NEW COMMUNIQUÉ ON TECHNICAL BANKRUPTCY RULES: FLEXIBILITY ON FX LIABILITIES

Following the recent economic developments in Turkey and the associated steps taken by the government to avoid certain negative impacts, the Ministry of Commerce has issued a communiqué on 15 September 2018 (the "**Communiqué**") on the procedures and principles for implementation of Article 376 of the Turkish Commercial Code (Law No. 6102) (the "**TCC**") regulating compulsory measures to be taken in the event of technical bankruptcy (i.e. balance sheet insolvency). Whilst the Communiqué does not introduce any fundamental novelties to the essence of the technical bankruptcy provisions under the TCC, it intends to provide a clearer guideline in respect of implementation actions. The main takeaway of the Communiqué is the introduction of a new interim calculation method which aims to offset foreign exchange rate losses.

EVIDENCES OF TECHNICAL BANKRUPTCY AND RECOVERY METHODS

The TCC provides three scenarios in which a company will be considered to be in technical bankruptcy and provides separate remedial actions for each scenario. These are: (i) loss of half of the share capital and legal reserves, (ii) loss of two-thirds of the share capital and legal reserves and (iii) loss of the entire share capital and legal reserves.

LOSS OF HALF OF THE SHARE CAPITAL AND LEGAL RESERVES

According to the Communiqué, based on the annual balance sheet for the previous year, if half of the share capital and legal reserves is lost, the board of directors (the "Board") is required to convene the general assembly and explain the financial status of the company, also proposing remedial actions. The Communiqué sets out certain remedies that may be taken in a non-exhaustive manner. These actions include the below remedial actions as well as downsizing the production facilities, sale of subsidiaries or changing the marketing system. The general assembly is not obliged to select any of the proposals of the Board and may decide to change them or apply different remedies.

LOSS OF TWO THIRDS OF THE SHARE CAPITAL AND LEGAL RESERVES

If two thirds of the share capital and legal reserves is lost, based on the annual balance sheet for the previous year, the Board is required to call a general assembly meeting which should resolve on the following: (i) decrease the share capital; (ii) replenish the share capital by cash injection; or (iii) increase the share capital. If the general assembly does not resolve on any of these remedial actions, then the company will automatically be liquidated in accordance with the provisions of the TCC. These remedial actions may be discussed and resolved upon by the general assembly in an ordinary or extraordinary meeting to be convened.

LOSS OF THE ENTIRE SHARE CAPITAL /FINANCIAL DISTRESS

If the assets of a company do not cover its liabilities, the company is considered to be in financial distress. Financial distress may be determined from the annual or interim balance sheet of the company, audit reports (if the company is publicly held), reports of early detection of the risk committee or the assessments of the Board.

If there are signs indicating financial distress, the Board must immediately prepare an interim balance sheet by valuing the assets on a going concern basis and based on current market value of the assets. If, based on the review of the interim balance sheet, the Board recognises that the assets of the company are not sufficient to meet its liabilities, and if the company has not taken any of the below remedial actions, then the company must file for bankruptcy, although some of these actions may not be appropriate to cure the technical bankruptcy. It may be worth noting that the result of failure by general assembly to take remedial actions upon the loss of two-thirds or the entire share capital is different: the former results in an automatic liquidation of the company, whilst the latter requires the Board to file for bankruptcy. Further, whilst the Communiqué does not explicitly refer to these, certain actions can be taken to recover the company from the state of insolvency until filing for bankruptcy, which may include subordination of the creditors' claims from the debtor whose receivables are sufficient to recover from insolvency with a statement that the receivables would not be collected and, instead, be subordinated to all other claims until the company is no longer insolvent (in written form and confirmed by an expert appointed by the court where the bankruptcy request is to be filed).

REMEDIAL ACTIONS

Share Capital Decrease

The share capital decrease will be carried out in accordance with the TCC and the company will continue its operations with one third of the share capital, provided that minimum capital requirements under the TCC are met.

Whilst resolving to decrease the share capital in the amount of the loss, the general assembly may also decide to simultaneously increase the share capital. In this case, the Communiqué requires at least one-quarter of the increased share capital to be paid in advance.

Supplementing the Share Capital

The shareholders may also agree to remedy the deficit by replenishing the share capital. All shareholders may join this procedure pro rata to their shareholding in the company and the payments will be irrevocable and complimentary. These payments are not considered as advance share capital payments. Any dispute amongst the shareholders for replenishing the share capital will not constitute an obstacle for the remaining shareholders to take necessary actions. Although, in practice, this method was used by Turkish companies to remedy the deficits in the balance sheet, there was an ambiguity regarding the treatment of additional shareholder contributions in the balance sheet from an accounting perspective. The Communiqué elaborates on this method to clarify such ambiguity.

Share Capital Increase

The general assembly may also opt to increase the share capital of the company. In such case, the shareholders are required to pay at least half of the increased share capital to the company prior to the registration of the general assembly resolution at the trade registry.

CALCULATION AND FOREIGN CURRENCY LIABILITIES

The Communiqué provides that all balance sheets to be prepared for determining the loss of share capital are prepared in accordance with Turkish Accounting Standards (TAS). In other words, companies will have flexibility to apply TAS, a method similar to IFRS, which was a matter of debate until the issuance of the Communiqué. Further, when determining absence or existence of technical bankruptcy, liabilities arising from foreign exchange rate related losses may be disregarded for the calculations to be made under Article 376 of the TCC, which diverts from the standard calculation methods both under TAS and IFRS. The option to disregard these liabilities will only be available to companies until 1 January 2023, unless such period is extended by the Ministry of Commerce.

MERGER

The Communiqué also elaborates on the provisions of the TCC regarding corporate mergers. Accordingly, a company which is in technical bankruptcy may merge with another company that has sufficient net assets to provide the former with the lost share capital. The financial status of the merging company (i.e. the company that has sufficient net assets) must be verified through a report prepared by an accountant that also sets forth the accounting method. If the merging companies are subject to independent audit, this report may be prepared by the independent auditor.

COMMENTARY

Even though there are some helpful clarifications, the Communiqué does not introduce fundamental changes to the existing system but rather provides a legal basis to practice typically employed in day to day commercial life. One exception to this, is the temporary calculation method which allows a company to disregard foreign currency rate related losses. Given the recent devaluation of Turkish Lira against foreign currencies, this option will likely allow companies to avoid technical bankruptcy for a certain period of time.

CONTACTS

Mete Yegin
Partner

T +90 212 339 00 12
E mete.yegin@yeginciftci.av.tr

Itır Çiftçi
Partner

T +90 212 339 00 77
E itir.ciftci@yeginciftci.av.tr

Kemal Aksel
Counsel

T +90 212 339 00 64
E kemal.aksel@yeginciftci.av.tr

Sait Eryılmaz
Senior Associate

T +90 212 339 00 60
E sait.eryilmaz@yeginciftci.av.tr

İrem Su
Senior Associate

T +90 212 339 00 08
E irem.su@yeginciftci.av.tr

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Registered office: Kanyon Ofis Binasi, Kat 10, Buyukdere Cad. No:185 34394 Levent, Istanbul, Turkey