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Corporate Governance Tips for Mergers & Acquisitions

Authors: Tunç Lokmanhekim, Nazlı Nil Yukaruç and Çağla Yazdıç, ELIG, Attorneys-at-Law

I. Introduction

This article is prepared for demonstrating the role corporate governance issues play in mergers & acquisitions ("M&A"). The term "corporate governance" can be briefly defined as rules introduced by the articles of association of companies, regulations on representation and binding of a company, and mandatory rules of law, which regulate the day-to-day activities, relations between the shareholders, responsibilities and obligations of the directors as well as the shareholders. A provision in the articles of association of the target company in an M&A transaction may derail the contemplated transaction. Moreover, following completion of the transaction minority or majority shareholders and directors may face difficulties and be restricted in running the operations of the company. For these reasons, it is very important to be able to plan the closing and post-closing corporate governance issues of the target company in an M&A transaction.

II. Limitation on Share Transfers

An M&A transaction can as well be structured in the form of a "share transfer". In accordance with the Turkish Commercial Code numbered 6102 ("TCC"), as a general rule, except as otherwise provided under articles of association of a company, in joint stock companies shares can be freely transferred.

Notwithstanding the foregoing, according to article 491 of the TCC, registered shares that have not been totally paid-in, may only be transferred upon the approval of the target company (exceptions to the rule being, share transfers realized by means of inheritance, marital property regime between spouses, or enforcement procedures). In spite of this restriction, the TCC provides that the target company can only refuse to approve the share transfer in the event that the transferee's financial ability raises doubts and if any, security requested by the target company is not provided by the transferee.

According to article 491 of the TCC; the articles of association may stipulate that registered shares can only be transferred by obtaining the company's approval. As a very specific mandatory rule of the TCC, article 493 (7) provides that the articles of association cannot aggravate restrictive conditions for share transfers. However, the articles of association may grant rights to the non-transferring shareholders such as right of first offer, tag-along or drag-along rights.

According to article 493 of the TCC, the target company may block the share transfer on the basis of an "important reason" (which must be related to the "economic independence of the company", or "composition of the shareholders") as stated under the articles of association, or by offering to purchase the said shares from the transferring shareholder on their actual value at the time of the purchase request, on behalf of the company, its shareholders or third parties.

The transferee may request from the commercial court of first instance placed in the company's headquarters determination of the actual value of the sale shares. In case the transferee does not reject the amount determined by the court within one month of the determination, the transferee is deemed to have accepted the company's purchase offer.

According to article 494, if approval of the company to the share transfer cannot be obtained, ownership of the shares and all rights related thereto shall remain with the transferor. In case the company does not reject the share transfer within three months as of the request date, the approval is deemed obtained.

As far as share transfers in limited liability companies are concerned, there are similar restrictive provisions in the TCC however, as share transfers in limited liability companies present tax disadvantages for the sell side, this type of companies almost never become the subject of M&A transactions which are formulated through share transfers.

In light of the above, by closely observing the requirements of the articles of association and the TCC, required closing actions, approvals or waivers, as the case may be, should be regulated under the conditions precedent section of the share purchase agreement.

III. Limitations on Financing

Joint stock and limited liability companies are prohibited from acquiring their own shares (also known as "share buybacks") or placing pledges thereon. Transactions in violation of this prohibition are considered null and void pursuant to article 379 of the TCC. Main purposes of the prohibition under the TCC are to preserve the company's share capital, to protect the interest of the creditors, and to prevent unequal treatment among the company's shareholders. There are certain exceptions to these prohibitions under the TCC. Further, companies are not allowed to provide advance funding, loan or security to third persons who contemplate purchasing their shares (the term "prohibition of financial assistance" is also used interchangeably) as per article 380 of the TCC.

A joint stock company is permitted to acquire or place pledge over its own shares if the total amount of the shares offered for acquisition or as security does not exceed one tenth of the company's share capital, or its issued capital. The board of directors of the joint stock company should be authorized by the general assembly of shareholders to acquire or place pledge over the joint stock company's own shares. The term of the authorization granted to the board of directors cannot exceed five years, uninterrupted. As per the said general assembly resolution authorizing the board of directors, the general assembly of shareholders shall also determine value of the shares that can be acquired or accepted as pledge, together with the lower and upper limits of the value of those shares.

In addition to the prerequisites explained above, worth of net assets of the company following the deduction of the consideration paid for the acquired (or pledged) own shares' should at least be equal to the sum of the share capital and reserve funds of the company, which anyway have to be preserved in accordance with the TCC. Only the shares those are fully paid-in can be acquired or accepted as security by the company.

Exceptions to the foregoing rules are regulated under article 382 of the TCC. According to the said article, companies may acquire their own shares without being subject to the conditions and restrictions set forth above if a share buyback is made (i) through share capital decrease, (ii) as a result of global succession, (iii) in virtue of a legal obligation for acquisition, (iv) as a result of an enforcement procedure initiated for collection of the company's receivables, provided that the concerned shares are fully paid-in, or (v) if the company is engaged in trade of securities.

Even though the TCC allows share buybacks under certain conditions, companies are not entitled to hold such shares perpetually. Acquired own shares must be disposed of as soon as possible, and without causing any loss to the company and in any event, within three years following their acquisition. In the event that own shares are acquired (or accepted as a pledge) in breach of the principles indicated above, such shares must be disposed of (or the pledge should be released, as the case may be) within a maximum period of six months commencing from the date of their acquisition or acceptance as pledge. Unless shares are disposed of in either of the two ways stated above, then the shares must be immediately redeemed by way of capital decrease.

Financial assistance, as prohibited, is defined as a transaction aiming at provision or grant of an advance, loan or security, entered into by the company with a person who is contemplating to acquire the shares in that company. Prohibition of financial assistance as introduced by TCC under article 380 serves the same purpose with prohibiting the transactions such as advance funding, loan or security to third parties by the company for the purchase of its shares, and unlawful financial assistance shall be deemed null and void.

There are two exceptions to the prohibition of financial assistance. One of these exceptions is related to transactions which are entered into by credit and financial institutions as a part of their ordinary course of business, and the other exception is related to advance payment, loan or security provision transactions through which own shares are acquired by the company for employees of the company or those of its subsidiaries. However, if (i) transactions identified above as exceptions have the effect of reducing the reserves of the company below levels, which the company is required to preserve pursuant to applicable law, (ii) rules pertaining to expenditure of legal reserves set out in article 519 of the TCC are violated, or (iii) rules ordering the company to set aside a reserve fund to cover the costs of repurchasing of its own shares under article 520 of the TCC are violated, such transactions shall again be deemed null and void.

Additionally, an arrangement between the company and a third party, which grants that third party the right to acquire the company's own shares in the account of the company, company's affiliates, or another company that the majority of its shares are held by the company, shall be null and void, if the transaction constitutes a breach of article 379 of the TCC.

Therefore, in an M&A transaction that is structured as a share transfer the foregoing regulations under the TCC should be observed, especially while structuring the financing of the transaction.

IV. Minority Rights

A "minority shareholder" is defined under article 411 of TCC as a shareholder holding shares in a company that represent at least 10% (ten percent) of the share capital in joint stock companies and 5% (five percent) in publicly held joint stock companies. Minority rights that may be of relevance in an M&A transaction are summarized below:

- Right to Request A Special Auditor:

Pursuant to article 438 of the TCC, every shareholder (i.e. not only minority shareholders) has the right to request from the general assembly of shareholders the conduct of an audit for clarification of certain issues or transactions whenever needed, provided that the "right to obtain information" has already been exercised by that shareholder. If such request is rejected by the general assembly, then each minority shareholder, or shareholders whose total nominal value of shares is at least TRL 1,000,000 (one million Turkish Liras) may request from the commercial court of first instance that has jurisdiction over the registered address of the company, appointment of a special auditor.

- Protective Rights against the "Dominant Shareholder" / "Controlling Company"

Pursuant to article 195 of the TCC a corporation is deemed to be in control of another corporation, directly or indirectly, in case of (i) possession of majority of voting rights, (ii) constituting majority in the board of directors, (iii) ability to use majority of voting rights based on an agreement, alone with or other shareholders, or (iv) ability to manage the company on the basis of an agreement or by other means. The first company is considered as the "controlling company" and the other is the "controlled company". Pursuant to article 202 of the TCC, a controlling company shall not exercise its control in a way that would make the controlled company incur a loss. In particular, the controlling company cannot direct the controlled company to carry out legal transactions such as transfer of business, assets, funds, staff, receivables and debt, to decrease or transfer its profit, to encumber its assets with in-rem or personal rights, to undertake liabilities such as providing surety, guarantee and bill of guarantee, to make payments, to adopt decisions or take measures, which negatively affect its efficiency and activity such as not renovating its facilities, limiting, suspending its investments without reasonable grounds, to refrain from taking measures that will hinder its development. Such actions might be allowed only if any loss incurred due to such acts or decisions is made good within that financial year, or a right to claim the "equivalent value" is granted to the controlled company no later than the end of that financial year, with a specific explanation of how and when this loss will be recovered.

V. Conclusion

As explained in detail above, pre-closing and post-closing actions of an M&A transaction should be determined considering that corporate governance issues may interrupt both the completion and business continuity. Limitations on share transfers should be taken into account while regulating the contractual undertakings of sellers, conditions precedent, completion actions whereas restrictions on financing should be taken into account while structuring the funding of the acquisition.

Author Contact: Tunç Lokmanhekim Email: tunc.lokmanhekim@elig.com

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