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# *Recent Developments in Turkish Commercial Law and a Brief Legal Market Overview*

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Turkey has been going through some extensive legislative changes recently that will have significant effects on businesses related to Turkey. The new Turkish Commercial Code ("New TCC") and the new Turkish Code of Obligations ("New TCO"), both enacted in January 2011 and effective from July 1, 2012, are expected to have significant impact on Turkey's role to attract international capital to further boost its economy. Whilst the recent legal reforms intend to harmonize Turkey's legal system with the EU law, Turkish law continues to show many particularities, especially with regards to capital markets law and banking regulations that need to be assessed with diligence. Thus, most of the new provisions will require further clarification in secondary legislations that are yet to come.

Major impacts of the New TCC and New TCO are expected in private equity business, for which Turkey has been an attractive market for a considerable time now. Furthermore, M&A, general corporate law as well financing practices are expected to be affected from the recent reforms, mostly in a positive way, whereas some uncertainties continue to remain. Besides the recent reforms, Turkey continues to remain as a rather unattractive market for restructurings, whereas this is also expected to change as Turkey's financial and legal markets evolve and become more integrated with international markets and practices.

This newsletter intends to provide summary information about the New TCC and the New TCO with respect to certain fields of commercial life.

## I. GENERAL CORPORATE LAW

### *A. Incorporating Companies with a Single Shareholder*

Prior to the New TCC establishment of a joint stock company required at least 5 shareholders, an limited liability companies required at least 2 shareholders. Under the New TCC, joint stock companies and limited liability companies may be incorporated with a single real or legal person shareholder. This will ease the company establishments for foreign investors in Turkey and save them from going into mandatory partnerships with local entrepreneurs or look for single-share shareholders just to fulfill the minimum shareholder requirements of the old commercial law system.

### *B. Regulating Group of Companies*

The New TCC introduces a new concept for "*group of companies*", which has its roots in the continental European legal systems. The New TCC intends to preclude the parent company's abuse of control over its subsidiaries and cause to incur losses, and they provide for more transparency. The term control is defined broadly and includes the shareholding levels, any kind of parent's ability to control the decision making via voting rights or via contractual arrangements such as

control agreements. The provisions of the New TCC concerning the group of companies will be applicable, if either the parent or the subsidiary company has its seat in Turkey. The new structures introduced by these provisions include, among others:

- A parent company's obligation not to cause losses for its subsidiary and to compensate the losses caused within a one year period;
- The right of a parent company holding 100% of the shares or voting rights of its subsidiary to give instructions in line with the group's policies, regardless of whether such transactions are to the detriment of the subsidiary or causes losses, provided that such instructions don't explicitly exceed the subsidiary's ability to pay, jeopardizes its existence or results in losses of material assets. This is likely to create difficulties for leveraged finance structures in which the cash or assets of the subsidiary are made use of for securing the parent company's borrowings from third party lenders.
- Minority shareholders can be excluded by the newly introduced squeeze-out mechanism for group of companies, provided that the parent entity directly or indirectly holds at least 90% of the shares or voting rights in the subsidiary and a just cause for the squeeze-out as described in law exists.

### *C. Introduction of IFRS and IAS Standards and Publicity Requirements*

The New TCC introduces new accounting and financial reporting standards for Turkish equity companies. Accordingly, financial statements of joint stock companies, limited liability companies and group of companies must be prepared by independent external auditors in accordance with the IFRS and such financial statements will be audited according to IAS. Such financial statements will be published on the company's website, which must be launched by equity companies and must contain general information about the relevant company. These changes to achieve internationally recognized standards are expected to boost the M&A practice and increase integration of Turkish businesses with the international market. However, new amendments to the New TCC are being expected that will restrict the scope of provisions concerning the independent external auditors and launching websites to companies having revenues and employee numbers above the limit that will be determined by the proposed amendment.

### *D. New Provisions concerning Mergers / Spin-offs / Changes of Company Type*

With the New TCC, the old and complicated system of mergers has been abandoned. Instead, a "fast-track merger" mechanism between a parent and its 100% subsidiary, as well a unilateral squeeze-out right for shareholders holding at least 90% equity in case of a merger (especially in leveraged finance deals where financing banks want to hold a stake in the company) have been introduced. These developments will be welcomed by private equity investors for facilitating better deal structuring.

### *E. Electronic Voting and Virtual Board and Shareholder Meetings*

The New TCC permits online board and shareholder meetings executed by electronic signatures for joint stock companies. This seems to make such meetings for foreign investors and funds much easier to hold and administer their portfolio companies.

### *F. More Freedom of Regulation in Limited Liability Company Articles*

The New TCC permits the drafting of complex share transfer rights and restrictions as well as additional contribution duties on shareholders in the articles of a limited liability company for the first time. However, this does not apply to joint stock companies. In light of these restrictions, it is expected that the importance of shareholders agreements for joint stock companies will increase in the practice.

## II. CORPORATE FINANCE PRACTICE

### *A. Conditional Capital Increase and Authorized Capital*

Under the New TCC regime it is now possible for closed joint stock companies and limited liability companies to make use of the conditional capital increase such as for issuing debt instruments to satisfy the financing needs of their companies. Moreover, closed joint stock companies can now also use the authorized share capital system. Before the New TCC, such measures were only possible for listed joint stock companies under the capital markets law.

### *B. Introduction of Mezzanine Financing Tools for Not-listed Companies*

The New TCC makes it also for closed joint stock companies and limited liability companies possible to have access to mezzanine financing tools such as convertible bonds and bonds with stock purchase warrants which were only permitted for listed companies under the capital markets law.

### *C. Participation Certificates for Limited Liability Companies*

The New TCC introduces radical changes especially for limited liability companies to support the more frequent use of this company form in the business life. One other example is the introduction of the right to issue certificates to participate in the profit, liquidation or right to purchase new company shares to be issued, which will give more financing opportunities to the shareholders of a limited liability company who want to maintain their shareholding structure at the same time.

### *D. Share Buybacks*

The New TCC permits the acquisition of own shares by the equity companies up to 10% of the company's share capital, provided that the net assets of the company after the payment of price for the acquired own shares covers at least the sum of the registered share capital amount and mandatory capital reserves as required by law. The same rule applies if a subsidiary intends to acquire shares of its parent company.

### *E. Company - Shareholder Transactions and Shareholder Loans*

For joint stock companies, the New TCC regulates that shareholders may only be indebted towards the company - except for capital subscription - provided that they have paid all their due capital subscriptions and the company's profits together with the free reserves are at a sufficient level to meet the previous year's losses. The provisions regarding the intra-group transactions are reserved and these restrictions will not apply to them. Also banking law provisions are exempt from these new rules.

## III. IMPACTS on M&A and PRIVATE EQUITY PRACTICES

### *A. Prohibition of Financial Assistance*

Prior to the New TCC, leveraged buyouts could easily be carried out through financial assistance due to the lack of regulation under the old commercial law regime. With the introduction of the financial assistance ban based on the EU regulation, it will no longer be possible for joint stock companies to provide loans or collaterals in view of acquisition of their own shares. Therefore, the newly introduced merger mechanisms are expected to be practiced more frequently in private equity deals. Conversion of the target joint company into a limited liability company may also help to structure the financing of transactions.

Moreover, the rules on group of companies mentioned under Section I.B above also restrict intra-group transactions and hold parent companies liable for damages incurred by their subsidiary entities. This seems like another obstacle before private equity backed leveraged buyouts. The banks and investors should work hard through this strict legal environment with alternative

solutions such as taking advantage of the improved merger provisions in the New TCC. Additionally, the provisions on group of companies may also be favoring for private equity investors, especially in cases of 100% shareholding.

### *B. Merger Squeeze-out*

The unilateral minority squeeze-out will allow private equity funds holding at least 90% stake in the target company to structure mechanisms for buying out remaining shareholders in the target company.

### *C. Legal Person Company Directors Allowed*

A very important development introduced by the New TCC is the possibility of assigning legal entities as board members of joint stock companies and as managers of limited liability companies. This way, foreign shareholders in Turkish entities will not be obliged to assign a real person each time they want to hold a position in the management of such company. This development should benefit private equity investors who want to limit the liability of their directors. Moreover, the requirement of being a shareholder to become a board member at a joint stock company has been abolished which will help foreign investors to manage their portfolio companies easier.

### *D. Limits on the Content of Articles of Joint Stock Companies*

Even though the New TCC gives more freedom to regulate the articles of limited liability companies, it also limits the contents of the articles of joint stock companies. This may mean that private equity investors will not be able to introduce share transfer rights or restrictions such as drag/tag along rights and put/call options. As a result, it is expected that the private equity investors will start relying more on shareholders' agreements or maybe even rule out an exit by way of an IPO due to these complexities associated with the joint stock companies.

### *E. A majority board will be less able to block share transfers*

Under the New TCC, contrary to the old regime, a majority board of a joint stock company may not prevent a share transfer at its discretion, instead, it now requires 'important' reasons for its objection to do so. However, the board may reject a share transfer and instead of this it may require the company, the majority shareholders or third parties to buy such shares at a fair value. It is unclear how the application of such mechanism will develop in practice but it would be wise to safeguard share transfer rights properly.

## IV. BANKING PRACTICE

Besides the recent legislative reforms, Turkish banking law remains to be a specific field with special provisions. In addition to the banking laws, the frequent control and regulations enacted by the Banking Regulation and Supervision Agency ("**BDDK**") regulate the banking sector in Turkey in a unique and complex manner.

### *A. New Regulation on Capital Adequacy*

The new Regulation on the Calculation and Evaluation of the Capital Adequacy of Banks enacted by the BDDK and effective as of July 1, 2012 aims to regulate the procedures and basis of banks holding sufficient amount of both consolidated and non-consolidated capital against the possible losses in the framework of the Basel II regulations.

### *B. The New TCO and General Terms and Conditions of Financing*

The New TCO codifies the provisions regarding general terms and conditions in contract law which have been expected for a long time. The New TCO provides for material legal consequences such

as those terms and conditions may be void and unenforceable. Therefore, financing contracts should comply with the requirements of the New TCO ensure their enforceability.

### *C. New Surety Provisions*

The New TCO introduces new rules on surety as a very common type of personal guarantees. The newly introduced rules intend to protect real person surety (or also guarantee) providers (such as the requirement of the previous consent of the spouse of the surety provider or introduction of the upper limit of 10 years for a real person's surety) and generally do not apply to corporate guarantees in negotiated and structured transactions. However, the strict form requirements for the establishment of a surety apply also to legal entities.

## V. RESTRUCTURING AND INSOLVENCY PRACTICE

Turkey has a rather underdeveloped restructuring and insolvency practice. Due to this fact, it has not been able to attract considerable amount of investors specialized on restructurings on international level. This is mainly based on the nature of formal procedures provided under Turkish law. However, this is expected to change due to the rapidly growing economy and integration with the international markets.

Turkish legal system provides several formal procedure types. These are: voluntary bankruptcy applicable to joint stock and limited liability companies; bankruptcy (ordinary, special and direct bankruptcy); and the postponement of bankruptcy available to joint stock and limited liability companies. In addition to these mechanisms, there is a rather formal and less practiced *concord restructuring mechanism* and a rather new mechanism of '*amicable restructuring*' available only for joint stock and limited liability companies and cooperatives. It is expected that the Turkish insolvency law will need to be amended in the near future to make the Turkish market attractive also for restructurings.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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