The laws they are a-changin'

Noyan Turunç and Kerem Turunç of TURUNÇ discuss some of the potential effects of the new Turkish Commercial Code on private equity transactions

Anyone closely following international financial publications is unlikely to go a week without reading an article about the rising private equity interest in Turkey. And rightly so: the private equity market in the country is maturing rapidly and Turkey is on track to becoming a key investment market for private equity funds. Making this statement would have been a pipedream for someone writing in *IFLR* a decade or so ago. By the best estimates, private equity investments in Turkey averaged just around $30 million per annum between 1995 and 2005. Then they spiked suddenly in 2006 with $2.2 billion, followed by $2.3 billion and $4.9 billion in 2007 and 2008, respectively. Despite the weaker volumes in 2009 ($700 million) and 2010 ($900 million), they were on the rise again in 2011 with an estimated $1.2 billion in investments, and look poised to continue growing in 2012 and beyond.

The proliferation of private equity investments in Turkey is part of a larger macroeconomic story unfolding over the past few years: GDP grew by 8.5% in 2011 and 9% in 2010, a relatively low inflation rate has settled in after historical rates of near triple digits, a sizeable consumption-driven young middle class stimulates growth and demand, and financing is abundantly available to private equity funds from local banks, which largely sailed through the financial turmoil of the recent global recession unscathed. Further driving the growth in private equity investments in Turkey is the existence of a plethora of family-owned businesses of varying sizes across a multitude of industries that are worried about succession. In addition, Turkey is increasingly being seen by outside investors as more attractive in light of the recent heightened economic instabilities experienced by the eurozone and the political quandaries of the Middle East.

Today, there are well over 50 private equity firms exploring deal opportunities in the country. Most of those firms are foreign funds without a permanent presence in Turkey but there are around 15 firms with offices in the country, a number of which are Turkey dedicated funds. Having said that, the number of closed deals remains modest in comparison to the number of deal opportunities being explored by domestic and foreign funds in Turkey, which suggests a seller's market and heavy competition for private equity houses. However, as explained below, there are also a number of structural reasons for the gap between potential and closed deals.

High profile deals as well as successful exits over the last few years have diminished much of the historical scepticism on the part of targets and investors alike, and increased everyone's appetite. For example, TPG Capital's successful exit from Mey Içki, the largest alcoholic beverages producer in Turkey, by selling the company to Diageo, the London-based distiller, for $2.1 billion in 2011 marked the biggest private equity sale on record in Turkey. Another recent exit was Abraaj Capital's divestment of its entire 50% shareholding in the Acıbadem healthcare group to Integrated Healthcare Holdings, a California-based publicly traded hospital management company, and Khazanah Nasional, the investment holding arm of the Malaysian government, for an undisclosed sum that Abraaj described as having created a "significant profit" on its investment of $600 million during 2007-2008. In exemplifying the rapid growth of the private equity industry in the country, it should be telling that when one of the authors worked on the initial acquisition of Mey Içki by TPG as recently as 2006, the deal, valued at $810 million, was the first true sponsor-backed leveraged buy-out (LBO) conducted in Turkey by a foreign fund, and the first time a private equity transaction exceeded $150 million in Turkey.

> "Turkish law imposes no investment restrictions specific to private equity investments or club deals"

A large component of investor confidence, private equity and otherwise, is the legal framework available in the market. While Turkish law essentially imposes no investment restrictions specific to private equity investments or club deals, certain legal issues have long been somewhat worrisome for funds. The new Turkish Commercial Code, scheduled to go into effect as of July 1, is expected

to cure some of those worries by introducing extensive provisions related to corporate governance and transparency, among others. Having said that, as explained below, the new Commercial Code is also likely to create some new worries, but on balance, the changes it will bring are likely to be welcomed by private equity players.

> "The new Commercial Code contains many changes of interest for private equity players"

Corporate governance

One of the biggest issues for private equity funds looking to invest in Turkish companies (in particular small to mid-size ones) has traditionally been the lack of transparency and inadequate corporate governance practices. For decades, it has been difficult for funds to get a healthy understanding of their potential targets at all or without expending significant resources. Inadequate bookkeeping standards, the unavailability of International Financial Reporting Standards (IFRS)-compliant financial statements at most companies, pervasive tax non-compliance, extensive related party transactions (including inter-company and shareholder transactions), and the widespread practice of unrecorded transactions with customers and vendors often make due diligence and valuations difficult and expensive, even practically impossible at times (which partially explains the relatively small number of closed deals compared to the number of private equity players active in the market). In addition to ineffective enforcement by the relevant regulators, a lot of this has been due to the fact that corporate governance rules and the related liability provisions under the old commercial code were extremely limited.

The new Commercial Code, on the other hand, introduces extensive corporate governance and transparency requirements for all companies, public and private alike. As an overarching theme, the new Commercial Code requires that bookkeeping be done so as to enable third-party experts reviewing the company's records to be adequately informed about the operations and financial condition of the company within a reasonable time. Moreover, the responsibility of the board for company records and operations, as well as directors' accountability over them, have been significantly expanded and effectively brought in line with international standards.

An area of concern for private equity investors in Turkey is the lack of consistent and easy-to-understand financial statements. Turkish companies typically use different accounting methods for different purposes, and tend to engage in many cash transactions and transactions with shareholders and affiliates that do not get adequately reflected in the company's books. Starting in 2013, however, Turkish companies will be required to prepare financial statements using Turkish accounting standards to be based on the IFRS, and these statements will also need to be audited by independent auditors. (This is subject, however, to the possible amendments brought about by a new legislative proposal mentioned below.) This change is expected to help private equity investors as they will find it much easier to read their potential targets' financials – for the first time, sellers and buyers in the Turkish market will be speaking the same accounting language. However, the requirement for IFRS-compliant and independently audited financial statements for all companies is likely to impose unwarranted cost and compliance burdens on smaller companies. The regulators would do well to create certain exemptions for such companies.

In addition to statutory auditors of accounts, the new Commercial Code introduces two other types of independent auditors: transaction auditors and special auditors. For certain corporate events such as incorporation, capital increases, mergers and de-mergers, companies will be required to engage transaction auditors, who will deliver compliance and/or fairness opinions on various aspects of such transactions. Again, this is subject to potential legislative amendments. Furthermore, shareholders will have the right, subject to certain conditions, and in some instances shareholding thresholds, to request the appointment of special auditors in order to investigate certain matters relating to the operation of the company. All three types of auditors will have extensive liability vis-à-vis the shareholders and the creditors of the company for damages arising out of their wilful misconduct or negligence in fulfilling their duties. It remains to be seen whether the supply of qual-

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ified auditors will be sufficient to meet the new demand and whether smaller companies will be able to afford the extensive costs associated with engaging auditors.

The mandatory use of IFRS-based financial statements and the comprehensive audit system adopted by the new Commercial Code are not only likely to make the financial statements of Turkish companies easier to understand and more trustworthy, they are also likely to increase the appetite for minority investments by private equity funds, which will find that their interests are now better protected.

While the new Commercial Code's emphasis on transparency is one of its most positive attributes, some of the requirements it imposes go beyond those employed by the laws of the world's most developed economies. For example, beginning on July 1 2013, every capital stock company will be required to maintain a website, which will have to include, among other things, financial statements, statutory auditors' reports, documents relating to the general assembly of shareholders, information regarding the remuneration of directors and top management, information on major corporate events, all information "necessary for shareholders to protect their interests," and information "necessary to be disclosed for transparency purposes and the functioning of an information society." The scope of the disclosure requirements is unclear at this point but clearly very broad. While the dissemination of such detailed information is beneficial for investors analysing companies and specific industries, the costs associated with such extensive disclosure requirements and the high risk of leakage of trade secrets are somewhat alarming, and the new Commercial Code should be revised to reduce the disclosure requirements for private companies and create exemptions for smaller companies. If the goal is the protection of minority shareholders, as argued by the drafters of the new Commercial Code, that goal can be obtained by granting extensive rights to shareholders to access the company's books and imposing serious fines for uncooperative boards and officers, or by making the required information available to shareholders on a secured subsite of the company's website. While private equity investors may enjoy having access to information and data of such magnitude about their targets, they are unlikely to derive the same pleasure from disclosing the same information about their own portfolio companies.

Another area where the new Commercial Code goes too far is with respect to the penalties it imposes for non-compliance with its provisions. While directors, officers and shareholders ought to be held responsible for not fulfilling their legal obligations, some of the penalties that the new Commercial Code imposes on them are too extensive, including, in some instances, jail sentences (for example, for not creating a website or failing to post all required information on the website). Again, this could change should the recent legislative proposals become law. Short of crimes such as embezzlement and insider trading, jail sentences are not appropriate for non-compliance with corporate governance rules.

Squeeze-outs

For the first time in Turkish law, the new Commercial Code will enable majority shareholders to squeeze out minority shareholders under certain specified circumstances. Pursuant to Article 208, if a minority shareholder of a company "prevents the operation of the company, acts against the principle of good faith, creates discernible hardship or acts recklessly," then the company's parent company, provided that it holds at least 90% of the shares and voting rights in the company, will be permitted to purchase the shares of such minority either at the prevailing trading price, if the company's shares are listed on a stock exchange, or their true value or a price calculated under a generally accepted method, if the shares are not traded on an exchange or if the trading price is not fair (see Article 202/2).

Another squeeze-out method is defined under Article 141, under which the merging entities in a merger transaction may decide in the merger agreement either (1) to pay a cash consideration to the shareholders of the non-surviving entity *pro rata* to their shareholding interests, or (2) to offer to those shareholders the choice between (a) such cash consideration or (b) shares in the surviving entity *pro rata* to their shareholding interests. In order for such a clause to be valid, the merger agreement needs to be approved by shareholders holding at least 90% of the voting rights in the non-surviving company (see Article 151/5).

Both of these provisions are likely to help private equity investors, in particular when uncooperative small shareholders are in the picture. However, time will show how practical it will be to employ these provisions, which will depend to a large extent on how courts will interpret them.

Financial assistance

Article 380 of the new Commercial Code introduces into Turkish law, for the first time, a prohibition on "financial assistance," a concept borrowed from Council Directive 77/91/EEC regarding the formation of public limited liability companies and the maintenance and alteration of their capital, which was amended in 2006 by the current Directive 2006/68/EC. However, Article 380 follows the original EC Directive and states that a joint stock company (*anonim sirket*) may not advance funds, nor make loans, nor provide security, with a view to the acquisition of its shares by a third-party (borrowed almost verbatim from the original EC Directive). The exceptions to the prohibition also follow the original EC Directive and are limited to transactions by banks and other financial institutions in their ordinary course of business, and transactions undertaken for the acquisition of shares by the employees of the company or the employees of one of its subsidiaries.

However, these exceptions may not be used if they have the effect of reducing the reserves of the company below mandatory statutory thresholds or limits set by the company's articles of association, or if they prevent the creation of statutorily mandated reserves or the use of such reserves. Read broadly, which is generally agreed by practitioners to be the legislative intent of the article, this provision would essentially rule out the use of acquisition financing by a target operating company. It will remain to be seen whether regulators will interpret the provision also to preclude alternative structures, for example the merger of the

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operating company with the holding company in a financed transaction.

Besides the practical problems it is likely to cause, what is troubling about Article 380 is that it follows an outdated Directive. First of all, even under the original EC Directive, many EU members never extended the prohibition to privately-owned companies. Furthermore, the current EC Directive was adopted because of the general view that European LBO markets were being hampered by some of the heavy-handed provisions of the original EC Directive. The current EC Directive permits companies (whether publicly or privately owned) to provide financial assistance for the acquisition of their shares as long as certain conditions, such as arm's-length terms, the approval of shareholders, and the maintenance of prescribed net asset and reserve thresholds, among others, are met. The drafting of the new Commercial Code began before the current EC Directive was adopted and Article 380, modelled after the original EC Directive, was not updated to reflect the relevant changes contained in the current EC Directive. If Turkey is interested in emulating its European counterparts, it would do well to amend Article 380 to apply only to publicly floated companies and permit financial assistance by such companies subject to the types of safeguards contained in the current EC Directive.

Shareholders' agreements

The new Commercial Code recognises the existence of shareholder rights such as put/call options and tag-along/drag-along rights. While the new Commercial Code permits the inclusion of such rights in the articles of association of limited companies (*limited sirket*), it indirectly precludes their inclusion in the articles of association of joint stock companies (*anonim sirket*), for which separate shareholders' agreements will need to be concluded. However, joint stock companies are likely to continue to be the preferred corporate form for M&A activity due to certain tax advantages they provide vis-à-vis limited companies, and permitting the inclusion of arrangements among shareholders in their articles of association would make the enforcement of such arrangements easier in Turkish courts. Many private equity investments in Turkish companies are undertaken through the use of special purpose vehicles in a European jurisdiction (often Luxembourg or the Netherlands), in large part because of the unequivocal enforceability of such rights in those jurisdictions. The new Commercial Code should be amended to clarify the status of shareholder arrangements and guarantee their enforcement for all companies. This would boost investor confidence in the Turkish legal system and encourage investors to remain onshore by making them feel comfortable about subjecting themselves to, and trusting in, the law of this land.

Other changes

The new Commercial Code contains many other changes of potential interest for private equity players. For example, single shareholder companies and single member boards will now be possible, and legal entities will be permitted to hold board memberships (through a real person representative).

Privately owned joint stock companies will now be able to adopt a registered capital system; under the old law, only public companies could do so. Furthermore, the new Commercial Code introduces the concept of "conditional capital increases," which is likely to help the use of previously unavailable (or difficult) structures in acquisitions. Also, share buybacks of up to 10% of the company's capital will be permitted (up to 20% in limited companies under certain limited circumstances). Finally, the maximum number of votes granted to preferred shares will be limited to 15 per share.

On balance, the new Commercial Code is likely to encourage private equity investments in Turkish companies. Enhanced transparency and new audit requirements will enable investors to consider a wider range of potential targets and evaluate them quicker and more economically. Access to information and improved corporate governance practices are also likely to make companies more attractive for minority investments, which are relatively uncommon in Turkey. As discussed above, if necessary amendments are made to some of its provisions and effective enforcement mechanisms are implemented, the new Commercial Code will play a significant role in the flourishing of the private equity market in the country.

Shortly before this article went to print, a legislative proposal for the amendment of a variety of the new Commercial Code's provisions was released. If the proposal becomes law, the following changes, among others, would be made to the new Commercial Code: (i) Turkish accounting standards would be based on "international standards," a somewhat vague term, instead of on the IFRS; (ii) the body in charge of devising the Turkish accounting standards would be authorised to create different standards for corporations of different sizes, different sectors and non-profits; (iii) the government would have the authority to determine which types/groups of companies would be subject to the new Commercial Code's mandatory audit requirements; (iv) website disclosure requirements would be reduced and made applicable only to those companies subject to the mandatory audit requirements; (v) transaction auditors would be eliminated altogether; and (vi) many jail sentences would become monetary penalties.