



ENFORCEABILITY OF SHAREHOLDERS AGREEMENTS

Shareholders' agreements are commonly used in M&A transactions, whereby investors (either private equity funds or corporations active in the same sector as that of the target) become shareholders in the target. Existing shareholders and investors sign shareholders' agreements for the purpose of governing the shareholders' rights and obligations towards each other, as well as the company.

Shareholders' agreements are not specifically dealt with under Turkish law. According to Turkish legal scholars, shareholders' agreements have the nature of a constitution for shareholders that are party to the agreement. Different legal systems in different countries accept the premise that shareholders' agreements differ from the articles of association, the execution of which is a statutory requirement for the establishment of a corporation in almost every country, including Turkey.

As a result of their flexibility regarding the articles of association, subject to the limitations of corporate law, shareholders' agreements generally contain provisions that cannot be included in the articles of association, such as provisions relating to:

- the company's financing, grounds for termination;
- non-compete undertakings;
- loyalty obligations;
- redemption rights; and
- personnel, investment and profit policies.

These agreements do not fall within the scope of corporate law, but are deemed agreements executed in line with the principle of the freedom of contract set forth in the Turkish obligations law. As such, contrary to the articles of association, a shareholders' agreement binds only its signatories, not other existing or future shareholders.

In shareholders' agreements, the parties almost always agree on share transfer-related provisions (eg, put options and call options, drag-along and tag-along rights and rights of first refusal) in an effort to make share transfers conditional in one way or another or to facilitate the exit from the corporation. However, in the event of breach of these provisions, it is difficult to enforce these rights.

Possible remedies in event of breach

Under Turkish law, shareholders' agreements are not corporative and the law applicable is the Turkish Code of Obligations. Accordingly, possible remedies under the general provisions of the Code of Obligations must be looked into and a legally and practically applicable remedy in the event of breach of shareholders' agreements must be defined. Remedies in the event of a breach of obligations under the Code of Obligations include:

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- specific performance and compensation due to the delay in performance of the relevant obligation;
- compensation due to non-performance instead of specific performance; and
- rescission or termination of the contract.

The non-breaching party is free to choose which remedy to request. It may be argued that specific performance of a debt is always preferable to other alternatives. However, specific performance may not always be possible. As for shareholders' agreements in particular, the specific performance of tag-along and drag-along rights, rights of first refusal, call options and put options may be problematic.

Right of first refusal

A right of first refusal grants the holder the right to buy the shares of another shareholder if that shareholder wants to sell its shares to a third party. As such, the transferring shareholder is obliged to offer to sell its shares to the holder of the right of first refusal. However, if the transferring shareholder breaches this obligation, the holder of the right of first refusal will most likely be unable to demand specific performance, as the shares at stake will have most likely been transferred to a third party, which makes specific performance legally impossible. As a result, the holder of the right of first refusal may claim compensation from the transferring shareholder.

The right of first refusal should not be confused with the statutory pre-emptive purchase right under the Commercial Code. The pre-emptive purchase right grants existing shareholders the right to buy newly issued shares in the event of a capital increase *pro-rata* of their shareholdings. If this right is infringed and the newly issued shares are transferred to third parties, shareholders have the right to demand specific performance, by means of which the transfer of shares to the third party will be deemed null and void by a court decision.

Drag-along and tag-along rights

There are also practical constraints with regard to the enforcement of drag-along and tag-along rights in particular. 'Drag-along' clauses allow a shareholder to drag along a reluctant shareholder in the event of an exit if a potential buyer wishes to acquire more than the stake of the transferring shareholder. However, 'tag-along' clauses are designed to protect minority shareholders in the event that a majority shareholder decides to exit the corporation. Minority shareholders have the right to be bought out, on a *pro-rata* basis, along with the majority shareholder.

Exit rights, including drag-along and tag-along rights, are not regulated under Turkish law and execution of these rights may thus be problematic. In case of a dispute between the shareholders, the courts will not render a specific performance decision, but instead will grant monetary compensation to remedy the drag-along or tag-along rights related breaches. Delivering the share certificates with a blank endorsement to an escrow may be an alternative to secure enforcement.

Call options and put options

A 'call option' entitles a shareholder to require other shareholders to sell their shares, whereas a 'put option' entitles a shareholder to require the other shareholders to acquire its shares. The exercise of the call or put option may be made subject to a particular time period or the occurrence of a particular event. The majority shareholders generally want to

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have a call option right, while the minority shareholders want to have a put option right, to strengthen their exit rights from the company.

In the event of breach of call option or put option rights, shareholders are entitled to demand specific performance. The specific performance will be the transfer of the shares by the breaching shareholder to the shareholder exercising a call option. When demanding specific performance, the shareholder exercising a call option should declare its readiness to pay the total value of the shares to be transferred. As for the put option, specific performance will be payment of the value of the shares to be transferred. The shareholder exercising a put option should declare its readiness to transfer its shares. In theory, the courts can render a specific performance decision, unless there is a legal impossibility.

Many scholars suggest that execution of a specific performance decision on a call option is possible in accordance with Article 24 of the Execution and Bankruptcy Law. This article regulates the execution of decisions requiring delivery of moveable assets. In such case the execution office orders the debtor to deliver the moveable assets in question to the execution office within seven days, failing which the execution office clerk can take over the moveable assets in question by force.

In a joint stock corporation where the shares are represented by share certificates, specific performance of a call option will be realised by way of delivery of the share certificates. If the breaching party does not voluntarily deliver the share certificates, the execution office clerk is entitled to take them over by force. Specific performance of a put option is relatively easy, as it involves payment of the value of the shares. Upon a specific performance decision, the execution office will send a payment order to the breaching party and order the payment in seven days, failing which the breaching party's assets can be attached.

Execution officers have yet to conduct this process in practice. The absence of such a precedent gives some cause for caution among legal practitioners advising on M&A transactions. Although there is no precedent on the execution of a specific performance decision, a recent Court of Appeals decision which underlined the possibility of specific performance of a call option is encouraging.

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