THE EFFECT OF THE NEW TURKISH COMMERCIAL CODE ON ACQUISITION FINANCE AND PRIVATE EQUITY INVESTMENTS:

A Presentation by **Ece Güner, Managing Partner of Güner Law Office**
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Ladies and Gentlemen, Good afternoon;

In my presentation today, I will first talk of the effect of the new Turkish Commercial Code (**new TCC**) on acquisition finance, and then will very briefly outline a few other important changes brought by the new TCC.

1 The effect on acquisition finance

With the enactment of the new TCC, a prohibition with respect to financial assistance has been introduced into Turkish law for the first time. Article 380 of the new TCC prohibits the provision of an **advance**, **loan** or **security** by a company for the purpose of the acquisition of its own shares by a third party. Accordingly, financial assistance provided in breach of this rule will be null and void. The new TCC brings only two exceptions to this prohibition;

(i) it will not apply to transactions performed by banks or financial institutions in their ordinary course of business; and

(ii) it will not apply to transactions effected for share acquisition by the employees of the company or the employees of a subsidiary company.

If, however, these exempted transactions may have the effect of reducing the reserves of a company below certain levels, even such transactions may result in being null and void.

Please note that it is argued that the exception (i) above could be interpreted in a broad manner. However, our initial view is that such exemption cannot really provide a strong relief as it will most certainly be interpreted in a very limited manner, as is the case in the EU. Therefore, the said exception should be basically limited to bank shares acquisitions.

This Article 380 of the new TCC is based directly on and almost copied word-by-word from the Second Council Directive of the European Union (77/91/EEC) (**Directive**). Indeed, in its primitive form when adopted in **1976**, the Directive prohibited financial assistance by public companies for the acquisition of their own shares. The underlying rationale of this prohibition at the time was to protect the creditors and shareholders of public companies from possible abusive conduct by the controlling shareholders in takeover situations.

What happened from 1976 until 2006 is that EU Countries all followed the Directive for public companies. While some countries (like Belgium or Spain) extended the same prohibition in a strict manner and applied it to private companies, others (like the UK) adopted a more liberal regime for private companies with the so-called “white wash” regime, which permitted a stronger growth of the LBO market in the UK.

What happened then however is that at the EU level, people realised that the implementation of the financial assistance prohibition went beyond the initial legislative intent, and constrained the modern European LBO markets. The European Commission amended the relevant provisions of the Directive in **2006**. The amendments introduced gateway procedures whereby even public companies could provide financial assistance as long as certain conditions were satisfied. The conditions are basically as follows:

- the financial assistance must be at reasonable market conditions (i.e. on an arm’s length basis, in terms of interest received, financial credit-worthiness of the acquirer etc.);

- the board of directors (**Board**) of the company must present a report to its shareholders on the proposed financial assistance;

- the proposed transaction must be approved by the general assembly of the target company (**OpCo**) by an affirmative vote of the shareholders representing at least two-thirds of the share capital;

- the aggregate amount of financial assistance shall at no time result in the reduction of the net assets of the OpCo below the amount of the subscribed capital plus non-distributable reserves; and

- a reserve shall be set aside by the OpCo equivalent to the amount of the financial assistance.

What we criticise in the new TCC’s Article 380 is that; (1) it takes the old Directive of 1976 as its basis, rather than its more evolved 2006 form and (2) it applies the prohibition equally to public and private companies, going even beyond the intent of the old-dated and conservative Directive of 1976.

If Article 380 remains in its current form, what will be the possible effect on acquisition finance in Turkey?

It is certain that it will prevent direct financial assistance; provision of loan, advance or security by the OpCo[1]. But will it also prohibit certain structures like the merger of the holding company (**HoldCo**) with the OpCo? This is more of a grey area.

Several academicians we have discussed the matter with believe it will prohibit such structures too, because the reasoning of the law states that the Article 380 should be applied and interpreted very broadly and comprehensively and therefore any structure having the eventual effect of putting the assets of the OpCo in the picture for the repayment of the acquisition finance would be seen as falling within the ambit of this restriction.

[1] We have heard some debate as to whether a HoldCo will be prohibited from creating security interest on its own assets for the purpose of acquiring OpCo’s shares. We would like to clarify that the prohibition in Article 380 does not of course apply to the scenario where the HoldCo creates security interest over its own assets. Therefore, a HoldCo can of course, for example, pledge the shares it owns in an OpCo.

On the other hand, there are also strong arguments to claim that the “merger structure” should not fall within the scope of this prohibition, as minority shareholders and creditors rights would generally be protected under the new TCC and Capital Markets Board regulations.

Particularly, under the new TCC rules on mergers - applicable to both public and private companies - very strong levels of controls and protections are brought in; the Boards of the relevant companies have to prepare a detailed merger report and a detailed merger agreement; these are then submitted to the shareholders’ approval, but also to a transaction auditor’s review. The board report, the merger agreement and the auditor report on the matter are all to be published, including for private companies. The new TCC very clearly provides that the shares given to the shareholders of the merged (dissolved) company must reflect true value. [Only mergers where one of the shareholders owns at least 90% of the shares in the company are exempted from this procedure, but in such case, the 90% shareholder must buy-out the 10% minority at a “fair price”, the whole matter proceeding under court and auditor scrutiny.]

And what about the protection of the creditors of the merged/dissolved entity? The new TCC clearly provides that the merged entity shall give appropriate security to the receivables existing at the time of the merger, within 3 months from the merger taking effect.

As seen above, in case a future transaction would be challenged and brought before the courts, there are some serious arguments to claim that the merger itself is subject to sufficient protective rules to make sure no shareholder or creditor is damaged and therefore the extension of the financial assistance prohibition to it is unnecessary and misplaced.

Nevertheless, uncertainty is never a good thing in law, and it would be better if Article 380’s exact scope of application would be clarified and preferably amended.

We believe that Article 380 should either be clarified or be amended to be aligned with the EU’s current approach on financial assistance; in other words, apply only to public companies, and even there, be permitted under certain conditions. Otherwise, there is a risk that acquisition finance will be adversely affected, and thereby potentially affecting the growth in capital entry in Turkey. We believe that the current draft of Article 380, rather than being a wilful intention of the Turkish legislator, is mostly due to the fact that the academic commission drafting the new TCC started its works before the revision of the Directive in 2006 and based itself on the older, more conservative text. As Güner Law Office, we are involved in the working committees within the Ministry of Science Technology and Industry as part of the promotion of the investment environment meetings, to try to improve certain provisions of the new TCC and this is certainly one of them.

2 A few points of interest in the new TCC

As we all very well know, the financial assistance prohibition is not the only novelty introduced by the new TCC. The new TCC, overall, constitutes an important improvement to and modernisation of Turkish company law.

It would -of course- not be possible to address all novelties introduced by the new TCC and the issues to be considered by Turkish companies and potential investors in such a limited time frame. However, I will try to mention some of the more fundamental changes that might be of interest to this audience.

2.1 A focus on transparency and modern accounting which should facilitate acquisitions:

First of all, the new TCC brings a major focus on transparency. Until today, non-listed Turkish companies were pretty much utter "closed-boxes". One would not really know what to expect from them until a full due diligence was conducted. According to the new TCC, all companies, whether public or private, will be required as of July 2013, to have a web-site with very comprehensive information on the company. The web-site will include comprehensive financial information on the company (board reports, auditor reports etc.), including, for example, even the remunerations of top management!

Overall, this is a very good improvement, and a strong level of transparency will no doubt facilitate PE firms' efforts to locate interesting target companies, and should certainly reduce the risk of facing major surprises once one reaches the due diligence phase of the deal.

Nevertheless, we believe the level of disclosure required (and the penalty – including jail sentence – attached to an insufficient disclosure) is excessive and should ideally be softened until July 2013 to apply only to public companies, with a lighter disclosure burden on private companies. Most EU Countries stipulate such exemptions in their legislation and do not prescribe such extensive disclosure requirements for private companies.

Another helpful improvement brought by the new TCC is the alignment of Turkish accounting standards with the IFRS as of January 2013, and the need for the accounts to be audited. This will make Turkish accounts more "understandable" to international investors. Potential buyers and sellers will hopefully be "speaking the same accounting language" and accounts data should be more reliable, which again, should strongly help the transaction environment.

A final important comment in this respect is that a very strong role is given to audit firms on a broad range of issues throughout the new TCC such as accounts auditing, control/special audits of certain corporate decisions (like capital increases, mergers etc.) and control of intra-group company dealings. Furthermore, rules similar to the Sarbanes-Oxley Act are imposed to ensure auditors' independence. All these rules apply without distinction to both public and private companies under the new TCC. Therefore, even though we believe the new TCC has gone too far in some of these requirements (and we believe some should be softened), generally, they constitute steps in the direction of better corporate governance.

2.2 Flexibility brought in the governance of companies

Certain simple but important flexibilities are introduced into the ways in which companies were governed and organised until today. For example, single shareholder companies will now be permitted. There will no longer be the need to find 4 more nominal shareholders.

Similarly, a Board composed of only 1 Board member will be permitted. And legal entities will be allowed to be Board members themselves; allowing them to replace their representative with a simple letter to the company, without the need for a general assembly or a Board meeting.

Flexibilities have also been introduced into the Board's appointment and decision-making processes. The Directors will be able to delegate their powers and responsibilities to professional managers. In line with this novelty, the concept of "*absolute responsibility*" of the directors will be abandoned and in its place, the modern corporate governance approach of top management accountability will be introduced.

2.3 Limitation on privileged shares

The new TCC limits the number of voting rights that can be granted as a privilege to 15 votes / share.

But more importantly, it introduces a serious limitation on privileged shares in public companies. As of the entry into force of the new TCC in July of this year, in public companies, only up to half of the Board members of the company will be appointed based on a privilege. Therefore, a shareholder which does not own a simple majority of the shares of a listed company will not be able to appoint the majority of the Board based on privileged shares. This is an important restriction that needs to be considered by companies that are planning to go public.

Existing public companies will not be affected by the restriction if such privileges were already in place before 13 January **2010**; these will be considered as "acquired rights".

2.4 Prohibition of company loans to shareholders

As you know, many Turkish companies keep current accounts with their shareholders. Therefore, it is not uncommon to observe shareholders who are indebted to the companies they hold shares in. Once the new TCC comes into effect, companies will not be permitted to provide loans to their shareholders anymore. However, if certain conditions are met, it will be possible for companies to provide "advance dividends" to their shareholders. This nevertheless is an important change to and restriction on the way business is currently conducted.

The existing debts of the shareholders will need to be paid back to the company in cash, within 3 years of the new TCC coming into effect.

2.5 Specific performance of put/call options and tag/drag along rights

The specific performance – in other words, enforceability – of concepts such as put and call options has long been debated under Turkish Law.

> **Limited liability companies:** The new TCC brings clarity to this issue by stating explicitly that it will be possible to include put option, call option, tag along and drag along provisions in the Articles of Association (**Articles**) of limited liability companies. It provides that these rights will be fully binding and enforceable in these companies. Unfortunately, limited liability companies are not likely to become more popular for the structuring of transactions due to the continuing taxation disadvantages.
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> **Joint stock companies:** The new TCC does not contain any provision with respect to put option, call option, tag along and drag along rights for joint stock companies. Furthermore, it lists the issues that will be included in the Articles of joint stock companies and provides that the Articles will basically not be allowed to deviate from such list.

As a result, it will be prudent to assume that it will not be possible to include put/call options, or tag along/drag along rights in the Articles of joint stock companies once the new TCC comes into effect. It will, however, still be possible to include such provisions in shareholders' agreements and to secure their compliance through penalty clauses, blank endorsements or escrow mechanisms (albeit there are theoretical debates regarding the validity of the latter two under Turkish Law). Alternatively of course, it will still be possible to establish these rights at the level of a HoldCo/SPV that is set up in a jurisdiction fully recognising these rights. Such an SPV company would own the Turkish operating company. A Turkish limited liability HoldCo/SPV would also be possible; however, the share transfer tax that would incur on transfer of limited liability shares would probably render this option impracticable.

Generally, it is important to note that for share transfers in joint stock companies, the legislator has taken the approach that the fundamental principle should be "freedom of transfer". The new TCC requires the Board to demonstrate an "important reason set out in the Articles" of the company to refuse to register/accept a share transfer. Alternatively, the Board may refuse to register a share transfer if it proposes that the company, the majority shareholders or even a third party buys - at their "true value" - the shares that are proposed to be transferred. This should generally reduce the risk of a Board resisting a share transfer and not offering an alternative solution to the minority shareholders wishing to exit the company. This has obviously pros and cons. On the one hand, it may facilitate exits in certain circumstances while benefitting all parties, not only the PE investor. These new rules will have to be carefully taken into consideration when structuring an acquisition from now on.

2.6 IPO at incorporation phase

One of the noteworthy novelties that have been introduced by the new TCC is the possibility for joint stock companies to make IPOs during/as a part of their incorporation process. Accordingly, the founding shareholders of a joint stock company may state in the Articles that a certain portion of the company's shares will be offered to the public within 2 months of the company's incorporation. Accordingly, proceeds that will arise from the offering will be paid to the company as capital contribution.

2.7 Minority Rights

Generally, shareholders' rights will gain prominence with the New TCC. For example, the new TCC substantially extends the shareholder's right to information. Shareholders will be entitled to request to review intra-group transactions and demand compensation if there is abuse. They will have the right to ask for a special audit on certain matters. Furthermore, minority shareholders will have the right to request the dissolution of the company from the courts. Of course, dissolution would require a just cause and it would be a last resort mechanism. However, the existence of this option may serve as a pressure tool against abusive behaviour by majority shareholders.

In joint stock companies, the annual activity reports of the Board will need to be very detailed. As you know, the current TCC does not have any such detail requirement. In many private joint stock companies, the Boards submit very short, one paragraph texts as their annual activity reports. They will now have to contain certain financial information as well as the Board's interpretation of the financial situation of the company. Furthermore, potential risks that the Company may face and the financial benefits of the Board members need to be pointed out. The accuracy of the financial information provided in these reports will be subject to scrutiny by the company's independent auditor, whose negative opinion may lead to serious consequences. In the event that the independent auditor issues a "negative" report (or an "abstaining" report), the general assembly will not be entitled to decide on a dividend distribution and the Board will be forced to resign and call for a general assembly meeting in which a new Board will be elected.

2.8 Novelties regarding capital structure

2.8.1 Registered share capital

Until now, it was possible to adopt the registered share capital system only in public companies. The new TCC allows this for private joint stock companies, too. Accordingly, it will be possible to set a registered capital ceiling and the Board will be allowed to increase the share capital up to such ceiling.

2.8.2 Conditional Capital Increase

Another interesting novelty is the introduction of the "conditional capital increase" concept which basically sets forth the possibility of “equity kickers” and “debt-to-equity swaps”. This should allow some interesting new structuring possibilities.

2.8.3 Companies’ acquisition of their own shares

PE investors often request (or desire), as a possible “exit” mechanism, that companies they invest in are able to buy their own shares. Until now, this was not possible for Turkish companies. The new TCC allows this to a certain level: up to 10% in joint stock companies and 20% in limited liability companies. Although the thresholds are low, we see this as an improvement for minority PE investments. Furthermore, the general assembly can give a 5-year authorisation to the Board to implement this instrument, and in certain situations, the Board can implement it directly even without being subject to such an authorisation.

2.8.4 Group Companies

The new TCC has also introduced for the first time an extensive definition of group companies. A group company is not defined by reference to shareholding levels but to the notion of "control", including control through contractual arrangements. The new TCC sets forth important requirements in terms of disclosing intra-group transactions and imposes a duty of "compensation/adjustment" within the same year, in case a transaction was made to the benefit of the parent (or another group company) and to the detriment of a specific subsidiary. These are generally welcome arrangements for minority investors in a subsidiary part of a larger group, as it rationalises intra-group arrangements.

2.8.5 Merger transactions

As I have mentioned in the first part of my speech, the new TCC introduces a clearer and more rational process for merger transactions. Such rules should help facilitate the merger process.

Two important novelties that have been introduced by the new TCC are the abolition (subject to certain exceptions) of the requirement for the merging companies to be of the same company type (e.g. joint stock company, limited liability company) and the possibility of a squeeze out: if it is specifically set out under the merger agreement and 90% of the merging company's shareholders vote as such, it will be possible to squeeze out the minority shareholders (the remaining 10%) by paying the value of their respective shares. Furthermore, the courts’ involvement has been “replaced” by an Auditor Report.

The new TCC's focus on transparency will affect merger transactions, too. Accordingly, certain documentation will be made available by the merging companies to a broad range of interested parties. These include the merger agreement, the merger report, the audit report and the financial tables of the company. Such information will also be disclosed on the company's official website.

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