Legal Due Diligence: Most Common Vulnerabilities of Turkish Companies

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Introduction

Although it is difficult to provide one global definition for the term "due diligence", we are going to use it below in the sense of an examination, through which a prospective buyer would obtain information about the target entity. The need for a due diligence usually arises in the context of a takeover, be that an asset deal or a share deal, or it may sometimes be simply utilized for internal purposes. Our discussion below is based on the context of a share deal.

1. Perception of Legal Due Diligence by the Parties to the Transaction

Buy-side and the sell-side in a transaction usually have different perceptions with respect to the due diligence process. As for the buy-side, the information obtained through due diligence would help it assess "the risks attached to existing and potential liabilities"[1], along with "future revenue streams and the quality of assets and earnings"[2], all of which would serve to properly value the transaction[3], to evaluate when and how to pay the purchase price, conditions for closing of the transaction, and ultimately to determine whether engaging in such transaction is a good business decision within itself. In addition to risk assessment and valuation, findings of the due diligence process would also help form the basis of the sell-side's representations and warranties.[4]

As for the expectation of the sell-side, main aim of the due diligence would be to limit its own liability. Sell-side would try to negotiate including in the share purchase documentation catch-all provisions such as that it will not be liable for damages with respect to breaches or shortcomings that the buy-side "was aware of (or should have been aware of) prior to closing" as a result of the information it obtained through due diligence.[5] From the Turkish law perspective, this approach of the sell-side finds its roots in the provisions of the Turkish Code of Obligations numbered 6098, regarding the seller's liability due to defect where the buy-side while seeking remedy would be encumbered to prove that there are legal or financial defects that significantly reduce the benefit expected from the target entity[6]. If, as the sell-side wishes, catch-all provisions as to the knowledge of the buy-side are to be included, sell-side would highly likely be able to successfully counter buy-side's claims as per the

[1] Emma H.C. Lee, 'The Right Time and Circumstances: M&A Strategy' (2015) WL 1802925.
[2] ibid.
[3] ibid.
[4] Gerrit M. Beckhaus, "'Comply Or Explain' - A Flexible Mechanism to Countervail Behavioral Biases in M&A Transactions" (2013) 21 U. Miami Bus. L. Rev. 183.
[5] Irwin A. Kishner, 'The Changing Legal Landscape and Matters Affecting M&A Documentation' (2015) WL 9875592.
[6] Turkish Code of Obligations, Article 219.

abovementioned provisions of the Turkish Code of Obligations. On the other hand, the buy-side would prefer not to limit its remedial options just because of having conducted a due diligence.

Again, with a different perception, the buy-side would expect the sell-side to reveal during the due diligence all inconsistencies with respect to each representation and warranty to be negotiated, arguing that the process of due diligence was for its own benefit and not the sell-side's, and with the aim to clearly determine the remedy procedures against the sell-side.

Types of due diligence would mainly be classified into four: legal, tax, operational and financial due diligence. A more detailed list, depending on the nature of the target's activities could also include (but not be limited to) environmental, and especially with respect to cross-border transactions, FCPA and US anti-trust laws, because of their possible extraterritorial effects[7].

We will discuss below some of the issues most commonly detected by buy-sides during the process of legal due diligence in Turkish targets.

2. A View to Some of the Most Commonly Found Issues in Turkish Targets

The most commonly found issues during legal due diligence in Turkish targets arise out of (i) failure of the target entity to have paid stamp duty with respect to written contracts it entered into, (ii) premises lacking appropriate permits and licenses, (iii) incompliance with employment, health and workplace security legislation, and (iv) failure to comply with novelties of the Turkish Commercial Code numbered 6102.

(i) Stamp Duty

The Law of Stamp Duty dates back to the year 1964. Although it underwent certain amendments, its main principles remain the same. It applies to many types of documents, among which the most relevant ones, for the purposes of this article, would be written agreements, to which the Turkish target entity is a party. Stamp duty would have to be paid for written agreements, in an amount calculated over the greatest amount referred to within the text of the agreement.

Experience suggests that, in practice, Turkish targets could lean towards not paying such amount. Thereby, they are running the risk of paying the stamp tax plus a penalty plus default interest, only if and when this failure is detected by the relevant authorities. This practice may even extend to "leaving no traces behind", meaning that targets could even resort to destroying any evidence as to written agreements entered, which would leave the potential buy-side face to face with unrecorded transactions.

[7] Lee (n 2) 5.

In light of the foregoing, during the due diligence phase, it would be recommendable that the financial/tax advisors do check accounting documentation to confirm that the stamp duty is duly paid by the Turkish target entity with respect to all its relevant agreements.

It should be noted that the share purchase documentation itself will almost always be subject to stamp duty.

(ii) Premises Lacking Appropriate Permits and Licenses

The legislation firmly states that a workplace cannot be opened or operated, without obtaining the required license from the relevant authority. That said, experience again, suggests that it can frequently become the case that the target entities lack permits and licenses with respect to the workplaces in which they operate. The best example to missing permits would be the "building utilization permit", existence of which certifies that the building was constructed in compliance with the approved building plans therefore; there is no unauthorized space in the workplace. As the target entity grows, so does the network of workplaces where it operates. As such, during the due diligence phase, it will bear importance that all licenses that need to be obtained by the Turkish target entity are determined by the legal due diligence team, and that it is confirmed that the relevant entity possesses all of them with respect to each of the workplaces where it operates.

(iii) Incompliance with Occupational Health and Safety Legislation

This is a fairly new piece of legislation, which was published on the Official Gazette in June 2012. Said legislation provides number of liabilities on the employer (i.e. sell-side) such as assignment of workplace doctor and health and safety experts, to provide education and training to the employees, to take certain actions to minimize risks at the work place. Otherwise, the legislation sets forth penalties including monetary fines at different levels and shut-down. Despite the severe consequences, experience suggests that it is not yet widely complied with by Turkish targets in full.

(iv) Failure to Comply with Novelties of the Turkish Commercial Code numbered 6102

This also is a fairly new piece of legislation, which was published on the Official Gazette in February 2012. Article 1534 of the relevant law stipulates that certain of the law's provisions would enter into force later than the date on which the law was published on the Official Gazette. Additionally, the secondary legislation and the practice of the trade registries also have taken certain time to develop. In light of the foregoing, Turkish targets have been seen to have difficulty to comply.

Some of the main issues which firstly come to mind, would be failure to update the articles of association (which could only be realized through resolution(s) adopted in a general

assembly), lack of issuance of "internal directives" on convening of the general assembly and the limited signature authorities of the relevant target entity, and lack of compliance with certain notification requirements, newly introduced by the law.

3. How to Mitigate Such Risks

A well-conducted due diligence would help to determine and mitigate many of the risks mentioned above. The general approach would be that the share purchase documentation accommodates conditions precedent to ensure that missing pieces are put in place pre-closing, and sell-side's representations and warranties that are formulated to mitigate such risks. If material issues are detected during the due diligence process, the buy-side may wish to reserve its right to break the transaction unless those are remedied pre-closing. In case a monetary value could be quoted for the existing or potential risks detected, then the option of adjusting the share purchase price could be entertained. Further, it may be negotiated to have the sell-side remain liable for certain damages and losses of the buy-side and/or the target entity, for a period longer than customary and/or subject to higher or even no liability caps. In order to secure such liability, a certain amount of the share purchase price to be paid to the sell-side can be held in an escrow account for a certain time.

Conclusion

By their nature, buy-side and sell-side develop different perceptions (and expectations) with respect to the due diligence process. While the main aim of the buy-side is to convince itself that what is to be entered is a good business deal, the sell-side mainly expects to be able to limit its liabilities under such deal, through use of the outcome of the due diligence process. ELIG's experience in due diligences show that certain issues arise quite frequently in Turkish targets, as exemplified above. What the buy-side could negotiate would be to insert in the share purchase documentation conditions precedent and wider and easily operated indemnity procedures, so as to mitigate certain risks. Revision of the share purchase price and reserving of a certain amount in an escrow account could also be negotiated.

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