Corporate Law of Israel

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Abstract

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Keywords: Israel, company law, corporate governance, duty of loyalty, duty of care, business judgment rule, veil piercing, derivative action, controlling shareholders, directors and officers

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Corporate Law of Israel

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Chapter for THE LAW OF ISRAEL (Christian Walter, Barak Medina, Lothar Scholz, and Heinz-Bernd Wabnitz, eds., forthcoming)

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I. INTRODUCTION

Israel's company law is based primarily on the Companies Law, 1999, which provides a modern framework for business entities, both private (closely-held) and public (listed). However, as of this writing, the Companies Law has been amended more than twenty five times, in some cases quite substantially and with regard to basic issues, thus making the statutory basis somewhat unstable. Against this backdrop, attention should be paid to the more general legal infrastructure within which the Law is embedded.

Israeli law has common law origins thanks to the heritage of the British Mandate in Palestine that was in force until 1948. Applicable law thus consists of an amalgam of statutory provisions and case law that adheres to the *stare decisis* principle.[1] Israeli company law relies on a backbone of fiduciary law that draws its main principles and many rules from English law. In recent years, however, it has become more fashionable to turn to Delaware law for comparative analysis. To date, there is still a considerable number of statutes in force that were enacted during the British Mandate ("Ordinances") and upheld, amended, and consolidated by acts of the Knesset ("Laws"). Thus, the Companies Law replaced much of the Companies Ordinance, 1929, which followed the U.K. Companies Act, 1929. In addition to the Companies Law, Israeli company law comprises the Securities Law, 1968, dealing with securities regulation, and the Companies Ordinance, 1929, which currently regulates corporate bankruptcy.

As is often the case, the development of Israeli company law has been influenced by the socio-economic environment, namely, by its corporate governance. Thus, during the first decades of the State of Israel, when the economy was struggling

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[1] Basic Law: Adjudication, Section 20.

and did not have a capital market to speak of, Israeli company law stagnated as well. The heritage of that period consists primarily of seminal Supreme Court decisions that solidified core principles of fiduciary and company law.[2] In contrast, the Companies Law was enacted after Israel had developed a vibrant, open economy that is interconnected with global markets. The establishment in 2010 of an economic division in the Tel Aviv District Court with special jurisdiction on company and securities law cases has increased the judicial output, yet its jurisprudence is not uncontroversial.

There are currently several hundred companies listed on the Tel Aviv Stock Exchange and a few dozen Israeli companies listed abroad, mostly on U.S. markets. Nearly invariably, Israeli public companies have a dominant shareholder, making the protection of minority shareholders a salient issue that indeed receives substantial attention by the law.

II. INCORPORATION

A. Legal Personality

The Companies Law authorizes the incorporation of a business firm as a separate legal entity.[3] After incorporation, the law grants the company the capacity for "any right, duty or act consistent with its character and nature as an incorporated body." In tandem, Israeli law's definition of a "person" encompasses corporations as

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[2] E.g., Mo. 100/52 Hevra Yerushalmit LeTaasiya Ltd v. Agion, 6 P.D. 887 (1952) (duty of loyalty); C.A. 80/49 Pupko v. Hamadi, 5 P.D. 242 (1951) (fiduciary accounting); C.A. 333/49 *Rothlevi v. Barshai*, 14 P.D. 1156 (1960) (duty of care); C.A. 667/76 Glickmann v. A.M. Barkai, 32(2) P.D. 281 (1978) (oppression of minority); C.A. 817/79, *Kossoy v. Y.L. Feuchtwanger Bank Ltd*., 38(3) P.D. 253 (duty of loyalty of office holders and controlling shareholders).

[3] Section 4. The company's independent legal status is in effect from the day of incorporation, as set in the company's certificate of incorporation, until its incorporation is ended upon its dissolution; Section 5.

well.[4] The common thread that can be found in cases that attempted to clarify this provision is a broad implementation of the 'real entity theory'. This theory's hallmark is the recognition of the corporate form as host for a multitude of legal norms that one would normally associate with natural persons.5 More fundamentally, certain constitutional rights apply to corporations. A company's petition to the Supreme Court with regard to constitutional protection of property rights thus set in motion Israel' nascent "Constitutional Revolution."6 Only a handful of cases attempt to illuminate which other constitutional rights attach to the corporate form, however. This subject is relatively underdeveloped at this stage.

B. Corporate Foundational Documents

Incorporating a company is conditioned on the filing of a copy of the bylaws with the Companies' Registrar.[7] The Companies Law mandates four specific provisions that must be included in a company's bylaws.[8] Incorporators are free to supplement the bylaws with additional provisions as they see fit. The only qualification is that these provisions must broadly relate to the company or its

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4 Section 4 Statutory Interpretation Law

5 As Israeli jurisprudence often implements teleological statutory interpretation, policy justifications assist in defining which legal norms should be applicable to the corporate form. For example, promoting traffic security was held to justify imposing criminal liability on the owner of a vehicle caught running a red light, even if the owner is a company; Crim.A. 3027/90 Chevrat Modi'im Binuy VePituach, Ltd. v. State of Israel 45(4) P.D. 364 (1991) 364. In L.Crim.A 847/11 Chevrat Nimlei Israel – Pituach U-Nechasim Ltd.v. State of Israel –Environmental Protection Ministry (23.10.2012), the Supreme Court reasoned that the rehabilitative concerns that apply to flesh-and-blood defendants apply to the corporate form as well in connection to withholding a criminal conviction for rehabilitation purposes.

6 C.A. 6821/93 Bank HaMizrachi HaMeuchad, Ltd. v. Migdal Kfar Shitufi 49(4) P.D. 221 (1995).

7 Prior to enactment of the Companies Law, incorporators were required to file both a charter and bylaws (frequently translated as articles of association). The Companies Law eliminated the requirement for a charter for all companies incorporated under it. Companies incorporated prior to February 1, 2000 were given a choice to retain the previous structure or move to a bylaws-only structure; Section 24.

8 Section 18. These four provisions are: the company's name, the company's objective, details regarding authorized share capital, and details regarding shareholders' limited liability.

shareholders.[9] The default rule for bylaw amendment is set on a simple majority, and the parties are free to raise the required majority.[10] It is commonly said that the Companies Law reflects a 'contractual approach'. This view perceives company law legislation as an enabling set of off-the-shelf default rules aimed at lowering transaction costs for future bylaw drafters.[11] Supreme Court decisions solidify shareholders' largely unencumbered right to define their contractual relationship in the bylaws,[12] at least for non-listed companies.[13] Shareholders agreements that are not enshrined in the bylaws, at least in public companies, are deemed enforceable only if fully disclosed.[14]

III. STRUCTURE AND ORGANS

A. Institutional Organs

This section describes the main institutional organs prescribed by the Law. In addition to the enumerated powers, organs enjoy all auxiliary powers necessary to

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9 Section 19.

10 Section 20(a). Contracting out of the default can be done with regard to a single provision or all of the bylaws. Because of this rule, Israeli companies might have bylaw provisions that are subject to different voting requirements. Provisions that are so defined are protected from subsequent amendments unless the shareholder vote musters the 'super majority'. Section 20(c).

11 Section 17(a) and 352(a) of the Companies Law embody this approach. Section 17(a) states that "a company's bylaws shall be considered as a contract between the company and its shareholders, and between its shareholders themselves".

12 R.H. 39/80 Berdigo v. D.G.B. Textile Ltd. 34(4) P.D. (1981) 197, H.C.J. 6432/02 Igud Kupot HaGemel HaAnfiot v. Finance Minister 57(3) P.D. 924 (2003), .

13 Since the Companies Law is a broad enabling act, the holding of *Igud Kupot HaGemel HaAnfiot* allows shareholders to draft bylaw provisions that run counter to Sections in the Companies Law. However, not every provision can be contracted around or out of. If a section's intent is to protect third parties' interests, defend the public interest or safeguard minority shareholders' interests, the provision is binding and unmalleable. Safeguarding minority shareholders' interests is most important in the context of publicly traded companies.

14 C.A. 54/96 Hollander v. HaMeimad HeHadash Tochna Ltd., 52(5) P.D. 673 (1998). In *Hollander*, the Court refused to assign any evidentiary weight to the alleged intent behind a contiguous shareholder's agreement for the interpretation of a listed company's bylaws.

carry out their duties.[15] Authority not specified in the Law or the company's bylaw is considered part of the Board of Director's residual authority.[16]

Shareholders' position at the top of the corporate hierarchy is exemplified by their sole authority to amend the corporate constitutional documents and decide on raising or lowering the stated capital.[17] Shareholder approval is required for the appointment of high-ranking office holders entrusted with monitoring on their behalf, such as outside directors and independent auditors.[18] Momentous or inherently suspect or sensitive events in the company's life, such as mergers or related party transactions, require shareholder consent.

Israeli companies have a single-tier board of directors. After a general proclamation charging the Board with outlining the company's policy and overseeing the performance of the General Manager, the Law goes on to delineate specific areas of non-transferable authority.[19] Listed companies are required to have Audit and Compensation Committees.[20] The Audit Committee is broadly entrusted with locating and correcting any deficiencies in the company's management as well as approving

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[15] Section 48(d).

[16] Section 49.

[17] Section 52.

[18] Note that the appointment of regular directors is absent from the list of non-transferable authorities. The General Assembly's authority to appoint regular directors is a default rule which can be contracted around or out of; Section 59.

[19] Section 92. These areas include: determining the company's plans of action, principles for funding them and the priorities between them; examining the company's financial status, including setting the company's credit limits; determining the organizational policy of the company and its wage policy; deciding on the issuance of all security instruments; preparing financial reports and certifying them; preparing yearly reports to the General Assembly regarding the company's financial situation; appointing and removing the General Manager; approving related party transactions; resolving to effect a distribution; preparing a response to a tender offer; and, for publicly traded or publicly traded debt companies, deciding the minimal number of directors with financial expertise that must be part of the incumbent board.

[20] Section 114 (Audit Committees) and Section 118A (Compensation Committee). Recognizing the redundancy of having both Audit and Compensation Committees fulfil similar roles, Amendment 27 allows for an Audit Committee comporting to the personnel of a duly-appointed Compensation Committee to fill both roles; Section 118A(d).

certain suspicious related party transactions.[21] The Compensation Committee is tasked with creating compensation guidelines for board approval as well as approving the compensation of high-ranking company officers.[22] The manning of these two committees highlights their importance in curbing potential excesses by the controlling shareholder.[23]

In addition to these statutorily mandated committees, recent court decisions have facilitated the adoption of ad-hoc “Special Independent Committees.” Purporting to rely on customs and precedents from Delaware courts, a handful of decisions from the economic division held that properly-constructed and well-functioning Special Committees may afford the company an as-of-yet unclarified benefit when defending a claim filed by disgruntled shareholders.[24] As this is a relatively new area of judicial lawmaking, the law on Special Independent Committees is far from settled.

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[21] Recent statutory amendments have clarified the Committee’s role in this endeavor. The Law now states that the Committee is tasked with deciding which transactions and acts are “essential” or “extraordinary”, as the approval process for non-essential and non-extraordinary acts are different. The Committee is also charged with overseeing a competitive pricing negotiations process for non-extraordinary related party transactions.

[22] Section 118B. The Compensation Committee is required to habitually re-evaluate its guidelines and update it as need be, and at least once every three years.

[23] Section 115. Audit Committees are comprised of at least 3 directors, two of which must be outside directors. One of these outside directors must hold the chairmanship position of the Committee. Audit Committee membership is disallowed for the Board Chairperson or any director that is employed by the company or any other company controlled by the controlling shareholder. This prohibition extends to employees at companies that habitually provide services to the company or other companies owned by the same controlling shareholder, and any directors who is reliant on the controlling shareholder as their main source of income. Recent amendments have forbidden the upsetting tendency of disqualified board members to show up and observe Audit Committee meetings. Directors that are disqualified from Audit Committee membership may still participate at the meeting at the invitation of the Committee Chairperson, if their participation is needed to present an issue and as long as they leave before the Committee’s deliberations. Additionally, a majority of the Audit Committee’s members must comply with Law-mandated independence measures.

All outside directors are required to serve on the Compensation Committees and they must comprise the majority of the Committee’s members. In addition to complying with the eligibility criteria for membership on the Audit Committee, the remaining Compensation Committee members must conform to the restrictions imposed on the compensation of outside directors.

[24] E.g., D.A. (Tel Aviv) 32690-10-11 Gotlieb v. Ayalon Achzakot Ltd. (3.9.2012).

The Companies Law introduced the General Manager as the principal executive organ of the company.[25] The General Manager is responsible for the day-to-day administration of the affairs of the company, within the scope of the policies determined by the board of directors, and subject to its guidelines.[26] In order to achieve these aims, the Law affords the General Manager all managerial and executive powers not already granted to any other organ of the company.[27]

B. Directors and Officers

The Companies Law holds a very liberal approach with regard to the board of directors in terms of its size and composition. A closely-held company thus can have a single-person board. The composition of the board in public companies is more heavily regulated, however, especially with regard to outside directors. Through regulation of their personal attributes, these directors serve as vehicles for various policies, some less related to the board's responsibilities than others. All listed companies are thus required to appoint at least two outside directors.[28] The principal requirement for outside director eligibility is that the nominee is neither a relative of the controlling shareholder nor does he have any "linkage" to the company, the controlling shareholder, or any affiliates thereof.[29] Nominees to the post of outside

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[25] Section 119. All listed companies are required to appoint a General Manager, and they are allowed to appoint more than one. Privately held companies may elect not to appoint a General Manager. If they choose not to, the General Manager's statutory authority is vested in the Board of Directors. The General Manager is required to submit periodic reports according to a timeframe designated by the Board. In the event that the General Manager believes that an extraordinary matter demands the attention of the Board, he is bound to notify the Board Chairperson. The General Manager is also required to produce reports to the Board on request of the Chairperson or following a Board resolution; Section 122.

[26] Section 120. C.A. 5663/90 Haspaka Hevra Merkazit LeHakla'im Ltd. (in liq.) v. Gross, 48(3) P.D. 86 (1994).

[27] Section 121. Managerial and executive power may be reconfigured in the bylaws.

[28] Section 239(a).

[29] Nominees are also disqualified from the post of outside director if the disqualifying linkage applies to a relative, a business partner, an employer, anybody that he is directly or indirectly subordinate to, or a company under his control, in the two years prior to the proposed appointment.

director are required to declare their compliance with the intricate web of disqualifying relationships.[30] An outside director's term of office is set at three years, with a maximum incumbency of 3 terms. In the event that the board finds that the formal qualifications no longer apply,[31] it may convene a general assembly to remove the outside director from office.[32] Both the election and re-election of outside directors are subject to unaffiliated shareholder approval in order to insulate them from the controller's influence.[33] Complementary regulation setting out the outside director's remuneration has the same goal.[34]

Outside directors must comport with the promulgated definition of either "professional competence" or "financial or accounting expertise", with the latter definition applying to at least one outside director.[35] Finally, in order to promote board gender diversity as part of implementing a broader affirmative action policy for

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Disqualifying linkages are broadly defined to include labor relations, business or professional relations generally or by way of control, as well as previous incumbency as an office holder. Specific prohibitions are in place in case a structurally unworthy candidate manages to avoid disqualification due to a lack of a formal "linkage". Individuals whose position or business might give rise to a conflict of interest with their role as a director of the company are prohibited from elevation to the post of outside director. Additionally, individuals who serve as directors at one company are excluded from serving as an outside director at another company if a director at that company serves as an outside directors at the first company.

A recent statutory amendment explicitly disqualifies individuals who either they, their relative, business associate, employer, or anyone that they are directly or indirectly subordinate to, or a company that they control, enjoys a business or professional relationship to any party that represents a disqualifying linkage. This expansion specifically equates the receipt of a benefit in a manner not approved by Law with non-compliance of the outside director eligibility requirements.

[30] Section 241(a).

[31] The outside director is required to update the company if he no longer comports to the independence requirements and voluntarily resign from his post; Section 245A.

[32] A positive vote by a majority of the non-affiliated shareholders is required to remove the outside director; Section 246. Alternatively, a company may petition the court to have the outside director removed from office; Section 247.

[33] Section 239(b). In the event that the controller refuses to support the re-election of an incumbent outside director, unaffiliated shareholder owning at least 1% of the company's equity may force inclusion of the incumbent nominee on the ballot. Approval by a majority of the unaffiliated shares results in re-election, thus sidestepping the controlling shareholder's apparent veto rights.

[34] Section 244. Receipt of compensation not contemplated in those regulations is strictly prohibited.

[35] Section 240(a1).

women,[36] the Law (and the Companies Ordinance before that) provides that for boards composed entirely of members of one gender, the newly-appointed outside director must be of the other gender.[37]

While the appointment of outside directors is mandatory, a 2011 amendment allows public companies to voluntarily appoint "independent directors" by way of "soft regulation". Independent directors must conform to the formal and substantial independence requirements which are imposed on outside directors.[38] The chief difference between outside and independent directors is that the latter are not subject to special election requirements and their tenure is not limited to 9 years. To the best of our knowledge, few if any Israeli companies have actually implemented this option voluntarily (banks and insurers are required to do so due to specific regulation).

IV. Duties

A. Directors and Officers

1. The Objective of the Company

The Companies Law provides for two major duties of office holders (namely, directors and senior officers): a duty of care and a duty of loyalty, both of which are owed "to the company." This raises the core question of company law - that is, what is the objective of the company? In this respect, the Law exhibits a relatively explicit stance: "The company's objective is to operate according to business considerations for the maximization of profits and among those considerations the interests of its

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[36] H.C.J. 453/94 Shedulat HaNashim BeYisrael v. Government of Israel, 48(5) P.D. 501 (1994).

[37] 239(d). If the controlling shareholder and her family members sit on the board they are not counted for assessing board diversity according to this subsection. Proposals to increase the share of women on the boards of public companies to forty percent, in line with similar measures in Europe, have failed.

[38] Section 249B. Reigning directors may be designated independent directors, so long as their incumbency is less than 9 years.

creditors and employees and the public interest may also be taken into account."[39] Bearing in mind that only shareholders can receive profits, when dividends are paid out (as well as enjoy director appointment rights), one finds it hard to avoid the conclusion that, as in many other legal systems, shareholders enjoy primacy with regard to company objectives. Israeli case law, however, has long adopted the English formula of the "best interests of the company as a whole",[40] which affords corporate decision makers substantial leeway to consider the interests of other constituencies as they see fit. More recently, the Supreme Court in an important yet controversial decision held that in charting a course of action for the company the interests of all stakeholders, especially those of creditors, should be balanced.[41]

2. Duty of Loyalty

The Companies Law's statutory provision on office holders' duty of loyalty implements standard elements of common law fiduciary loyalty. Thus, "an office holder owes a duty of loyalty to the company and shall act in good faith for its benefit".[42] After this general stipulation there follow subsections that include a prescription to avoid conflicts of interest,[43] a duty to disclose relevant information, and requirements to avoid competition with the company and exploitation of the company's business opportunities. Somewhat surprisingly, there is relatively little Israeli case law dealing with the various elements of this duty. A seminal Supreme

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39 Section 11(a).

40 E.g., C.A. 87/75 A.&H. Feuchtwanger Hevra LeHashkaot VeNihul Ltd. v. Asher Feuchtwanger Ltd., 29(2) P.D. 81 (1975), citing Greenhalgh v. Arderne Cinemas, [1951] Ch. 286 (C.A.).

41 C.A. 4263/04 Mishmar HaEmek v. Manor, Adv., as Liquidator of Efrochei HaZafon Ltd., 63(1) P.D. 458 (2009). Technically, the Efrochei HaZafon case dealt with a liquidator's subordination request for the shareholders' debt. The Supreme Court's inclusive framework regarding the interests of the company has not been emulated in situations where the company is solvent.

42 Section 254(a).

43 See also Agion, *supra* note 2.

Court case adopted the "no further inquiry" approach to conflicted fiduciary action, including with respect to potential conflict.[44] In tandem, a recent Supreme Court decision implemented a rule of "enhanced scrutiny" judicial review for corporate actions, with regard to which there is concern about potential conflict of office holders; in such cases the burden shifts to show a "reasonable business logic" of the tainted action.[45] Recent case law also exhibits some confusion with regard to the good faith component. Although in the context of fiduciary loyalty good faith stands for a subjective state of mind, it has been intermixed with a broad, objective requirement of propriety for conduct that Israeli private law applies to every legal action.[46] At this stage, the law is unclear. In another context that crucially hinges on the definition of good faith - namely, exculpation, insurance and indemnification - there also exists some uncertainty.[47] Time will tell if and when the Supreme Court will eliminate this uncertainty, especially since earlier case law did not find much difficulty in this regard.

The Companies Law's provisions dealing with remedies for breach of loyalty are exceptionally poorly drafted, leading several courts to error.[48] A detailed analysis exceeds the present scope. In principle, case law indicates that the regular rules of fiduciary law should apply. As the duty of loyalty requires an uncompromising dedication to the interests of the company, unauthorized conflicted transactions may

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44 C.A. 267/55 Tokatli v. Shimshon Ltd., 11(2) P.D. 1569 (1957), citing Aberdeen Railway Co. v. Blaikie Brothers (1854) 1 Macq 461 (H.L.).

45 C.A. 7735/14 Vrednikov v. Alovitch (28.12.2016). In Vrednikov, the suspect actions were the approval of enormous cash dividends following a control-changing leveraged buyout.

46 D.A. 49615-04-13 Lahav v. IDB Hevra LeFituach Ltd. (6/11/2013). Note, however, that this is a district court case.

47 E.g., L.C.A. 4024/14 Africa Israel Hevra LeHashkaot Ltd. v. Cohen (26.4.2015); D.C. 10466-09-12 (Merkaz) Ostrovsky v. Hevrat Hashkaot Discount Ltd. (9.8.2015).

48 In particular, Sections 256, 281 and 283.

be avoided with the office holder being liable to account to the company.[49] The same holds for other breaches of loyalty. The Companies Law proscribes an authorization mechanism for potential breaches of loyalty.[50] The tenor of this mechanism will be more fully explained below.

3. Duty of Care

Office holders in Israeli companies owe a legal duty to have the requisite skill and exercise due care in discharging their stewardship. This duty is a specific case of the general duty of care in the law of negligence.[51] The Law employs a "reasonable office holder" standard to gauge the requisite level of care.[52]

Directors and office holders at non-listed companies are not subject to any formal skill requirements. Nevertheless, several court decisions have established the baseline skill level that is expected of an Israeli director.[53] At a minimum, every director is expected to understand the company's business and its financial situation as reflected in its financial statements.[54] She is required to be able to fulfill her role, including in terms of having available time, and to notify the company should

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[49] Kossoy, *supra* note 2; C.C. (Haifa) 324/05 Bar-Haim v. Weizman (5.3.2006).

[50] Section 255 deals with potential breaches of loyalty by office holders. Breaches can be sanctioned by the company, provided there is full disclosure by the office holder and the company follows the guidelines set forth in Sections 268-284.

[51] The duty of care's tort law origin is clarified in the statute. Section 252(a) specifically references the sections dealing with the general duty of care in the Civil Wrongs Ordinance [New Version].

[52] Section 253 provides: "An office holder shall act with the standard of proficiency with which a reasonable office holder, in the same position and in the same circumstances, would act; this shall include taking reasonable steps, in view of the circumstances of the case, to obtain information regarding the business expedience of an act submitted for his approval or of an act done by him by virtue of his position, and to obtain all other pertinent information regarding such acts."

[53] C.A. 610/94 Buchbinder v. The Official Receiver, in his capacity as Temporary Liquidator of Bank Tzfon America, 57(4) P.D. 281 (2003); Africa Israel *supra* note 47.

[54] Office holders who are not proficient in the intricacies of financial reporting or lack professional knowledge that is essential to fulfilling their role may consult with both external and internal advisors, provided this consultation is reasonable and does not amount to a dereliction of their role.

circumstances change.[55] As noted above, special regulations apply to the skills of outside directors in listed companies. In order not to deter prospective qualified candidates or induce free riding by the non-experts, the Companies Law specifies that inclusion of designated experts does not change the duties that govern all directors.[56]

Office holders owe a continuous obligation to exercise due care in discharging their duties. This duty is procedural in nature, calling on them to take reasonable measures to inform themselves with regard to the corporate action at bar.[57] Beyond this general statement, Israeli law on office holders' duty of care is currently in a state of flux. For years, the Supreme Court repeatedly held that the court will not interfere with the business management of companies, including in the context of liability for negligence. When liability for negligence was imposed on directors and officers, the court focused on (neglect of) general oversight and monitoring duties.[58] After years of relegating the subject to *obiter dicta*, the Supreme Court recently adopted the American-influenced "Business Judgment Rule", albeit with a caveat calling for an Israeli-specific implementation..[59] This decision falls into line with a multitude of recent company law decisions that contain an analysis along the lines of the Business Judgment Rule (BJR) and its various justifications.

Against this backdrop, and in clear and unexplained tension with the statutory and judicial policy that emphasizes judicial review of the procedure of business

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55 Sections 224A, 227A; C.A. 4024/13 Tikva – Kfar LeHachshara Miktzoit BeGivat Zeid Ltd. v. Finkovich (29.8.2016)

56 Section 253A.

57 Section 253; see *supra* note 52.

58 E.g., Rothlevi, *supra* note 2; Buchbinder, *supra* note 53. Substantial company assets necessitate heightened monitoring efforts and the undertaking of curative measures when appropriate; C.C. (TA) 2193/06 Matok Efraim Ve'Banav Ltd. v. Avivi (2.4.2013). A related issue that has so not yet been fully examined in Israeli law is director liability for the company's breach of applicable law.

59 *Vrednikov*, *supra* note 45.

decisions, recent Supreme Court decisions can be interpreted as calling for judicial inquiry into the substantive reasonableness of the content of the decision.[60] Such allusions to a director's "reasonable business judgment" and its relationship to the BJR will need to be clarified in future decisions.

In order to alleviate the fear of potential liability, the Companies Law authorizes the company to grant office holders insurance, indemnification and exculpation.[61] Bylaw authorization is a condition for all three statutory immunization measures. The Companies Law goes a long way in this direction. In addition to good faith breaches of the duty of care, which can be subject to exculpation, insurance and indemnification, a company can indemnify and buy insurance for an office holder's breaches of loyalty provided they were made in good faith for the benefit of the company.[62] The latter provision reflects a view of such breaches as merely accidents.

B. Control Persons

1. Duty of "Fairness"/Loyalty

Murky as Israeli law may have recently become with regard to office holders' duty of care, the duties of control persons to the company are shrouded in mystery. Ironically, this has much to do with legislative efforts to provide clear rules in the Companies Law. Stated briefly, it is unclear as of this writing in what circumstances are controlling shareholders and other control persons deemed fiduciaries who owe loyalty to the company, and in what circumstances (and to what extent) they may pursue their self-interest with impunity. In the 1984 seminal decision in *Kossoy*, the Supreme Court held that a controlling shareholder who knowingly sells the control to

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[60] C.A. 239/13 Michlelet East London HaShlucha LeIsrael Ltd. v. Berman (25.7.2016); Tikva – Kfar LeHachshara Miktzoit BeGivat Zeid Ltd. v. Finkovich *supra* note 55; C.A. 8712/13 Adler v. Livnat (1.9.2015).

[61] Sections 258-264.

[62] Section 263(1).

an abusive buyer breaches his duty of loyalty to the company and is subject to the panoply of equitable remedies available against breaching fiduciaries.[63] The drafters of the Companies Law purported, among other things, simultaneously to remain loyal to *Kossoy*, widely considered the most important company law case in Israeli law, and to delineate controlling shareholders' duties that are somehow laxer than office holders' duty of loyalty, with a view to giving the former some leeway to pursue their self-interest - a "weakened" duty of loyalty, so to speak. The result was Section 193 of the Companies Law, which provides for a "duty of fairness" owed by a controlling shareholder and other shareholders owning a pivotal vote or having another power vis-à-vis the company. There is currently no authoritative interpretation of this duty. Obiter dicta made in passing about it range from the "weakened" view to virtual overlap with fiduciary loyalty as owed by directors, although the former interpretation was recently endorsed in a detailed *dictum* in the importat *Vrednikov* decision.[64] The general layout of the statutory mechanism for authorizing related party transactions, discussed below, is consistent with treating controlling shareholders in those particular circumstances as equivalent to office holders.

2. Duty of Care

The Companies Law does not include a provision on controlling shareholders' duty of care. As noted, however, because this duty applies to office holders by dint of general principles of tort law, the same principles should apply to shareholders when they exercise their control,[65] e.g., when appointing directors.

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[63] *Kossoy*, *supra* note 2.

[64] *Vrednikov*, *supra* note 45. *Cf.* CA 345/03 Reichart v. Yorshei HaManuach Ezra Shemesh Z"L 62(2) 437 (2007) with C.A. (TA) 50487-06-15 Go.Di.Em Hashkaot Ltd. v. Panamed Inc. (18.4.2016).

[65] Reichart, *supra* note 64.

3. Unfair Prejudice

Following developments in English law, Israeli company law had replaced the doctrine of oppression of the minority with the more flexible unfair prejudice doctrine.[66] The unfair prejudice doctrine grants the courts a wide berth of latitude in rectifying perceived inequities. This doctrine employs two parallel tests for court intervention: an "unfair" distribution of corporate assets or harm to shareholders' reasonable expectations.[67]

C. Regular Shareholders

All shareholders, big or small, owe a duty of good faith to the company and to fellow shareholders.[68] Since the principle of good faith as a basic-level, objective duty applies universally in Israeli law, this provision is merely declaratory, although the duty is sometimes alluded to in tandem with the duty of fairness that applies to pivotal shareholder votes.

V. Related Party Transactions

Related party transactions are transactions between the company and insiders such as high ranking office holders, substantial shareholders, or affiliates of both. Being inherently suspect due to their potential of extracting wealth from the company and minority shareholders, these transactions are subject to special authorization rules. In general, the Companies Law employs the regular fiduciary law principle of conditioning the validity of tainted actions on the beneficiary's fully-informed consent

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[66] Sections 191, 192(b).

[67] C.A. 5025 Prat Ta'asiyot Matechet Ltd. v. Dadon (28.2.2016). Israeli courts have reinforced minority shareholders' reasonable expectations by forcing the declaration of dividends or even drafting provisions into the company's foundational documents to ensure future collaboration. Although court-ordered company liquidation is rare, recent cases have resulted in mandated buy-outs to resolve irreconcilable acrimonious shareholder relationships.

[68] Section 192.

(a 'property rule' approach). In a corporate context, *ex ante* approval by qualified disinterested organ(s) based on full disclosure is a prerequisite for effectuation of the transactions. The following offers a bird's-eye view of the particularly intricate set of rules that govern related party transaction approval for listed companies.[69] These comprise both direct transactions with an office holder or controlling shareholder and transactions in which the officer or controlling shareholder has a personal interest, where "personal interest" stands for any material (often referred to as "substantial") interest that is not proportionally shared by all shareholders.[70] Transactions with office holders are contingent on prior approval by the Board of Directors. In order to transact with a director, a vote of the General Assembly is required, following approval of either the Audit or Compensation Committee and then the full Board.[71] This process is replicated for the controlling shareholder, with an additional "majority of the minority" approval stage - namely, a majority of shares "devoid of a personal interest" vote in favor of the transaction.[72]

Public outcry over perceived compensation excesses led to a 2012 statutory amendment pursuant to which all listed companies are required to submit compensation guidelines for a non-binding unaffiliated shareholder vote at least once every three years. The amendment and complementary regulations are designed to streamline compensation practices and disclosure, thereby enhancing the alignment of

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69 Sections 268-284.

70 Section 1; Crim.A. 3891/04 Arad Hashkaot U-Fituach Ta'asiya Ltd. v. State of Israel, 60(1) P.D. 294 (2005).

71 The Companies Law the law requires the exclusion of interested directors from the Board and Committee deliberations and subsequent vote.

72 The only qualification of this veto right is that at least 2% of the company's equity holders vote against the transaction. This qualification is designed to ensure that a miniscule portion of the broad equity base does not take advantage of low voter turnout.

actual operating profits with receipt of bonuses. With some exceptions, office holder compensation may not deviate from the parameters set forth in the guidelines.[73]

Notwithstanding the fact that the Companies Law conditions the validity of related party transaction on a state-of-the-art mechanism of fully-informed approval by disinterested organs, which was acknowledged by the Supreme Court,[74] and despite an earlier Supreme Court precedent that emphatically rejected the relevance of the fairness of such tainted transactions,[75] in recent years there has developed a judicial approach that nonetheless does consider such fairness as relevant. This "judicial mood", which is particularly prominent in (but not limited to) decisions coming from the Economic Division of the Tel Aviv District Court, is strongly inspired by Delaware's Entire Fairness doctrine. The Supreme Court's *Vrednikov* decision regards fully-authorized tainted transactions only with qualified deference, the contours of which are yet unclear.[76]

VI. CORPORATE LITIGATION

A. Veil Piercing

In an ambitious display of legislative drafting, the Companies Law codified the veil piercing doctrine.[77] The years following codification experienced a surge of veil piercing claims and perceived judicial leniency in granting awards. Less than five years since its drafting, the desire to assuage investors' liability concerns led to a complete legislative overhaul. The Law now authorizes courts to hold a shareholder

[73] Sections 267A-267C

[74] C.A. 2773/04 NZBA Hevra LeHitnachalut Ltd. v. Atar, 62(1) P.D. 456 (2006).

[75] *Tokatli*, *supra* note 44.

[76] *Vrednikov*, *supra* note 45

[77] In addition to "classic" veil piercing, Section 6 codifies the doctrines applicable to subordination and attribution of characteristics.

liable for the company's debts, if it is right and proper under the circumstances, in exceptional cases in which the separate legal personality was utilized in a matter that either might lead to defrauding of a person or discrimination of a company's creditor or in a manner that is adverse to the purpose of the company, while taking unreasonable risks regarding the company's ability to repay creditors.[78] The last condition is problematic as the Supreme Court has ruled that thin capitalization, by itself, is enough to justify veil piercing, without setting guidelines to explain when a risk becomes unreasonable.[79] Importantly, the Law conditions veil piercing on the shareholder's awareness of the unfair use of the company form, and requires the court to consider the shareholder's relative power in the company - namely, control - as well as the company's ability to repay its debt - namely, its (in)solvency. Courts' interpretation of the statutory provision has not insisted on its details and tended to treat it rather expansively.[80]

B. Shareholder Representative Claims

Recent years have seen a surge in shareholder representative claims. Shareholder derivative claims are codified in the Companies Law.[81] Shareholder class actions are governed by a designated class action statute. Both statutory endeavors attempt to balance shareholder monitoring with the risks that representative litigation may pose to the company.[82] Financial incentives are designed to promote meritorious

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[78] Section 6(a)(1).

[79] *Efrochei HaZafon*, *supra* note 41. The Court's majority opinion reasoned that creditors' property rights and asymmetric access to information gives rise to a higher shareholder duty.

[80] L.C.A. 3031/09 Kat Kol v. Ben Yaakov (2.8.2009); compare C.A. 10582/02 Ben Abu v. Delatot Hamadia Ltd. (16.10.2005).

[81] Sections 194-206.

[82] The identity of the injured party is the main test applied by the courts to distinguish between direct and derivative claims; see C.A. 3051/98 Drin v. Hevrat Hashkaot Discount Ltd. 59(1) P.D. 673 (2004).

claims.[83] A shareholder demand for board action is a prerequisite for a derivative claim. However, demand may be excused if the authorizing organ faces a disqualifying personal interest or if it is reasonable to assume that making the demand might undermine the chance of receiving effective redress.[84] Court approval following streamlined preliminary proceedings is designed to filter nuisance suits.[85]

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[83] Both arrangements authorize payment for the claimant and her attorneys. The Companies Law further provides a filing fee discount for derivative claimants as well as the opportunity for monetary assistance by the Israeli Securities Authority.

[84] Section 194.

[85] In the derivative setting, court approval will come following a prima facie showing that the litigation is in the best interests of the company and that the plaintiff is not acting with a lack of good faith.

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