. 1, 2000, 2000 WL 17821520.

¹³³ See *id.*

offer nine-month courses that bring local residents up to the skill level required to work in the plants.¹³⁴

Although most companies do not have such a large investment in Israel, many invest in small Israeli start-ups in order to get faster access to new technologies.¹³⁵ These relationships with large U.S. companies also give such start-ups coveted access to the U.S. telecommunications market.¹³⁶ Additionally, Israel now ranks tenth in fastest growing U.S. high-tech markets, growing ninety-five percent from 1998 to 1999.¹³⁷

Now this relationship is being taken one step further, with the United States serving as the preferred incorporation destination of Israeli start-ups.

4.1. Incorporation in Delaware

Delaware has been the choice state of incorporation for companies reporting under the Securities Exchange Act of 1934 ("1934 Act"). Approximately half of all the companies that come under the 1934 Act are incorporated in Delaware, as are a majority of Fortune 500 companies.¹³⁸ In general, Delaware is an attractive state for incorporation for several reasons. Delaware's Chancery Court is well known and respected for its stability, predictability, and speed.¹³⁹ Incorporating in Delaware is viewed as a method of reducing legal risk due to the comprehensive body of case law under the Chancery Court, one of the only state courts completely dedicated to hearing corporate cases.¹⁴⁰ Whether or not the court's rulings are favorable to the corporation, the Court usually interprets the law clearly.¹⁴¹ This feature of the Delaware court system was given even greater influence in corporate decision-making after the Private Securities Litigation Reform Act ("PSLRA") was

¹³⁴ See Kaplow, *Intel's Roots*, *supra* note 128.

¹³⁵ See Levine, *supra* note 7.

¹³⁶ See *id.*

¹³⁷ See *New Report Highlights World's Top Technology Markets*, EDP WKLY'S IT MONITOR, Mar. 20, 2000, 2000 WL 10367611.

¹³⁸ See Cyril Moscow, *Michigan or Delaware Incorporation*, 42 WAYNE L. REV. 1897, 1900 (1996).

¹³⁹ See Marlon Millner, D.C., VA. *Less Business-Friendly*, WASH. BUS. J., Feb. 26, 1999, 1999 WL 7856121.

¹⁴⁰ See *Delaware Continues to Attract Corporations on Paper, If Not in Person*, ASSOC. PRESS, Dec. 26, 1997, available at 1997 WL 4898349 [hereinafter *Delaware Continues*].

¹⁴¹ See *id.*

passed in 1995.¹⁴² Intended to reduce the number of lawsuits filed against companies, instead the PSLRA simply shifted such suits from federal court to state court.¹⁴³ Given the aforementioned features of the Delaware Chancery Court, many view Delaware as the best place in which to have corporate cases heard.¹⁴⁴ Additionally, since the Court hears only business cases, it is not backlogged with torts and criminal cases like other courts.¹⁴⁵ This has given rise to a system which can handle corporate issues more efficiently than can other jurisdictions.

Delaware's popularity, however, goes beyond reverence for its Chancery Court. Delaware's legislature and judiciary continuously revise the corporate law to respond to the changing needs of business, making transactions simpler to accomplish.¹⁴⁶ For example, Delaware was one of the first states to recognize the legal insignificance of which corporation actually survives a merger and to permit mergers to be transacted through various forms of consideration.¹⁴⁷

Delaware also has a set of jurisdictional rules that allow for personal jurisdiction over important defendants, making the state a center for corporate litigation.¹⁴⁸

Businesses favor incorporation in Delaware for other reasons as well. Many consider Delaware to have moderate and consistent tax policies, a corporation law that allows management to conduct business without the usual red tape, and an efficient system for handling corporate filings with the Division of Corporations directed by the Secretary of State.¹⁴⁹ Finally, and quite importantly for new companies, Delaware incorporation impresses and reassures Wall Street investors.¹⁵⁰

Although the above features of Delaware law hold true for any company, there are specific features of Delaware law which, when compared to Israeli law, make it a much more suitable place of in-

¹⁴² 15 U.S.C. § 77z-1 (2000).

¹⁴³ See *Delaware Continues*, *supra* note 140.

¹⁴⁴ See *id.*

¹⁴⁵ See *Moscow*, *supra* note 138, at 1903.

¹⁴⁶ See *id.*

¹⁴⁷ DEL. CODE ANN. tit. 8, § 251 (1999). See *Moscow*, *supra* note 138, at 1903.

¹⁴⁸ See *Moscow*, *supra* note 138, at 1903.

¹⁴⁹ See *id.* at 1905-06.

¹⁵⁰ See *Millner*, *supra* note 139.

corporation for Israeli companies.¹⁵¹ The major sources of discontent with Israeli law are its tax and M&A laws, which are considered "antiquated for the high-tech era,"¹⁵² especially in comparison with Delaware law. Delaware taxes capital gains at twenty percent; further, the state taxes stock exchanged during the course of a merger only when such stock is sold. By contrast, Israel taxes capital gains at rates up to fifty percent, and taxes merging companies even when only shares are exchanged.¹⁵³ Since high-tech companies that locate their management and control outside of Israel are not subject to Israeli taxation, there exists quite an incentive to incorporate in Delaware¹⁵⁴ and to locate company headquarters in, for example, California.

Another feature of Delaware law absent from Israeli law is the existence of the limited liability company ("LLC").¹⁵⁵ An LLC is similar to a corporation in legal status (i.e., members have limited liability¹⁵⁶) but it does not have the double taxation structure of a corporation. Instead, income is passed directly through to its owners, much like a partnership.¹⁵⁷ Israeli law views the LLC as a normal foreign company. Thus, if the LLC is established in Delaware and controlled outside Israel, it avoids Israeli taxes as well.¹⁵⁸

At first, the danger of this structure is unclear, since a company's incorporation in Delaware does not usually lead to a significant presence in that state.¹⁵⁹ However, the fees and taxes asso-

¹⁵¹ The American legal system differs from the Israeli legal system in that it is founded upon the idea of federalism. Whereas the United States often has comprehensive regulation on the same subject at both the federal and state levels, Israel adopts laws covering anything other than strictly local interests on a national level. Aaron M. Lampert & Alan G. Straus, *U.S., Israeli Practices Often, But Not Always, Similar*, 222 N.Y. L.J., Sept. 20, 1999, at S6.

¹⁵² See Hiltzik, *High Gear*, *supra* note 7, at A8.

¹⁵³ See Gwen Ackerman, *Chief Scientist: No Future for Hi-Tech Without Regulation Reform Plan*, JERUSALEM POST, Sept. 21, 2000, at 14 [hereinafter Ackerman, *Chief Scientist*]; see also ISRAELI BUSINESS LAW: AN ESSENTIAL GUIDE §§ 39.06-39.07 (Alon Kaplan ed., 1996) [hereinafter ISRAELI BUSINESS LAW] (explaining the income and capital gains tax structures for mergers, spin-offs, and stock sales).

¹⁵⁴ See Rafi Ton & Eli D. Clark, *Where to Incorporate Your Start-up*, JERUSALEM POST, Oct. 8, 2000, at 9.

¹⁵⁵ DEL. CODE ANN. tit. 6, § 18 (1999).

¹⁵⁶ *Id.* § 18-303.

¹⁵⁷ *Id.* § 18-1107(a).

¹⁵⁸ ISRAELI BUSINESS LAW, *supra* note 153, at 389.

¹⁵⁹ See generally *Delaware Continues*, *supra* note 140 (explaining that corporations do not relocate to Delaware, but rather reincorporate in that state in order to take advantage of a stable body of corporate law).

ciated with incorporation bring Delaware more than \$300 million in revenue per year.¹⁶⁰ Furthermore, to avoid Israeli taxes, a company must not only be incorporated elsewhere but also have managerial control outside of Israel. If a company does so, Israel loses not only the incorporation of a high-tech company, but also its headquarters. Therefore, the only potential aspects of the former start-up left in Israel are an R&D facility¹⁶¹ and, even less likely, a manufacturing plant. Given the above discussion regarding the major markets for the high-tech industry being thousands of miles away from Israel,¹⁶² there is an imminent danger that these companies could just leave Israel altogether.

4.2. *Incorporation and Location in Other States*

Israel has more to worry about than just the state of Delaware. Delaware is not the only U.S. state trying to lure Israeli high-tech businesses away from Israel for incorporation or location purposes.¹⁶³ States such as Florida, Georgia, and Virginia have joined the hunt for Israeli businesses as well.

South Florida has taken advantage of Israel's lack of a domestic market. In the past few years more than a dozen Israeli companies have started operations in South Florida.¹⁶⁴ South Florida has found that it attracts Israeli high-tech businesses due to its simultaneous similarities and differences from Israel, and it has taken advantage of both aspects to entice these companies. South Florida already has in place a strong Israeli-Jewish network. Thirty thousand Israelis already live there, and Miami has the second-largest Jewish population in the United States.¹⁶⁵ Nevertheless, Florida has two major distinctions from Israel—a proximity to major markets and friendlier tax laws.¹⁶⁶ Not only does a Florida location

¹⁶⁰ *Id.*

¹⁶¹ See Ton & Clark, *supra* note 154, at 9.

¹⁶² See *supra* Section 3.3.

¹⁶³ See Brian Bandell, *High-Tech's Promised Land: Israeli High-Tech Companies are Choosing South Florida to Grow Their Businesses*, MIAMI DAILY BUS. REV., June 30, 2000, LEXIS Publications File (describing the growth of Israeli companies in Florida); Celia Cohen, *Importing Incorporations: Attorneys Accompany Carper to Israel to Find Companies Interested in a Delaware Charter*, DEL. L. WKLY, July 13, 1999, at 1 (discussing Delaware Governor Thomas Carper's trip to Israel to convince companies to incorporate in Delaware).

¹⁶⁴ See Bandell, *supra* note 163.

¹⁶⁵ See *id.*

¹⁶⁶ *Id.*

give an Israeli company access to the U.S. market, which makes up from one-fourth to one-third of the world's high-tech market, it also affords a much closer relationship to Latin America.¹⁶⁷ Thus, organizations such as Enterprise Florida, a group which encourages business growth in the state, are able to use the existing cultural relationship as well as their superior market location and a more attractive tax system to attract the Israeli high-tech industry.¹⁶⁸ Even a month after the terrorist attacks on the United States on September 11, Florida hosted Israel's Communications Minister to strengthen and secure ties between the area and Israeli companies.¹⁶⁹

If Florida is getting into the game with Israeli high-tech companies, then Georgia is playing hardball. During the summer of 2000, the governor of Georgia led a business delegation to Israel that resulted in six Israeli companies moving their bases of operation to Georgia.¹⁷⁰ Recognizing that high-tech means high growth, Georgia is actively seeking to enlarge the number of Israeli companies doing business there.¹⁷¹ In travelling to Israel, the delegation made sure that Israeli companies know the positive aspects of locating in Georgia. First, and foremost, Georgia offers a "launching pad" to the U.S. market.¹⁷² Since location anywhere in the continental United States would accomplish the same thing, Georgia has also worked hard to make itself an ideal receptacle for the high-tech industry. The delegation emphasized that Georgia can provide what Israel cannot. Georgia has an availability of high-tech workers. It supplies trained workers through the fourth-largest university system in the country, which includes Georgia Tech, the third largest research institution in the United States, and programs like QuickStart and the Intellectual Capital Partnership

¹⁶⁷ *Id.* Latin America is an important growing market for the high-tech industry but is weak in services and facilities to accommodate a physical presence. For example, TTI Telecom International, Ltd., a software company which recently began operations in Florida, maintains that twenty percent of its revenues come from Latin America. *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *South Florida Still Hub Despite Sept. 11 Attacks*, SUN-SENTINEL, Oct. 22, 2001, LEXIS Publications File.

¹⁷⁰ See Buzzy Gordon, *Georgia New U.S. Hub for Israeli Hi-Tech Companies*, JERUSALEM POST, July 2, 2000, at 8.

¹⁷¹ *Id.* As of July 2000, the number of Israeli companies doing business in Georgia was forty. *Id.*

¹⁷² *Id.*

Program ("ICAPP").¹⁷³ QuickStart provides employee training at no cost to Georgia companies, and ICAPP allows companies to use the state's public colleges and universities to train its workers.¹⁷⁴ Georgia also offers economic incentives for the Israeli companies which locate there, including headhunters at the state's expense, tax credits for every new job created, and other tax incentives, including a sales-tax reduction on the purchase of computer hardware and clean-room equipment.¹⁷⁵ Along with other features such as a research alliance between the state, academia, and business; quality of life; and cost of living, Georgia is working hard to offer an alluring alternative to incorporation elsewhere for Israeli businesses.¹⁷⁶

Even the recent violence in the United States has not stopped Israeli firms from relocating to Fairfax County, Virginia, located just outside of Washington, D.C. The number of Israeli-owned high-tech companies has doubled in the past year, due in part to pitches by Fairfax County through the U.S.-Israel Business Exchange.¹⁷⁷ Banking on the fact that the commercialization of Israeli defense technologies has become increasingly lucrative, especially when located close to Washington, Fairfax County advertises itself to Israeli companies by highlighting its location and its large supply of technical workers.¹⁷⁸

5. CAN THE ISRAELI HIGH-TECH INDUSTRY SURVIVE?

The Israeli high-tech industry has been hailed as second only to Silicon Valley's. By one estimate, Israel is home to more than 3000 high-tech companies and 150 new start-ups every quarter. However, Israel has some potential problems that could have a devastating impact on the new industry. The issues that Israel faces with respect to its high-tech industry are three-fold. First, Israel's geographic location positions it far way from major high-tech markets and leaves it susceptible to nervous foreign investors. Second, Israel's corporation and tax laws are outdated and unfriendly to the high-tech industry. Third, other areas, particularly in the United

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ Dina El Boghdady, *Israeli Firms find Home in D.C. Area: Groups' Recruiting Efforts Paying Off*, WASH. POST, Nov. 6, 2001, at E5.

¹⁷⁸ *Id.*

States, seem to be working much harder than Israel to attract and retain Israeli companies. Finally, the worldwide economic slowdown, with its emphasis on technology companies, could cripple the once buoyant high-tech sector. For the first time in twenty years, Israel's high-tech trade balance narrowed in 2001, with high-tech exports dropping twelve percent.¹⁷⁹ Estimates reveal that twenty percent of Israeli start-ups, between five to six hundred companies, have closed their doors. Moreover, salaries for those in the high-tech industry have fallen dramatically over the past year: wages fell 27.4% in the R&D sector, 21.7% in the electronic communications equipment sector, and 20% in the computer services sector.¹⁸⁰

5.1. Steps in Progress

Israel has already taken steps to slow growing corporate flight by creating better market conditions for high-tech businesses. A proposed M&A law would impose taxes on an exchange of shares only after a two-year waiting period.¹⁸¹ The Corporate Companies Law is currently being amended to qualify the fiduciary responsibilities of the CEO.¹⁸² The government is also amending the R&D laws to ease restrictions on companies that receive funds from the OCS, such as requirements regarding local production and technology exporting.¹⁸³ A 1995 amendment to Israel's insolvency law encourages a company to reorganize if it is in bankruptcy, instead of liquidating at a creditor's demand.¹⁸⁴ The government has also increased its support for start-ups by cutting tax rates from their usual thirty-six percent to zero in the first year of business, with an increase of two and four percent in subsequent years. An Israeli high-tech company may also seek "approved enterprise" status, which benefits from a reduced tax rate as well.¹⁸⁵ Perhaps the most

¹⁷⁹ *Israel Suffers First High-Tech Export Decline in 20 Years*, COMPUTERWIRE, Jan. 4, 2002, 2002 WL 7049531.

¹⁸⁰ *High-Tech Salaries Crash*, IPR STRATEGIC BUS. INFO. DATABASE, Nov. 13, 2001, LEXIS Publications File.

¹⁸¹ Ackerman, *Low Tide*, *supra* note 71.

¹⁸² *Id.*

¹⁸³ *Id.*

¹⁸⁴ See Ronald J. Silverman & Yori Nehushtan, *Israeli Insolvency Law Moves to Encourage Reorganization*, 18 AM. BANKR. INST. J. 14 (1999), available at 1999 ABI JNL LEXIS 100.

¹⁸⁵ Ton & Clark, *supra* note 154, at 9.

encouraging step so far occurred in September 2001, when Israel's finance minister, Silvan Shalom, exempted foreign investors in Israeli venture capital funds from paying taxes through January 1, 2004.¹⁸⁶ Following this break, Israeli Prime Minister Sharon announced in early 2001 that he wants to lower capital gains taxes on investments in start-ups, an action designed to keep Israeli companies from moving their headquarters out of Israel.¹⁸⁷ Incorporating in Israel also has practical benefits. Creating an Israeli company is probably the easiest and cheapest option.¹⁸⁸ Israel's incorporation process is relatively simple and offers the convenience and clarity lacking in foreign incorporation.¹⁸⁹

Further, the heightened interest in security since the terrorist attacks on the United States on September 11, 2001 has attracted a renewed focus on Israeli companies that develop technologies adaptable to security functions. For example, one Israeli company has used advances in high-speed photography to record license plates on moving vehicles.¹⁹⁰ Building owners now use this technology to keep track of cars that enter and leave parking garages.¹⁹¹ Oz Vision is an Israeli company that created technology permitting users to transmit high-quality video surveillance over standard telephone or cellular phone lines.¹⁹² A year ago, Oz Vision pitched its idea of transmitting video surveillance from airplanes using a plane's existing satellite phone to the U.S. airline industry, but not one carrier showed interest.¹⁹³ Now, not only have the Federal Aviation Administration and commercial air carriers shown interest, Oz Vision is having difficulty keeping up with inquiries from companies throughout the transportation industry as well as school systems.¹⁹⁴ Other Israeli companies garnering attention are

¹⁸⁶ Avi Machlis, *Israel Gets a Tax Break*, RED HERRING, Dec. 6, 2001, available at <http://www.redherring.com/mag/issue107/388.html> (last visited Mar. 6, 2002); Dan Primack, *Israel Scraps Gains Tax for Foreign Investors*, VENT. CAP. J., Nov. 1, 2001, 2001 WL 2277869.

¹⁸⁷ Joshua Mitnick, *Sharon Says He Wants to Cut Taxes on Investment in Start-Ups*, BLOOMBERG NEWS, Jan. 3, 2002, available at LEXIS, News Group File, All.

¹⁸⁸ See Ton & Clark, *supra* note 154, at 9.

¹⁸⁹ *Id.*

¹⁹⁰ See John Maggs, *More Than Just Gadgets*, NAT'L J., Jan. 5, 2002, at 26.

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Marketplace: Israel's Security Firms in Demand by US Companies* (Minnesota Public Radio radio broadcast, Dec. 13, 2001) [hereinafter *Marketplace*].

¹⁹⁴ *Id.*

those that have developed methods to protect water reservoirs from biological weapon attacks, and affordable machines that can check mail for anthrax.¹⁹⁵ In addition, security firms composed of former members of the Israeli secret service are in high demand by the U.S. market, due to their experience in fighting terrorist attacks for the past fifty years.¹⁹⁶

5.2. Future Steps

To retain incorporators, Israel needs to create corporation and tax laws that are as favorable to boards and management, if not more so, as those of Delaware. Perhaps Israel could use Pennsylvania's corporation law, considered to be equal to Delaware law in most topics and even better in certain areas, as a guideline.¹⁹⁷ Israeli corporate law could not only allow boards of directors and managers to consider the interests of constituencies other than shareholders when making decisions, but also permit the board of directors not to consider shareholder interests dominant over these other constituencies.¹⁹⁸ Israeli law could provide that there is no duty to auction the company in order to obtain the highest price in the case of a merger.¹⁹⁹ Other possibilities for Israeli law include eliminating the duty of candor for directors, insulating directors against personal liability for breaches of the duty of loyalty, and permitting the indemnification of directors for expenses and judgment as long as there is no finding of willful misconduct or negligence.²⁰⁰ Yet another option for Israeli labor law is to permit no-shop/lock-up provisions.²⁰¹

Since a high-tech industry is critically dependent upon constant innovation, Israel should further amend its R&D laws to ease re-

¹⁹⁵ *Id.*

¹⁹⁶ See Dan Ephron, *The Bin Laden Dividend*, NEWSWEEK, Nov. 26, 2001, at 58; *Marketplace*, *supra* note 193. In November 2001, a partnership between El Al, the Israeli state-owned air carrier, and Boeing, the American plane manufacturer, was formed to provide air security consulting services. See Lou Marano, *Israel: A Security Partnership with Boeing*, UPI, Nov. 9, 2001, LEXIS, UPI File.

¹⁹⁷ Frederick D. Lipman, *Alternatives to Incorporating in Delaware*, N.Y. L.J., Nov. 6, 1997, at 5.

¹⁹⁸ See 15 PA. CONST. STAT. § 1715 (1995) (outlining the exercise of corporate powers in Pennsylvania law).

¹⁹⁹ See Lipman, *supra* note 197, at 5 (noting that the Pennsylvania corporate law has no duty to auction, and so is attractive to corporations).

²⁰⁰ 15 PA. CONST. STAT. § 1713.

²⁰¹ See Lipman, *supra* note 197.

strictions on creativity. Problematic issues in this area include a prohibition on technology transfer (which carries a penalty of up to three years in jail), an insistence on local production, and the grant allocation process.²⁰² Although it is understandable that the Israeli government does not want to fund technologies that benefit other countries, the current state of the law does not mesh with the current process of globalization. A potential solution is to require companies that transfer overseas to pay back any governmental grants.²⁰³ Local production restrictions should also be eased, given that there are few production jobs created by the high-tech industry.²⁰⁴ Finally, the grant-allocation process would be much more efficient if the government imposed an application deadline, and then allotted eighty percent of OCS grants by the end of the first quarter.²⁰⁵

These proposed solutions may not be the right ones for Israel for a variety of reasons, but they represent a starting point for change. Mere rejection must not be the lone response. Instead, several questions must follow. Why not? And if not, what then?

6. CONCLUSION

Israel is on the verge of leading the high technology industry, not only in innovation and development, but in its sustained and mature business presence. However, the industry is hampered by a severe lack of support professionals, corporation and IP laws that discourage high-tech companies from locating in Israel, and the diminishing global pool of venture capital funding.

However, Israel is capable of surmounting these obstacles. The presence of larger established companies in Israel and the passage of nothing more than time should give the Israeli high-tech industry the necessary personnel to manage the burgeoning infrastructure necessary to a successful business. Corporation and IP laws will develop to keep abreast of changes in the economy. The Knesset, in response to the demands of the people and business, will have to alter its laws or risk the loss of an industry it worked so hard to build. Finally, venture capital funding will inevitably

²⁰² See Ackerman, *Chief Scientist*, *supra* note 153, at 14.

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.*

return, because Israeli entrepreneurs will continue to cultivate new ideas and technologies, any of which could be worth millions.