Turkey: Love and marriage

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Turkey's commercial environment will see significant changes starting summer 2012. The two main legislative documents regulating any form of commercial and contractual affair, the New Code of Obligations (Turkish Code of Obligations numbered 6098 and dated January 11 2011) and the New Commercial Code (Turkish Commercial Code numbered 6102 and dated January 13 2011), will replace the current legislation when they enter into force on July 1.

Needless to say, the New Commercial Code and the New Obligations Code bring changes beyond what is being discussed in this article. For the purposes of this review, discussion is limited to certain select topics of consideration relevant to the structuring of M&A transactions. We will first look into certain new mechanisms that affect the structure of the shareholders' agreement and then discuss the new regime's effect on share purchase agreements.

With the New Commercial Code, the limited liability company (LLC) becomes a more sophisticated corporate form while the private joint-stock company (JSC) adopts certain mechanisms akin to publicly-traded companies, such as the authorised capital structure, issuance of convertible bonds and the treasury stock scheme. These are post-closing financing alternatives for the parties involved in an M&A transaction, which can now be regulated by the shareholders' agreement.

Registered capital

Many shareholders' agreements are accompanied by a three-year or five-year business plan, committing the parties to a financing and growth outlook determined at the initiation of a corporate partnership. The business plan is then exercised through capital increases as foreseen, which normally require a shareholders resolution at a duly convened general assembly meeting of the JSC in question. The New Commercial Code adopts the registered (or, authorised) capital system for JSCs, whereby the board of directors is allowed to increase the capital without the need of a shareholders resolution up to a predetermined ceiling (Article 460).

This mechanism was previously available only for publicly-traded companies. Under the new legislation, a private JSC can adopt the registered share capital system by a provision to this effect in its articles of association. The Articles of Association must indicate the aggregate ceiling of the capital and the time limit for the board's authority to increase the capital within that set limit, which cannot be longer than five years. These time and monetary limits reflect the business plan that is an integral part of the underlying shareholders agreement.

The minimum capital requirement for a JSC adopting the registered capital system is TRY100,000 (€42,500; $55,700), as opposed to TRY50,000 for regular JSCs. Unless expressly stated in the Articles of Association, the board of directors cannot issue privileged shares or shares with a premium over their nominal value or restrict pre-emptive rights of the shareholders.

Controlling minority stake

Most shareholders' agreements structure for a blocking minority through veto rights, increased meeting and decision quorums for significant decisions, appointing directors to the board and the like, ensuring that the investing partners have at least joint decision-making powers on the overall management of a company and its affairs regardless of their stake in its capital. These are equally applicable to shareholders resolutions and board decisions. Historically, these provisions have been reflected in the company's Articles for full enforcement before the Turkish courts pursuant to Turkish laws, running parallel to the parties' contractual obligations to this effect arising from the shareholders' agreement itself.

The New Commercial Code limits voting privileges in a JSC to a maximum of 15 votes per share. This number can be increased only by a court decision for the sake of institutionalisation or due to a just cause (Article 479). Thus, under the new regime, creating privileged shares may not suffice to form blocking rights, depending on the shareholding percentages and structure of a given JSC. The voting privileges do not extend to resolutions regarding amendment of the Articles of Association, appointment of a transaction auditor, or discharge of the Board or directors' liability claims.

These limitations do not apply to the appointment of representative directors to the board. Therefore, the provisions of the shareholders' agreements, allowing for a certain group of shareholders or the minority to appoint a given number of directors to the board can be fully reflected in the Articles of Association. This is further strengthened by the express obligation imposed on the shareholders to vote for the appointment of such nominee to the board (in the absence of a just cause to the contrary) (Article 360).

Share transfer restrictions

Limitations on the transfer of shares, through rights of first refusal, piggy back and tag-along provisions and the like, form an essential part of a shareholders' agreement, primarily arising from the reliance of the transacting parties or the co-investors to the specific qualities of its counterparty. Turkish M&A documents reflect these limitations in the Articles of Association of the relevant company. The New Commercial Code will change this practice as it introduces specific provisions regarding the restriction of share transfers in the Articles of Association separately for JSCs and LLCs, limiting the mechanisms for one while enabling it for the other.

The New Commercial Code requires JSCs to insert in their Articles the specific reasons in the occurrence of which share transfers can be rejected. Reasons related to the nature of the shareholders' composition, or the scope of the company's activities or the economic independency of the company are deemed as important grounds of rejection as per the New Commercial Code. This is not an exhaustive list: shareholders will need to select and pre-determine the grounds for share transfer rejections and be very specific about it if they want this protection to be reflected in the Articles. Otherwise, limitations on share transfer will continue only as a contractual obligation pursuant to the shareholders' agreement (Article 493).

The New Commercial Code provides for an escape clause to the JSC through the option to reject a share transfer without basing its decision on grounds explained above, by offering to acquire, at real value, the transfer shares itself or on behalf of its shareholders or of a third party.

In order for shareholders to resolve on the transfer restrictions of registered shares, an affirmative vote of 75% of the shareholders or their representatives is required (Article 421).

Contrary to the JSCs, the New Commercial Code allows LLCs explicitly to limit share transfers based on pre-emptive purchase rights, call options, other ancillary and/or additional obligations by so providing in their Articles of Association. Share transfers are subject to the approval of the board of partners and may be rejected without a just reason, unless otherwise stipulated in the Articles (Article 595).

Corporate financing: convertible bonds

As a financing method for JSCs, the New Commercial Code brings the conditional capital increase system, through the exercise of which, the company's creditors such as holders of bonds or other debt securities and its employees may partake in its equity (Article 463). The conditional capital increase is not triggered by new capital commitments of the shareholders, but through the exercise of exchange (conversion option) and pre-emptive rights by creditors

and employees.

In the event that bonds or similar debt securities including the right of exchange or pre-emptive right are issued, these bonds should firstly be proposed to current shareholders pro rata their shares. In this respect, the current shareholders of the company will not be deprived of exercising their rights. This option can be restricted in case of just cause, however (Article 466).

The share capital to be conditionally increased may not exceed 50% of the company's total share capital and the payment to be made must be at least equal to the nominal value (Article 464).

The Articles of Association must set forth the details of the conditional capital increase, such as the nominal value, number of shares, the group which can benefit from conversion or pre-emptive rights, the fact that current shareholders are deprived from their pre-emptive rights, privileges attributed to certain share groups, transfer restrictions of newly-issued registered shares, and so on (Article 465). Owners of bonds or debt securities and employees exercise their rights through a written statement addressed to the company with reference to the relevant provision of the company's Articles (Article 468). The capital is automatically increased in the pre-set terms with the exercise of the conversion option, upon which the corresponding provision is removed from the Articles of Association (Article 472).

An alternative to dividends

The New Commercial Code allows a privately-held JSC or an LLC to buy-back, or be the beneficiary of a pledge on, its own shares. Until the New Commercial Code, this option was available only to publicly-traded companies. Formation of treasury shares may be used as a method of increasing equity value per share and can be an alternative to increasing dividend payments. One of the most common uses of treasury shares is in fending against hostile takeovers.

From July 1 2012 onwards, a privately-held JSC or its subsidiary will be able to acquire up to 10% of its own (or, in the case of the subsidiary, of the holding company's) issued share capital through a board decision. The shareholders' resolution granting the board with this authority must specify the limits to the exercise of this option in time (which can be for a maximum period of five years), amount (with a floor and a ceiling to the acquisition price) and the nominal value of the shares (Article 379). Acquired shares must be fully paid-up and the company's remaining net assets must be at least equal to the sum of its statutory reserves and issued share capital after the deduction of the acquisition price. Shares so issued are stripped from any voting rights (Article 389).

An exception to the requirement of a shareholder's resolution is the case of an imminent threat, such as a hostile takeover, for the

prevention of which the Board can act on its own volition to buy back the company's shares (Article 381).

Any agreement between the JSC and a third party for the acquisition by that third party of the JSC's shares in lieu of the JSC itself or its affiliate or the parent company must comply with the terms set forth above. According to Article 380, an agreement or obligation to this effect in violation of the terms of Article 379 of the New Commercial Code will be invalid.

The New Commercial Code bans the JSC, or a third party or the JSC's subsidiary acting for the JSC, or the JSC's subsidiary promising shares in its parent company from undertaking to sell treasury shares.

Similar principles apply to share buybacks in LLCs. An LLC may acquire its own capital shares with two conditions: it must have the necessary equity that may be freely used to purchase these shares, and the nominal value of the shares to be purchased does not exceed 10% of the total share capital (Article 612). This limit is increased to 20% in case of acquisition of capital shares, due to an exit or dismissal from the partnership as provided for in the Articles of Association or as a result of a court decision. Capital shares acquired in excess of this amount must be disposed of or redeemed through a capital reduction within a maximum period of two years.

Likewise to JSCs, voting rights and the other rights attached to the capital shares subject to the buyback are suspended for the period that such capital shares are in the possession of the LLC.

Interim dividends

The New Commercial Code allows shareholders to receive interim dividends of a JSC before the year-end general assembly meeting. The procedure for the distribution of profit will be regulated by a communiqué of the Ministry of Customs and Trade on this matter (Article 509/3).

The interim dividends are an advance payment from the total profits to be distributed at the end of the financial year. In this sense, it constitutes an exception to the principle prohibiting indebtedness of shareholders to the company, which is a new rule brought by the New Commercial Code.

Related party transactions

In strengthening the arm's length principal, the New Commercial Code prohibits any indebtedness by a JSC's shareholders and directors to the company (other than those arising from a capital subscription, in the case of shareholders) (Article 358). In the event

the debt arises from a transaction conducted with the company as a requirement of the company's scope of activity or the business of a shareholder's enterprise, a related-party transaction will be allowed only if built on an arm's length basis (at market value and on equal terms, and so on). In LLCs, the same principles apply only for partners of the company and do not extend to its managers (Article 644).

Group company transactions often fall under this category. Transactions between a company and its shareholders are frequent and will now have to be adapted to the principals brought by the new legislative changes. All existing indebtedness falling under this category needs to be settled by July 1 2015 (Article 24 of the Code on Effectiveness and Enforcement of Turkish Commercial Code, numbered 6103 and dated January 14 2011).

Auditing

JSCs have to appoint a statutory auditor who often has questionable independence, if any at all. The New Commercial Code requires both JSCs and LLCs to retain external auditors and be audited by eligible, professional, and independent auditors complying with international accounting standards and acting with due care (Article 400). Differentiated by their size, medium and small companies can be audited either by one or more sworn financial auditors or independent auditors, whereas large companies can only be audited by independent auditing firms. This requirement helps in creating a more transparent investing environment and increases accountability standards.

The New Commercial Code additionally provides for a transaction auditor for the JSCs and LLCs. Some of the cases where the appointment of a transaction auditor is required are incorporation, capital increase and decrease, merger, spin-off, conversion of type of the company or the issuance of marketable securities. (The New Commercial Code gives the right to any shareholder to request the appointment of an independent auditor.)

An exit option

One of the crucial elements of a shareholders' agreement is devising an effective deadlock mechanism to be triggered if parties fail to resolve on an issue for a specific period of time at the board or general assembly meeting. Some events of deadlock are resolved by an umpire, some by pre-designating a surviving shareholder which ends the deadlock through acquiring the shares of the exiting partner, and so on.

In that respect, the New Commercial Code brings a tool for shareholders to file for the termination of the company with just cause before the commercial court of first instance (Article 531).

Shareholders holding at least 10% of the capital in privately-held JSCs (and representing 20% of the capital of the public joint-stock companies) can exercise this option. The court has the authority to resolve on an alternative method such as a squeeze out of the plaintiff minority-shareholder by paying him the equivalent of his shares if the continuance of the partnership is possible. In this sense, this new option may find application in deadlock events.

In LLCs, grounds of termination or exit and the related mechanisms can be provided in the Articles of Association (Article 577 and 638). In that respect, an LLC has become a more flexible corporate form where exit rights, casting vote rights for the prevention of a deadlock, share transfer limitations, call and put options, tag along and piggy back rights of a shareholders agreement can be reflected in the corresponding Articles. The New Commercial Code lists exit rights and their conditions, the type and the amount of cash payment for the exercise of the exit option; grounds for dismissal of a partner; and events of termination beyond those provided for in law, among the provisions that an LLC's Articles can regulate.

The share purchase agreement

In most cross-border M&A transactions in Turkey, where a foreign buyer acquires shares in a Turkish company, the share purchase agreement would be governed by a law equally foreign to the parties, if not by the laws of the buyer's jurisdiction. That being said, share purchase agreement can also be devised as a sales contract as governed by Turkish laws. The applicable legislation, in that case, is the Code of Obligations, which will be replaced effective July 1 2012. Some very typical provisions of a share purchase agreement, such as the material adverse change (Mac) clause, limitations of liability, and representation and warranties will be affected under the new regime.

Turkish law provisions on sales agreements apply to the share purchase agreements to which the New Code of Obligations sets forth certain changes. On the provisions relating to seller's warranties against defects, one such change is the increase of the statute of limitations to a minimum of two years (New Code of Obligations, Article 231). On the limitation of liability clauses, the new Code of Obligations sets forth that rovisions limiting seller's liability will be valid only in the absence of gross fault of the seller (Article 221).

Article 138 of the New Code of Obligations introduces a new provision regarding extraordinary difficulties faced in relation to performance of obligations under an agreement. This provision reflects the doctrine of frustration of agreement (collapse of the basis of an agreement) which has long been accepted by the Turkish scholars and which can also be applied to Mac clauses commonly found in share purchase agreements.

A typical Mac clause generally releases the buyers from payment of

the purchase price and acquisition of the sale shares at closing, if there is a change in the economic situation of the target company which would justify an objective buyer to rescind from the agreement and proceed with the closing. Until the New Code of Obligations, scholars grounded the validity of Mac clauses on the principle of good faith. With the New Code of Obligations, material adverse change events will have a direct statutory basis. According to the New Code of Obligations, "an extraordinary difficulty in performance" (in other words a material adverse change) occurs when the following conditions are met:

(i) the situation could not have been foreseen at the time of the signature of the agreement;

(ii) the situation must not have been caused by the acts of the buyer;

(iii) the circumstances existing at the time of signature of the agreement must change in such a way that it would be against the good faith principle to expect the buyer to proceed with the closing; and

(iv) the purchase of the shares must not be completed.

If these conditions are fulfilled, the buyer will not be forced to proceed with the closing and purchase the sale shares in an acquisition deal.

Most share purchase agreements are accompanied by a surety or guarantee for the payment of the purchase price. In Turkish law-governed share acquisitions where the sellers require the payment of the purchase price to be guaranteed with surety (generally by the buyer's parent company), the validity of the guarantee will be subject to the conditions brought by the New Code of Obligations. The guarantee (and any amendment thereto) will not be valid unless it sets forth, in the handwriting of the guarantor, the date and the maximum monetary amount of the guarantee and, whether it is undertaken jointly and severally (Article 583). A corporate guarantor's authorised representatives will need to insert the necessary information mentioned above in handwriting.

The New Obligations Code requires any agreement, whether named a surety, guarantee, or not, to the effect of providing personal guarantees by real persons to be subject to the validity conditions set forth above (Article 603). Therefore, in a Turkish law-governed share purchase agreement where the real person sellers are required to guarantee the performance of the obligations of the target company or that of the other seller(s), the same validity conditions will apply. The applicability of this to the practice may be prone to further scholarly debate and interpretation.

The latter half of 2012 will see significant changes in the M&A practice in Turkey. In this transition period, transaction counsel will lead the path for the investors to devise the company formations, shareholding structures, exercise of controls, exit rights, share

limitations and sell options, corporate financing mechanisms that can be reflected in the Articles of Association. Selecting an M&A lawyer with a thorough understanding of the possibilities as well as the limits provided by the new regime will be crucial.

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