Capital Loss and Financial Distress under the Turkish Commercial Code

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Introduction

The Turkish Commercial Code No. 6102[1] (the "**TCC**") gives particular importance to the protection of capital in joint stock companies and identifies compulsory measures to be taken by the organs of a joint stock company (the "**Company**") in the event of capital loss. Article 376 of the TCC distinguishes between three different levels of capital inadequacy and regulates the corporate remedies specific for each level. The first level involves a 50% loss of the sum of capital and legal reserves. The second level is defined as the loss of the sum of capital and legal reserves by two-thirds (technical bankruptcy). The final level is financial distress.

More recently, due to the implementation of the Tax Amnesty Law No. 6111[2] (the "**Tax Amnesty Law**"), a considerable number of undertakings, including project companies in various sectors, have reported capital losses reaching the level of technical bankruptcy, and have faced serious credibility losses. Obviously, the implications of Article 376 of the TCC can be accurately analyzed only if considered in connection with other legislations since it may have specific consequences under various regulations relating to energy, healthcare or financial services. Our analysis will mainly focus on its commercial law related consequences.

I. Capital Loss in Joint Stock Companies

Pursuant to Article 376(1) and (2) of the TCC, the board of directors (the "**Board**") should regularly check whether any of the following financial situations, which trigger the duty of the Board to take counter measures, is evident in the most recent annual balance sheet of the Company: (i) **half of the sum of its capital and legal reserves** has remained uncovered due to deficit; or (ii) **two thirds of the sum of its capital and legal reserves** have remained uncovered **due to deficit**. Both of these situations indicate that the financial stability of the Company is deteriorating or under risk.

Examination of the Annual Balance Sheet of the Company

For this financial check-up, the Board is required to take into consideration the most recent annual balance sheet of the Company. If the company is subject to independent auditing and thus to Turkish Accounting Standards requirement, it is not clear as to whether these financial statements must be prepared in accordance with Turkish Accounting Standards (the "**TAS**") or the Tax Procedural Law. The more dominant view is that it should be prepared based on the Turkish Accounting Standards in order to comply with the requirements of the TCC.

In parallel with this, publicly-held companies are required to carry out their financial check-up based on financial statements prepared in accordance with the standards set forth by the Capital Market Board ("**CMB**") pursuant to CMB legislation. Therefore, there seems to be no ambiguity for publicly-held companies.

Nevertheless, in the case where different legislations, applicable to a Company, impose varying accounting rules for the preparation of the balance sheet (i.e. principles set out in the Tax Procedure Law No. 213[3] and Turkish Accounting Standards), it is not clear which balance sheet should prevail in the consideration of capital loss in

Av. Naz Bandik Hatipoğlu

Associate

Av. Gülşen Kutlu

Associate

Av. Güneş Mermer

Associate

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2 Published in the Official Gazette No. 27857 (Repeated) dated 25 February 2011.

3 Published in the Official Gazette No. 10703-10705 dated 10 January 1961.

the event of contradicting results. Although the legislation is silent on this issue, the safer approach would be taking compulsory measures in the event that the capital loss thresholds are exceeded according to any of the financial statements.

Calculating the Uncovered Amount

In order to detect to what extent the loss of capital drained equity, the Board must compare (i) the shareholders' equity in the Company with (ii) the sum of capital and legal reserves of the Company. If the ratio between the shareholders' equity and capital+legal reserves is equal to or less than 1/2, the Company would not be deemed as under technical bankruptcy but would need to take necessary measures, as explained in below.

However, if the ratio is equal to or falls below 1/3, the financial instability of the Company reaches the level of "technical bankruptcy", as it is called in corporate practice. Although the term "technical bankruptcy" is widely used for ease of reference, it is prone to misunderstanding as "technical bankruptcy" has actually nothing in common with legal bankruptcy but refers only to the following adverse financial situation.

To illustrate a technical bankruptcy situation, imagine "Company X" with a statutory capital of YTL 50,000 and legal reserves of YTL 10,000. Based on the most recent annual balance sheet of Company X, its assets account for YTL 150,000 while its liabilities amount to YTL 135,000 and Company X has a shareholders' equity of YTL 15,000 (i.e. 150.000-135.000). Given that its shareholders' equity (YTL 15,000) is less than 1/3 of the sum of its capital and legal reserves, YTL 20,000 (i.e. 60,000/3), Company X would be considered in technical bankruptcy.

By defining the uncovered amount as a "*deficit*", in the larger sense, the TCC neglects the factual and financial reasons that give rise to the decrease in equity (i.e. the uncovered amount of the capital due to deficit). The Company may, therefore, experience a technical bankruptcy situation, even at the end of a financially successful fiscal year mainly due to the previous year's deficit.

For instance, as is widely known, the Amnesty Law allows adjustment of the balance sheet by placement of the lacking cash balance under non-deductible expenses in exchange for a 3% tax levied on the adjustment amount. In this context, the paid tax amounts are recorded as a deficit for the previous year and may unexpectedly give rise to a technical bankruptcy situation despite a decent level of earning.

Compulsory Remedies for Capital Loss

If the "shareholders' equity/capital+legal reserves" ratio is between 1/2 and 1/3, the Board must immediately notify its shareholders and convene a general assembly (the "**GA**") meeting whereby the Board must report the financial situation of the Company to the GA by explaining its reasons and suggest remedies. The proposed remedies may vary from capital increase, cost reduction policy, suspension of investments to the sale of assets, depending on the circumstances.

If the ratio is less than 1/3, the Board must immediately notify its shareholders and convene a GA meeting in order to discuss the financial situation of the Company and adopt one of the following remedies:

In the first option, the GA may decide to run the Company with the remaining shareholders' equity and thus decrease the Company's capital to an amount equal to 1/3 of its statutory capital (provided that the minimum capital requirements under the TCC and any other applicable legislation, as the case may be, are satisfied).

Alternatively, the GA may replenish the equity to its pre-loss amount either (i) by means of a capital decrease followed by a capital increase that takes affect simultaneously since both transactions are resolved in the same GA meeting and registered at the same time in the Trade Registry; or (ii) by creating a loss compensation fund into which the shareholders contribute additional funds or receivables of shareholders are converted. Loss compensation fund payments cannot be classified as capital or a loan and should not be paid back to the shareholders.

II. Financial Distress

Article 376(3) of the TCC regulates "financial distress" as follows:

"*(3) In the case where there are signs which create the impression that the company is in financial distress; the Board should prepare an interim balance sheets based on the fair market value of the assets and also taking the principle of continuity of the operations as the basis. If, pursuant to such reports, it is seen that the assets are not sufficient enough to cover the debts, then the Board shall notify this situation to the Commercial Court of First Instance located where the headquarters of the company is situated and request declaration of the bankruptcy of the company unless the creditors of the debts, with an amount covering the company deficit and remedying the financial distress, accept in writing prior to the bankruptcy decision that their debts may be deferred after all other creditors are satisfied; and the accuracy and validity of such statement is verified by the experts appointed by the court to which the bankruptcy request will be made. Otherwise, the application filed to the court for expert review shall be accepted as a bankruptcy notice.*"

Internal Determination of the Financial Distress

As understood from the above mentioned Article, if the assets of the company do not cover its liabilities; the financial situation of the company is no longer a capital loss or technical bankruptcy but falls under financial distress. In such a case the Board is required to ensure preparation of interim balance sheets as envisaged in

the TCC to evaluate the financial situation of the Company. One of those interim balance sheets should be prepared based on the fair market value of the assets; and the other one should take the principle of continuity of the operations, as the basis.

However, in practice, the existence of two separate balance sheets may lead to some uncertainties in case those two interim balance sheets reach two different results. We hope that at least the doctrine and/or court precedents answer this question in the near future.

Application to the Court for Declaration/Adjournment of the Bankruptcy

Board is required to apply to the competent court to notify the financial situation of the company; however, it does not envisage any a specific time period for such action. Nonetheless, taking into consideration the reference to "promptly" under the relevant provision in the Repealed TCC, it can be concluded that the safest approach would be to make such notification as soon as possible to avoid any possible claims by creditors, as any of them who cannot collect its receivable may take action against the board members and/or the Company.

III. Legal Remedies

As mentioned above, the remedies to be taken by the joint stock companies that are in financial distress are both regulated under TCC and Code of Execution and Bankruptcy No. 2004[4] (the "**Bankruptcy Law**").[5] In the event of financial distress, the Board is obligated to notify this situation to the Commercial Court of First Instance located where the headquarters of the company is situated and request either (i) declaration of the bankruptcy or (ii) bankruptcy adjournment.

However it should be noted that the Board or any of the creditors may request bankruptcy adjournment by submitting a recovery plan to the court stating the objective, real resources and measures that can be taken to the overcome bankruptcy situation. Bankruptcy Law requires that such recovery plan be serious and credible. The aim is to prevent the usage of the option of requesting bankruptcy adjournment as a way to delay making payments to the creditors of the Company.

Once the court resolves to take adjournment measures, the expert appointed by the court should analyze whether (i) the company is in financial distress and (ii) the recovery plan submitted to the court is serious and credible. If these two conditions exist, the court will rule to the continuation of the adjournment measures and adjournment of the bankruptcy. If it is determined that the company is in financial distress but the recovery plan is not serious and credible, the court will issue a ruling for the bankruptcy of the company.

In addition to the bankruptcy adjournment mechanism, the Company may seek to exercise any of the following methods to avoid the declaration of bankruptcy:

Requesting for Written Acceptance of the Creditors

A new remedy has been introduced with the effectiveness of the TCC. Accordingly, the creditors of the debts with an amount covering the company deficit and remedying the financial distress may prevent the declaration of bankruptcy. In order to do so they should accept in writing prior to the bankruptcy decision that their receivables may be deferred after all the other creditors, provided that the accuracy and validity of such statement is verified by the experts appointed by the court to which the bankruptcy request will be made. Otherwise, the application filed to the court for expert review will be accepted as a bankruptcy notice.

In case of bankruptcy, the receivables of the creditors of the company will be paid as per the order of precedence stated in the Bankruptcy Law. However, if the creditors accept in writing that the priority of the payment of their receivables remedying the financial distress may be deferred; the court cannot issue a ruling of bankruptcy. In such case, a written agreement must be entered into between the company and each creditor and the legitimacy, merits and validity of such agreement must be verified by the experts appointed by the court.

Merger

Article 139 (1) of the TCC provides that a company in financial distress may merge with a company that has enough equity to cover the financial distress. Thus, the Company may merge with a company in good financial standing as a recovery plan.

Conclusion

The main purpose of Article 376 of the TCC is to maintain the financial stability of companies and to ensure continuity of their operations. By distinguishing between three different levels of capital inadequacy, it provides an escalated protection structure and guides the Board and the GA about the corresponding remedies. Nevertheless, early detection and the mitigation of financial risks raised in Article 376 of the TCC may be achievable only if this structure is supported by mechanisms such as the independent audit requirement. Contrary to the companies subject to independent audit requirement general audit rules applicable to most companies remain unregulated since the secondary regulation has not been issued by the Ministry of Customs and Commerce. Finally, we believe that the entry into force of the pending audit regulation will reinforce the applicability of Article 376 of the TCC for all joint stock companies and may clear up the ambiguities in practice.

4 Published in the Official Gazette No. 2128 dated 19 July 1932.

5 As per Article 179 of the Bankruptcy Law, financial distress is a reason for bankruptcy for corporations.