



## Guideline for Turkish Companies Suffering from Capital Loss or Technical Insolvency

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Protection of the share capital is one of the fundamental principles of the Turkish Commercial Code [“TCC”]. In this respect, capital loss and negative equity [the so-called “technical insolvency”] are regulated under Article 376 of the TCC, and a Communiqué was enacted to set the rules regarding the application of this Article. As a result of the unpredictable fluctuations in foreign exchange rates in the economy as well as the negative impacts of the Covid-19 pandemic on the financials of the companies, Article 376 of the TCC gained a special popularity among the Turkish companies in recent years. Accordingly, this article explains the situations where capital loss and technical insolvency may emerge and the measures that should be taken in the given circumstances. The article further elaborates on the new rules adopted to reduce the negative effects arisen from the drop of Turkish Lira and the Covid-19 pandemic. The potential liability of the directors that may arise in case the necessary actions are not taken is also addressed.

### From capital loss to technical insolvency: Phases of capital loss

**First Stage, Loss of Half of the Capital:** Loss of half of the share capital refers to the balance sheet loss which is equal to the 1/2 or more than 1/2 and less than 2/3 of the sum of the capital and legal reserves. Such amount of loss will be deemed as a warning with regard to the company’s financial situation. To prevent the deterioration of the loss, the board of directors/managers [“Board”] should immediately call a meeting of the general assembly and present remedial measures. At this level, the TCC does not require the company to take certain actions and leaves the issue to the discretion of the shareholders and the Board. In this respect, remedial measures on the operations of the company, such as shutting down a production unit or the change of market strategies, may be considered, as an alternative to the capital-related measures, such as increasing or topping up the share capital, as discussed below.

**Second Stage, Loss of Two-Third of the Capital:** Loss of 2/3 of the share capital refers to the balance sheet loss which is equal to or more than 2/3 of the sum of the capital and the legal reserves. Such amount of loss demonstrates that the alarm bells are ringing relating to the company’s financial situation. Hence, the TCC requires the bodies of the company to take certain actions. In this respect, the Board should call for a general assembly meeting, and the general assembly should decide on one of the measures explained below. Otherwise, the company would face the risk of dissolution.

**Third Stage, Technical Insolvency:** Negative equity, the so-called “technical insolvency”, occurs when the assets of a company are not sufficient to cover its liabilities. Unlike the first two stages, this time the Board must prepare an interim balance sheet if there are any signs regarding the negative equity. This interim balance needs to be based on both the going concern and the probable sale price of the assets. Previously, before the entry into force of the Communiqué, it was argued due to the unclear wording of

the TCC that in case of technical insolvency, the Board had to apply to the court directly for bankruptcy. The Communiqué clarified the issue and now, those financially distressed companies are allowed to take any measures explained below, so as to survive. Nonetheless, should the Board prefer not to take the necessary actions and in case technical insolvency has become certain following relevant assessments, then the Board is obliged to apply to the commercial court for bankruptcy. On the other hand, the postponement of the bankruptcy may be possible, if the creditors agree to restructure their receivables or the creditors are also the company shareholders.

### **Items to be disregarded in the calculation of capital loss: Impacts of foreign exchange losses and Covid-19 pandemic**

Serious increases in the foreign exchange rates starting in 2018 have caused crucial damages in the balance sheets of the Turkish companies which are heavily indebted in foreign currencies. Accordingly, the Communiqué allows companies to disregard the exchange difference losses incurred due to liabilities in foreign currencies that have not been fulfilled yet in the relevant calculations until 1 January 2023. In this way, it is aimed to keep companies out of the scope of the capital loss and technical insolvency situations regulated in Article 376 of the TCC. Furthermore, an amendment was introduced to the Communiqué at the end of the year 2020 to minimize the effects if the Covid-19 pandemic on the balance sheets of Turkish companies. Pursuant to the new rule, the sum of half of the expenses arising from leases, amortizations, as well as personnel expenses accrued in 2020 and 2021 will not be taken into account in the calculations, in addition to the above-mentioned exchange difference expenses.

### **Measures to be taken in cases of capital loss and technical insolvency**

**Operational measures:** Companies that are exposed to capital loss, particularly those at the first stage, can take actions regarding their commercial operations. These measures can be downsizing the business volume by closing certain units of production or departments, sale of subsidiaries, and modifying marketing strategies. Even though it is possible to implement these measures at any level of capital losses, these actions may eventually fall short to remedy the financial condition of the company at the second stage of capital loss or in case of technical insolvency given the severity of the situation. Thus, those companies will further have to take capital-related measures discussed below.

**Altering the capital:** The TCC and the Communiqué introduce several measures concerning the capital which are discretionary at the first stage of capital loss, yet must be taken starting from the second stage of capital loss. Accordingly, decreasing, topping up and increasing the share capital may be on the agenda:

**Capital decrease:** The share capital can be decreased to offset the balance sheet losses. It is possible to decrease the total capital to the minimum capital amount, provided that at least half of the sum of the capital and legal reserves is preserved within equity. Minimum capital amounts foreseen by law correspond to 50,000.00 Turkish Liras for joint stock corporations, and 10,000.00 Turkish Liras for limited liability companies.

**Topping up the capital:** Topping up the share capital means injection of cash by the shareholders to cover balance sheet deficits. If the general assembly adopts a unanimous resolution, then all shareholders become liable to outrightly pay the necessary amount. Alternatively, only volunteer shareholders can top up the adverse balance. Payments that are made to cover the deficits will be collected in the “loss recovery fund” which will be solely dedicated to this objective. In other words, money that is deposited in this fund cannot be used for purposes other than the recovery of capital loss.

**Capital increase:** This method, in principle, requires increase of the registered share capital simultaneously after a capital decrease which is carried out by offsetting losses. The general rules of the TCC on share capital payments will apply to the payment of the increased amount. Accordingly, in joint stock corporations, 1/4 of the increased amount must be paid before the registration, while the remaining 3/4 can be paid within 24 months following the registration of the share capital increase. In limited liability companies, no payment of the increased share capital amount is required at registration, and the entire increased amount can be paid later. Also, capital market rules will need to be followed in publicly held corporations. Shareholders are also allowed to resolve on increasing the share capital, without a decrease. In this case, the amount which ensures at least half of the sum of the legal reserves and new registered capital to be retained within equity must be paid before the registration. Alternatively, the share capital can be increased to any amount and then decreased without following the condition of prepayment, provided however that, the share capital contributions are paid in full and at least half of the sum of the new share capital amount and legal reserves is retained in equity as a result of the transactions.

**Merger:** A merger is another method to recover from financial distress. The TCC and the Communiqué allows the companies suffering from capital loss or technical insolvency situation to merge with another company. In this case, the other merging company must have sufficient net assets to meet the capital loss of the financially distressed company.

### **Directors need to be cautious: Potential liabilities due to capital loss and technical insolvency situations**

There is no doubt that being a Board member comes with liabilities. In cases of capital loss or technical insolvency, the Board members may be held liable for damages incurred by shareholders and creditors due to the given conditions [Art. 553 of TCC]. Furthermore, directors' criminal liability may be at stake in case of omission of the obligation to notify the bankruptcy. Therefore, the Board members should be careful with regard to losses in the balance sheet not only for the purposes of survival of the company, but also in terms of their own liability. In this respect, notifying the court on the technical insolvency is an unassignable duty of the Board [Art. 375 of TCC], and failure to not apply to the commercial court may lead to criminal liability of the Board members, and even imprisonment up to 3 months. The Board of publicly held corporations are further required to establish a committee for early detection of risks which will be in charge of determining capital losses in advance and properly leading the company to take adequate steps. Closed companies may also establish a similar committee to enhance their capability of risk management.

## Conclusion

The TCC attributes special importance to the financial conditions of the Turkish companies, especially, if the balance sheet losses exceed certain thresholds considering the sum of the share capital and the legal reserves and if the company assets are not sufficient to cover the liabilities. Accordingly, the Communiqué was adopted for the purposes of providing concrete guidelines to such financially distressed companies. The Communiqué, on one hand, sets forth the measures that should be implemented for survival of the companies according to the principle of protection of the share capital, and on the other hand, aims to reduce the negative effects of both local and global contingencies including currency fluctuations and pandemics on the company's balance sheets. Finally, with the appropriate guidance of the Board and measures to be resolved on by the shareholders, it seems possible for the companies to recover from distressed conditions.

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