KOLCUOĞLU • DEMİRKAN
HUKUK BÜROSU • ATTORNEYS AT LAW

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New Turkish Commercial Code: Impact on Private Equity Investments

The New Turkish Commercial Code[1] (the "**New TCC**") entered into force on 1 July 2012[2] and introduced major changes to the corporate environment in Turkey. The New TCC will have significant effects in terms of structuring private equity investments in the Turkish market. Private equity firms interested in investing in the Turkish market, as well as those that are already active in Turkey should consider these changes when structuring their acquisition strategies. The purpose of this bulletin is to provide an overview of the significant changes in light of the new legal concepts introduced by the New TCC and their primary effects on private equity investments.

A. Single Shareholder Companies

The New TCC allows joint stock corporations (the "**JSC**"s) and limited liability partnerships (the "**LLP**"s) to be incorporated by a single shareholder. Such single shareholder can either be an individual or a legal entity. Accordingly, private equity firms are no longer required to find and appoint nominee shareholders to fulfill the "five shareholder requirement" in JSCs.

B. Capital Structure

The New TCC increases the minimum share capital for LLPs to TRY 10,000 while this amount is still TRY 50,000 for JSCs. Furthermore, non-public JSCs are now also allowed to adopt the registered capital system. Under the registered capital system, the board of directors (the "**BoD**") will simply need to adopt a resolution to increase the capital of a non-public JSC up to an amount determined in the articles of association (the "**AoA**"), instead of amending the AoA through convening the general assembly. By adopting the registered capital system, Turkish non-public JSCs will be able to make simpler and faster capital increases in portfolio companies.

There is another salient novelty of the New TCC. JSCs are now allowed to purchase their own shares. This can be used for a variety of purposes ranging from decreasing capital to stabilizing the trading price of floating shares in the stock exchange.

C. Management and Representation

In contrast to the former Turkish Commercial Code[3] (the "**Former TCC**"), which required the BoD to be comprised of at least three members, the New TCC introduces the possibility

[1] Published in the Official Gazette dated 14 February 2011.

[2] Amended by Law No. 6335 regarding the Amendment of the Turkish Commercial Code and the Law on Effectiveness and Implementation of the Turkish Commercial Code, published in the Official Gazette dated 30 June 2012.

[3] Published in Official Gazette dated 29 June 1956.

of BoDs to be composed of only a single individual or legal entity. Moreover, being a shareholder is no longer a prerequisite for becoming a BoD member. Under the Former TCC, only individuals could be BoD members. The New TCC allows legal entities to become BoD members. Private equity firms may represent themselves as the legal entity BoD members of the JSCs. The legal entity BoD member is required to elect an individual to represent the legal entity in BoD meetings. However, the liabilities of the BoD member will be bestowed on the legal entity itself, not on this individual representative. Accordingly, private equity firms' executives will not need to be concerned about their liabilities as a BoD member.

D. Distribution of Advance Profits (*Kar Payı Avansı*)

The New TCC allows distribution of profits in advance for both JSCs and LLPs. The principles and procedures of this system are regulated by the recently enacted communiqué (the "**ADP Communique**").[4] Under the ADP Communiqué, profits distributed in advance are calculated based on interim financial statements. In order to distribute advance profit, first, the company's interim financial statement(s) must show profit. Second, the general assembly must adopt a resolution to distribute advance profit. The losses of former years, taxes, funds and financial reserves, statutory reserves, and ancillary items,[5] if any, are taken into consideration while calculating the advance profit to be distributed. The sum of these items is deducted from the profit earned in the interim period (the "**Net Interim Profit**"). The maximum amount of advance profit to be distributed cannot exceed ½ of the Net Interim Profit.

This new system enables private equity firms to streamline profits generated by the target Turkish company upwards earlier. Although there are certain pre-conditions, this tool is particularly useful if the repayment of the acquisition financing is serviced / paid by the parent investment vehicle of the target company.

E. Financial Assistance

Certain rules introduced by the New TCC are not too positive for private equity firms. Under the New TCC, financial assistance is restricted. This restriction has been introduced in light of the Second Council Directive 77/91/EEC (the "**EC Directive**")[6] Accordingly, JSCs are prohibited from engaging in any transactions such as granting loans, advancing funds or providing security for the acquisition of their own shares (the "**Prohibition**"). There are two exceptions. The Prohibition is not applicable for (i) transactions by banks or other financial institutions and (ii) transactions conducted for the purchase of shares by the company's employees or its subsidiaries, provided that the company's reserves are not reduced as a result of such transactions.

The Prohibition significantly affects the scope of the security package in acquisition financing. The target company will not be able to provide its assets as collateral to secure the acquisition financing that may be used by private equity investors. There are no "white-wash" exemptions either. That said, the buy-side will still be able to pledge the shares of the target company as security, since the shares are not the assets of the target company. Nevertheless, the shrink in the security package of acquisition financings may increase the

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[4] The Communiqué regarding the Advance Distribution of Profit was published in the Official Gazette dated 9 August 2012.

[5] These ancillary items comprise of the amounts reserved for privileged shareholders, usufruct right certificate holders and other persons participating in the profit.

[6] The provision regulating financial assistance is not in line with the current EC Directive. The EC Directive has been amended by Directive 2006/68/EC of the European Parliament and of the Council.

cost of loans, since lenders would be inclined to price such shrink in the security package and reflect it as credit cost.

F. Group Companies

The New TCC introduces "Group Company" rules to prevent parent companies from abusing the sources/assets of their subsidiaries to the detriment of the minority shareholders and creditors and provide extra protection for their interests. In a group company structure, the parent company takes financial and organizational control over the subsidiary company. The New TCC does not contain a clear definition of what "dominant position" is, but states which aspects regulate the relationship between the parent and the subsidiary.

The New TCC prohibits the parent company from abusing its dominant position in a way to harm its subsidiary. If the subsidiary incurs any loss arising from the parent company's abuse of dominant position, the parent company must compensate such loss. If the parent company fails to compensate the financial losses of its subsidiary within the same fiscal year or to grant a claim right to its subsidiary company equal to such loss, the subsidiary's shareholders or creditors may ask the parent company or the parent company's directors to indemnify the subsidiary company for its loss. The shareholders may also file a lawsuit and ask for the purchase of their shares by the parent company or other remedies reasonable and compatible with the particular circumstances, instead of indemnification.

The New TCC sets forth additional rules to apply where the parent company has full dominance over its subsidiary (i.e., by having 100% of the shares or voting rights of such subsidiary). If there is such "full dominance", the parent company cannot instruct its subsidiary in way exceeding the subsidiary's financial power, jeopardizing the existence of the subsidiary or resulting in the loss of material assets of the subsidiary. In such case, the subsidiary's BoD cannot be held liable against company or shareholders for complying with the parent company's instructions. If the subsidiary incurs any loss due to the instructions of its parent company (or parent company's BoD) and the parent company fails to compensate the financial losses of its subsidiary within the same respective fiscal year or grant a claim right to its subsidiary company equal to such loss, the creditors of the subsidiary may ask the parent company or the parent company's directors to indemnify the subsidiary company for its loss.

The group company rules do not make any distinction between "strategic investors" and "financial investors". Therefore, as financial investors, private equity firms will also be subject to these group company rules alongside strategic investors. This is a critical legal issue, which should be carefully followed by private equity investors.

G. Squeeze-Outs

The New TCC enables majority shareholders to squeeze out minority shareholders under certain circumstances. The squeeze-out mechanism will assist private equity investors to buy-out the minority, when there are small shareholders not willing to cooperate. However, the practical efficiency of these methods is not clear and yet remains to be evaluated. If a minority shareholder hinders the company's operations or acts against the principle of good faith, causes clear hardship or acts recklessly, the majority shareholder (provided that it owns at least 90% of the total shares and voting rights) can acquire the shares of such a minority shareholder. The purchase price for the shares must be at least the trading price if the shares are listed in a stock exchange. If the shares are not listed in a stock exchange, the purchase price must be the true value of the shares. In such case, the court considers the recent data when deciding on the true value of the shares.

The squeeze-out tool can also be used in mergers. In such case, shareholders of the dissolving company may decide to squeeze-out minority shareholders. The merging companies may force the shareholders of the dissolving company to sell their shares in return for squeeze-out compensation. Unlike traditional merger transactions, in such a case, the dissolving company's minority shareholders will not receive shares in the surviving entity. Instead, they will receive "squeeze-out compensation". The merger report must explain the mechanics of this transaction in detail (e.g., amount compensation and grounds for making compensation instead of giving shares). The New TCC requires a qualified decision quorum for this squeeze-out mechanism. At least 90% of the shareholders of the dissolving company must agree to go through this process.

H. Exit

Creating a solid exit mechanism is essential in private equity investments. The lack of such mechanism significantly devalues the investment return. The New TCC creates a new exit regime. Under the New TCC, share transfers are rather liberalized and the BoD may refrain from approving the share transfers only under limited circumstances. However, the BoD now has a right of first refusal to acquire the respective shares on its own behalf. The BoD may exercise this right of first refusal on behalf of other shareholders as well as third parties. The new regime also creates a separate system for the shares listed on the stock exchange.

While the New TCC prohibits tag along, drag along rights, call options or put options to be regulated under the AoAs of the JSCs, it seems like the new system presents a rather flexible environment for incorporating rights first refusal/rights of first offer in AoAs of JSCs. Furthermore, the New TCC creates a different regime for LLPs. In fact, an LLP's AoA may explicitly regulate all these exit rights with "corporate effect". Therefore, LLPs now may be an interesting option as investment vehicles in private equity investments. However, private equity investors should still consider the usual tax related drawbacks of LLPs (e.g., lack of capital gains exception during sale of shares certificates in JSC, partners' liability arising from public/tax debts of an LLP, etc.) as well as the procedural nature of share transfers in LLPs.

Dr. Umut Kolcuoğlu (ukolcuoglu@kolcuoglu.av.tr) & Kemal Aksel (kaksel@kolcuoglu.av.tr)

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