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**Financially Distressed Companies under Turkish Commercial Code**

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## Introduction

To provide a definite scope of what is stipulated under law, thus what we will delve into in this article, the starting point would be to define what would constitute a financially distressed company. It must also be noted that what we call a company for the purposes of this article would be a joint-stock company. The Turkish Commercial Code Numbered 6102 (the "Code") uses certain technical reference points to define and regulate financially distressed companies. The lawmaker intends to regulate this area, so that it could provide protection for shareholders, creditors, and, ultimately, the whole economic environment by protection of share capital. The same provisions of the Code serve also as a guidance tool for the shareholders and the board of directors of the financially distressed company.

One of the intentions of the Code, which it seeks to achieve most, is the protection of share capital in companies. Among the many articles provided in the law pursuant to this intention are Article 128, which stipulates that each shareholder is obliged to pay to the company the share capital amount it undertook to pay, the highly disputed Article 379, which regulates the ban on the company purchasing its own shares, and Article 509, which stipulates that no interest payment shall accrue with respect to the share capital. Article 376, which we will introduce in length below, also serves this intention of the lawmaker.

## The Systematic of Article 376 of the Code

The systematic of the relevant article of the Code, Article 376, is so that it stipulates three different levels of financial distress in a company, for which it provides three different levels of countermeasures. Paragraph 1 of Article 376 stipulates cases, where half of the sum of a company's share capital and legal reserves remain uncovered as per the latest annual balance sheet, whereas Paragraph 2 of the same article stipulates cases, where two thirds of the sum of a company's share capital and legal reserves remain uncovered as per the latest annual balance sheet. Lastly, Paragraph 3 stipulates cases, where a company's assets do not suffice to cover for its debts.

### *(i) Half of the Sum of Share Capital and Legal Reserves Remain Uncovered*

Article 376(1) stipulates that if the latest annual balance sheet affirms that half of the sum of share capital and legal reserves remain uncovered due to loss, board of directors should immediately invite the shareholders to convene a general assembly meeting, and inform and provide the shareholders in the relevant meeting with possible remedies it sees fit. Possible remedies could be capital increase; call for collection of the remaining capital receivables, in case shareholders have not fully paid their share capital contribution undertakings; sale of assets, etc.[1]

There exists legal writing, which suggests that the reason why, for example, undistributed dividends are disregarded in the calculation above, is that the lawmaker has considered the conversion of undistributed dividend into capital as one of the first remedies that could be resorted to, thus knowingly left it out of scope of the calculation above[2].

The obligations of the board of directors which arise under this paragraph are that the board of directors invites the shareholders to a general assembly meeting, that it informs shareholders of the deteriorating financial condition of the company, and that it provides shareholders with remedies, it sees fit. In case the general assembly of shareholders does not act upon the remedies suggested by the board of directors, the board of directors shall not be held liable[3].

***(ii) Two Thirds of the Sum of Share Capital and Legal Reserves Remain Uncovered***

Article 376(2) stipulates that if the latest annual balance sheet affirms that two thirds of the sum of share capital and legal reserves remain uncovered due to loss, board of directors should immediately invite the shareholders to convene a general assembly meeting, and inform the shareholders in the relevant meeting of the current financial distress the company is in. Article 376(2) of the Code explicitly stipulates the resolutions, which could be adopted by the general assembly of shareholders during such meeting. Accordingly, the general assembly of shareholders should adopt one of the following two resolutions, that is, even if they were not on the agenda[4]. The first of the two resolutions is to decrease share capital to an amount equal to one third of the original share capital and to sustain current activities of the company. The second resolution that could be adopted is to replenish the capital to its original condition. This could be realized in two ways: (i) either cash injection by shareholders or (ii) decreasing share capital to an amount equal to one third of the original capital and simultaneously increasing it up in an amount equal to two thirds of the original capital[5]. That said, the general assembly cannot resolve to replenish the capital to its original condition, and force the shareholders to inject cash in the company, unless there is unanimity, since that would breach the general principle and the relevant article of the Code, Article 480, which stipulates the mere obligation of a shareholder as the payment of capital, which that shareholder undertakes to pay (subject to exceptions stipulated by law).

The company shall cease to exist, if the shareholders would not convene, or would convene, but would not adopt either of the aforementioned two resolutions. There is legal writing,

[1] Ünal Tekinalp, The New Law of Companies (Sermaye Ortaklıklarının Yeni Hukuku), p. 244.
[2] ibid.
[3] ibid.
[4] ibid.
[5] ibid.

which suggests that shareholders should be given the chance, if they would want to resolve to convene for a second time, instead of resolving on the aforementioned two decisions[6].

A third remedy to resort to in such case is merger as per Article 139 of the Code. The company, which is in financial distress, could merge with a company that fulfills the conditions under Article 139 of the Code, through absorption by such company. The company which is absorbing the company in financial distress should have disposable equity that is sufficient to cover lost share capital.

### *(iii) Liabilities Exceeding Assets*

Finally, the third paragraph of Article 376 stipulates cases, where liabilities (might) exceed assets. Accordingly, when there are indications that the liabilities exceed assets, the obligation imposed on the board of directors is that it should first prepare an interim balance sheet. This interim balance sheet should be prepared in compliance with the principle of company being a going concern, and based on the possible purchase price of the assets. If such balance sheet affirms that the liabilities of the company exceed its assets, then the board of directors should inform the relevant commercial court of first instance and file for bankruptcy. The liability in evaluating the relevant balance sheet to affirm that the liabilities indeed exceed assets lies with the board of directors[7].

The remedies that could be taken by the company prior to filing for bankruptcy are four in number[8]. The first one is the merger under Article 139 of the Code, and the second one is the replenishment of the share capital to its original condition, as explained above. The third would be to obtain an undertaking from certain creditors in which these certain creditors accept to become last in line to collect their receivables after all other creditors, and undertake not to request their receivables be paid until the company resolves its financial distress. Number of such creditors should suffice to enhance the current financial condition of the company. The company would then provide the relevant commercial court of first instance with documentation as to the agreements it entered into with, or the declarations it received from such creditors. These are subject to expert witness examination. If the expert witness finds such documentation reliable and/or sufficient, then the court would highly likely not decide on the bankruptcy of the company. In a negative scenario, if the expert witness does not find such documentation reliable and/or sufficient, then the request for expert witness examination will be accepted as filing for bankruptcy[9]. Last remedy would be to seek a postponement for bankruptcy as per relevant articles of the Execution and Bankruptcy Law Numbered 2128.

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[6] ibid 246.
[7] ibid 248.
[8] ibid 249.
[9] ibid 250.

**Conclusion**

Article 376 is regulated in a manner to guide both the board of directors and the general assembly of shareholders in cases, where company becomes financially distressed; with the ultimate aim of preventing the company from filing for bankruptcy. Bankruptcy of a company harms not only its shareholders and creditors, but the whole economic scene in general. Lawmaker, thus, by adopting a three-level approach, aimed to guide the shareholders and the board of directors, providing them with certain go-to methods, specifically designed for each of the three levels, to provide the welfare of the company, thus its shareholders, creditors, and as stated above, the whole economic scene.

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