AN ANALYSIS OF LEVERAGED BUYOUTS UNDER FINANCIAL AID PROHIBITION OF THE TURKISH COMMERCIAL CODE

Türk Ticaret Kanunu'nda Düzenlenen Finansal Yardım Yasağı Kapsamında Kaldıraçlı Devralmalara İlişkin Hukuki Bir Analiz

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Research Article

Abstract

"Leveraged buyout" (LBO) is one of the most preferred methods in company acquisitions. This method basically has three main legal aspects: The buyer (private equity) acquires controlling shares of the (target) company; S/he finances the acquisition price largely through loans from third parties and the loans used are ultimately either fully or largely secured by the target company's assets.

One of the main principles of joint stock company law is the principle of protecting the capital. In LBO models, since the final source of collateral is the capital or assets of the target company, different laws have forbidden this process, and in Turkish Law, this kind of financing is considered invalid to the extent that it is associated with the financial assistance prohibition.

Financial aid prohibition regulated in the Turkish Commercial Code No. 6102 (TCC), which has entered into force in 2012, is subject to significant criticism in doctrine, especially in terms of the amendment (2006/68/EC) in the Second Directive of the European Union in 2006, which enables financial assistance to third parties under certain conditions. In order to harmonize the amendment made in the Second Directive, we suggest amending Article 380 of the TCC in order to alleviate the financial assistance prohibition under certain conditions as in the Second Directive, not completely abolishing it.

Keywords: Business Law, Leveraged buy-outs (LBO), Financial aid prohibition.

Özet

"Kaldıraçlı Devralma" (LBO) şirket satın alma işlemlerinde kullanılan bir tür finansman yöntemidir. Bu yöntemde esas olan üç önemli unsur bulunmaktadır. Bunlar: Yatırımcının bir şirketin kontrolünü ele geçirecek şekilde pay iktisap etmesi; yatırımcının satış bedelini büyük ölçüde üçüncü kişilerden sağladığı kredi işlemleri ile finanse etmesi ve kullanılan kredilerin ise nihai olarak ya tamamen ya da büyük oranda hedef şirketin malvarlığı ile teminat altına alınmış olması.

Anonim şirketler hukukunun temel ilkelerinde birisi de sermayenin korunmasıdır. Kaldıraçlı devralma modellerinde nihai kaynağın hedef şirketin sermayesi ya da malvarlığı unsurları olması nedeniyle farklı hukuklar bu işlemi yasaklamış, Türk Hukuku'nda ise finansal yardım yasağı ile ilişkilendirildiği ölçüde bu işlemler geçersiz sayılmıştır.

Doktrinde, özellikle Avrupa Birliği'nin Şirketler Hukukuna ilişkin İkinci Yönergesi'nin 2006 yılında 2006/68/AT sayılı Yönerge ile değiştirilerek belirli koşulların gerçekleşmesi halinde üçüncü kişilere finansal yardıma olanak sağlanmış olmasına rağmen, 2012 yılında yürürlüğe giren 6102 sayılı Türk Ticaret Kanunu'nda (TTK) bir şekilde düzenlenen mali yardım yasağı eleştirilmektedir. Bu çalışmada, TTK'da katı bir biçimde düzenlenen finansal yardım yasağının tamamen kaldırılmasa dahi, AB mevzuatındaki gibi belirli şartlar çerçevesinde hafifletilmesi amacıyla TTK'nın 380 inci maddesinin değiştirilmesi önerilmektedir.

Anahtar Kelimeler: Ticaret hukuku, Kaldıraçlı devralma, Finansal yardım yasağı.

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INTRODUCTION

"Leveraged buy-outs" (LBO) is one of the most preferred financing methods in company acquisitions, due to its various financial advantages. In LBO method, basically a private group of investors comes together and borrows money heavily to purchase the control of another company, which is called "Target Company" in practice. In this acquisition method, the cash flows or assets of the target company are used to secure and repay the debt. So, if more loan money is put in the target company instead of capital, income as well as profitability of the target company will increase and the less money is spent by investors. This effect is called as the "leverage effect" in finance literature. In practice investors establish a company, which is called "Special Purpose Vehicle" (SPV), solely for LBO execution[1].

This financing method was freely applied in Turkey without any legal restriction until 1 July 2012, which is the date of the Turkish Commercial Code No. 6102 (TCC) entry into force. TCC stipulates that "*legal transactions involving advance payments, provision of loans or security, which are carried out by a company with another person for the purpose of acquisition of the company's shares, shall be null and void ...*".

LBO method, which was quite common before the entry into force of the TCC, is considered as subject to the financial aid prohibition provided in Article 380 of the TCC. In essence, financial assistance prohibition consists of restricting or prohibiting the acquisition of a controlling share of a target company with the target company's "credit card". Thus, the financial aid prohibition is subject to significant criticism in terms of its effects on the LBO method and it is still not possible to state that there are specific solutions that may apply to the explained matter.

This paper consists of two main parts: In the first part, we will examine definition, history, cons and pros of LBOs. In the second part, we will examine the provisions relevant to financial aid prohibitions of TCC and European Union Regulations. After all the discussions concerning financial aid prohibitions are explained in our paper, our main goal is to figure out whether LBO system can work legally in spite of the presence of the provisions in the TCC Article 380.

I. LEVERAGED BUYOUT

A. Terminology and Overview

Leveraged buyouts (LBO) and funds under management by private equity firms have become common and increased substantially in size over the last

[1] **Mäntysaari,** Petri: The Law of Corporate Finance: General Principles and EU Law: Volume III: Funding, Exit, Takeovers, Berlin, 2010, p. 550.

25 years[2]. LBO is not a legal concept, but a method or technique of purchasing and financing used to acquire the majority of company shares in financial literacy[3]. What is expressed by the "buyout" is the acquisition of the control of a company, or ideally all of the company shares. Thus, it is possible to use the company's assets to pay the debts borrowed by the new shareholder[4].

According to Patrick Gaughan, an LBO is a financing technique used by a variety of entities, including the management of a corporation, or outside groups, such as other corporations, partnerships, individuals or investment groups[5]. Particularly, it is the use of debt to purchase the shares of a corporation and it generally includes the process to take a public company to private. In broad terms, an LBO can be defined as an operation involving the acquisition, friendly or hostile[6], of a firm using a significant amount of borrowed funds (bonds or loans) to meet the cost of the takeover[7].

There are a number of authors who have studied this subject in the field of corporate finance[8]. Any acquisition can be structured as an LBO, although quite often, the LBO transaction will take the form of an asset purchase. The LBO is designed to allow the financial buyer to purchase the greatest amount of income-producing assets with the least amount of equity investment on the part of the financial buyer[9]. By borrowing against the assets of the target company, the typical LBO firm can invest a small amount of its own money, like 10 percent to 20 percent of the purchase prices and borrow the balance

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2 **Kaplan,** Steven N. / **Strömberg,** Per: "*Leveraged Buyouts and Private Equity*", Journal of Economic Perspectives 23, 2009, p. 123.; **Tripathi,** Pooja: "*Leveraged Buyout Analysis*", Journal of Law and Conflict Resolution Vol. 4(6), December, 2012, p. 85, Available online at http://www.academicjournals.org/JLCR (Last Access Date: 11.11.2020); **Loos,** Nicolaus: Value Creation in Leveraged Buyouts: Analysis of Factors Driving Private Equity Investment Performance, 2006, p.1-2.

3 **Loos,** p. 26.

4 **Tasma,** Martin: Leveraged Buyout und Glaubigerschutz, 2012, p. 11-12.

5 **Gaughan,** Patrick A.: Mergers, Acquisitions and Corporate Restructurings, 4th ed. 2007, p. 285.

6 An acquisition is termed as "hostile" if it is opposed by the management team of the target company. In this case, the acquirer can attempt to take control of the target by buying a majority of the target's voting shares in the open market, usually through a tender offer.

7 ECB, Financial Stability Review: Accounting for Rising Leveraged Buyout Activity, 2007, p. 172. https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart200706_05.en.pdf?720e1eb09c729d2f9ba93ec2f36a387f (Last Access Date: 11.11.2020)

8 See, e.g., **Thompson,** Steve/ **Wright,** Mike: "*Corporate Governance: The Role of Restructuring Transactions*", Economic Journal 105, 1995, p. 699. ; **Nikoskelainen,** Erkki/ **Wright,** Mike: "*The Impact of Corporate Governance Mechanisms on Value Increase in Leveraged Buyouts*", Journal of Corporate Finance, 2007, p. 512.

9 **Maynard,** Therese H.: Mergers and Acquisitions Cases, Materials, and Problems, 3rd ed., 2013, p. 72.

of the purchase price, earning a substantial return on its invested equity after paying the carrying cost of the debt.

In this context, we can conclude that in LBO method, investors use other people's money in order to purchase a company and then use the assets of that company in order to pay back the debts. Financial buyers hope that they can get a higher return than the interest rate of the loan. Therefore, the purpose of this structure is to make much more money with other people's money.

In order to make it clear, we can give an example: Buyer (B) (maybe an LBO Firm) plans to buy a target company (T). Within the framework of the LBO, B may prefer to pay the purchase price by way of a loan obtained by a bank, instead of financing it from its own capital. In such case, B will demand collateral in against of the loan and the buyer B may prefer to provide security from the T's assets (share pledge, plant or any other facility, mortgage, assignment of receivables, etc.), instead of providing security from its own assets.

LBO system or method works differently in the United States of America than it does in other countries. In many other countries, LBOs generally do not undertake a full buyout of the entire company. In the US, LBOs buy whole company (target company) meaning that they are not investing a minority of the shares. They actually take over the whole firm. However, in other countries, it is possible to see that LBOs purchase only some minority shares of the company.

On the other hand, some countries like Italy[10] and South Korea[11] directly prohibit LBO activities.[12] There are some reasons behind this prohibition. The first reason is to protect their own industries. Since LBO is not the kind of industry that actually produces something, those countries want to encourage the growth of local companies that actually product something. The second reason is to default of the money that LBOs use is coming from borrowing banks. The main issue here is if banks give a lot of money and LBO ends up being a disaster, the target company has some kind of financial distress, or they

10 For the latest improvements in Italy see, **Zambelli,** Simona: "*Recent Challenges of LBOs In Italy And Institutional Insights: The Devil Lies In The Details*", Corporate Ownership & Control / Volume 17, Issue 1, Autumn 2019 (Special Issue).

11 Related with Korean practice we can say that Korean Commercial Law and court precedents prohibit certain forms of LBOs as illegal asset-stripping, and a clear-cut standard on whether a given financing structure is permissible for a given transaction structure has not been provided to date. https://thelawreviews.co.uk/edition/the-mergers-acquisitions-review-edition-13/1197270/korea#:~:text=Korean%20statutory%20law%20and%20court,not%20been%20provided%20to%20date. (Last Access Date: 11.11.2020)

12 For more details regarding different country practices see, **Zerdin,** Marc (Editor): The Mergers & Acquisitions Review, 13th Ed., 2019.

can't turn it around, then the company goes into bankruptcy and the bank has left holding loans haven't collected on. So, for example, in India[13], this kind of transactions undermines their banking industry and they are already a country that is struggling with respect to the amount of capital that banks hold[14].

B. History

Securing the debts taken by the person who will acquire company shares for this purpose with company resources has become widespread in the United States in the 1980s[15]. While it is unclear when the first LBO transaction was carried out, it is generally agreed[16] that the first early LBOs were carried out in the years following World War I. In Great Britain, especially after the World War I, share purchases were made using the resources of the target company with leveraged buyout transactions and many companies collapsed in the great economic crisis of 1920-21. In the face of this development, it was deemed dangerous for companies to provide financing for the purchase of their own shares, and a rule was placed in the British Companies Law, adopted in 1929, that prohibits such financial assistance.

In the years following the end of World War I the Great Depression was still relatively fresh in the minds of America's corporate leaders, who considered it is wise to keep corporate debt ratios low. As a result, for the first three decades following World War I, very few American companies relied on debt as a significant source of funding. At the same time, American business became caught up in a wave of conglomerate building that began in the early 1960s. The number of LBOs increased dramatically in the 1980s in the United States, but they began to occur with some frequency in 1970s as an outgrowth of the 1960s bull markets[17]. Many private corporations took advantage of the high stock prices and chose this time to go public, thereby allowing many entrepreneurs to enjoy windfall gains[18].

In the late 1970s and early 1980s, newly formed firms such as Kohlberg Kravis Roberts and Thomas H. Lee Company saw an opportunity to profit

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[13] For detailed information LBO activities in India see **Chokshi,** Narendra: "Challenges Faced In Executing Leveraged Buyouts in India The Evolution of the Growth Buyout", 2007. Available at: https://archive.nyu.edu/bitstream/2451/25939/2/Chokshi.pdf (Last Access Date: 11.11.2020)

[14] **Gaughan,** p. 285.

[15] For detailed information of the origin of LBO transactions, see **Tasma,** p. 12.

[16] **King,** B. W: "*Past Its Prime. Financial Assistance Is an Old Idea Whose Time Has Passed*", International Financial Law Review, 2007, p. 28.

[17] Bull market is a financial market of group of securities in which prices are rising or expected to rise. The term "bull market" is most often used to refer to the stock market, but can be applied to anything that is traded, such as bonds, currencies and commodities.

[18] **Gaughan**, p. 285; **Maynard,** p. 73.

from inefficient and undervalued corporate assets. Many public companies were trading at a discount to net asset value, and many early LBOs were motivated by profits available from buying entire companies, breaking them up and selling off the pieces[19].

C. The LBO Model

LBO is one of the most preferred methods in company acquisitions, especially by acquiring companies, due to its various financial advantages. According to this method[20]:

- The buyer should acquire company shares in a manner that would enable it to take control over the relevant company,
- A considerable amount of the purchase price should be financed by third party loans,
- Full amount or a considerable amount of the relevant loans should be secured by the target company's assets.

Therefore; the main reason why LBO transactions are frequently used in financing; is the acquisition of the company with a low equity risk, and as a result achieving high total capital profitability.

The term "leveraged buyout" actually reflects the financial aspects of this method. If, according to this method, loan money is put in the company instead of capital, revenues as well as profitability of the company will increase and the less money is spent from the capital in addition to that the lower is the interest rate, the profitability of the company will increase again. This effect is called as the "leverage effect" in finance literature.

It should be noted that there is a direct relationship between LBO activities and interest rates. It means that when interest rates are low, in other words debt is cheap, then LBO volume is high. So when we look at in 2008-2009 period in the US, interest rates were high and the volume of LBOs was low. However, if we look at 2004-2007 period, when the interest rates were low, LBOs volume was very high.

D. Advantages and Risks of LBOs

There are a number of advantages to the use of LBOs in acquisitions[21]. First of all, it is a way of making high profit. That might actually also good for the

[19] This "bust-up" approach was largely responsible for the eventual media backlash against the greed of so-called "corporate raiders", illustrated by books such as *The Rain on Macy's Parade* and films such as *Wall Street* and *Barbarians at the Gate*, based on the book by the same name.

[20] **Veziroğlu,** Cem/ **Arıcı**, M. Fatih: Kaldıraçlı Devralma ve Anonim Şirketin Finansal Yardım Yasağı, 2018, p. 5-6.

[21] For detailed information and published literature see **Loos,** p. 21.

employees or other people who are working for the company purchased by LBOs. After the acquisition of the company that is under financial distress by LBO, the management will be changed. Therefore, LBO's can help to improve the management performance of the company.

In other words, it can increase management commitment and effort because they have greater equity stake in the company. In a publicly traded company, managers typically own only a small percentage of the common shares, and therefore can participate in only a small fraction of the gains resulting from improved managerial performance. After an LBO, however, executives can realize substantial financial gains from enhanced performance. This improvement in financial incentives for the firms' managers should result in greater effort on the part of management. Similarly, when employees are involved in an LBO, their increased stake in the company's success tends to improve their productivity and loyalty[22]. Besides, there is tax advantage associated with acquiring a company through debt financing rather than an outright purchase because the cost of servicing the debt is deductible. This actually allows the acquirers to pay more for the acquired company than would otherwise be possible, an obvious benefit to the sellers[23].

Large interest and principal payments can force the management to improve performance and operate efficiently. This "discipline of debt" can force management to focus on certain initiatives such as divesting non-core businesses, downsizing, cost cutting or investing in technological upgrades that might otherwise be postponed or rejected outright. In this manner, the use of debt serves not just as a financing technique, but also as a tool to force changes in managerial behavior.

Although venture capital-backed leveraged buyouts provide significant economic benefits in normal functioning of the market, they also contain some risks, as in every economic activity. If the company's cash flow and the sale of assets are insufficient to meet the interest payments arising from its high levels of debt, the LBO is likely to fail and the company may go bankrupt[24]. As a matter of fact, some concerns have arisen about LBO activities, including excessive leverage effect (deterioration of the financial situation/bankruptcy risk), conflict of interest, market abuse and lack of transparency[25].

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22 **Wadadekar,** Anand: "Leveraged buyout: An overview", 2009, p. 4.

23 **Tripathi,** p. 90.

24 **Wadadekar,** p.4.

25 For detailed assessments on risks and concerns see **Ferran,** Eilis: "*Regulation of Private Equity-Backed Leveraged Buyout Activity in Europe*", EGGI Law Working Paper 84/2007, March 2007, p. 7.
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=989748 (Last Access Date: 11.11.2020)

Lastly to say over the last decade, LBOs have been severely criticized, especially after the 2008 crisis. In the aftermath of the global financial crisis, media, regulators, and policymakers around the world increased their criticism for their potential detrimental effects on target companies and their stakeholders. These types of the transaction have been widely accused of involving a lack of full disclosure and a dangerous increase of the debt-equity ratio of target companies, which in turn could increase their default rate.[26]

II. FINANCIAL ASSISTANCE PROHIBITION

A. What is Financial Assistant Prohibition?

Financial assistance rules were developed in the United Kingdom in the eighteenth century, along with the development of common law rules governing capital maintenance in respect of British companies[27]. So we can say that roots of financial assistance prohibition lean on English law. In England, especially after the First World War, share purchases were made using the resources of the target company with leveraged buyouts and many companies collapsed in the great economic crisis of 1920-21. In the face of this development, it was deemed dangerous for companies to provide financing for the purchase of their own shares, and a rule was placed in the British Companies Law, adopted in 1929, that prohibits such financial assistance. After England's entry into the European Union, such law has been included in the Second Directive.

Primarily, financial assistance (aid) prohibition consists of restricting or prohibiting the acquisition of a controlling share of a target company with the target company's assets. The aim of this prohibition is to prevent the buyer, who wants to acquire the shares of the joint stock company, from receiving any financial assistance from the company. As a matter of fact, considering that the registering collaterals from the target company for the people who plans to acquire a small share is very rare in practice, the financial assistance prohibition is also referred to as leveraged buyout prohibition in the doctrine.

As it is mentioned above, an LBO is an acquisition where the purchase price is financed through a combination of equity and debt and in which the cash flows or assets of the target are used to secure and repay the debt[28]. As the debt usually has a lower cost of capital than the equity, the returns on the equity increase with increasing debt. The debt thus effectively serves as a device to increase returns, which explains the origin of the term LBO.

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26 **Zambelli,** p. 360.

27 **King,** p. 28.

28 **Gürel,** Murat: Anonim Şirketin Kendi Paylarını İktisabı Amacıyla Finansal Destek Verme Yasağı, 2014, p. 45.

To the contrary of the general definition in question, the implications of this restriction are more far-reaching than leveraged buyouts. Besides, the financial assistance prohibition is likely to come up in basically any transaction. In this context, financial aid is prohibited all cases unless it falls within one of the two limited exceptions that are stated explicitly in the Turkish Commercial Code No. 6102 **(TCC)**. Before examining the exceptions, it would be better to scrutinize[29] the components of financial aid prohibition which are “the company”, “a person” and “the transaction”.

The company: The financial aid prohibition in Turkey applies with respect to listed or privately held joint stock companies without distinction. It is important to note at this point that although the TCC[30] contains a provision for capital maintenance applicable to private limited liability companies[31], the financial aid prohibition would not be applicable to private limited liability companies. Besides, there is no express reference in the restriction on financial support granted by subsidiaries of a target company. This means that the company’s subsidiaries should not be caught by the restriction.

A person: According to the Article 380 of TCC, the person entering into the transactions with the target company, can be a real person, a company or a partnership and does not need to be the purchaser of the shares.

The transaction “for the purpose of acquiring shares”: The TCC gives the examples of *advance, loan or security* with an express note in the annotations that these are intended as superficial examples and that the reference to “transaction” should be interpreted broadly[32]. In terms of the “purpose” of the transaction, it is unclear at this stage what interpretation the Turkish courts will make, although the general expectation is that Turkish courts will undertake a “commercial purpose” review, that is to say, analyse the transactions taking into account the circumstances surrounding it as well as its commercial effects[33].

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29 **Bezen,** Yeşim/ **Cansun,** Nadia/ **Özilhan,** Can/ **Ündar,** Alaz Eker: “*Financial Assistance Prohibition in Turkey: A Familiar Concept in an Unfamiliar Jurisdiction*”, p. 2, (1-6) https://www.ebrd.com/downloads/research/law/lit13eb.pdf (Last Access Date: 11.11.2020).

30 Article 580 of TCC: “*Registered capital of private limited liability company shall be at least 10.000 Turkish Lira.*”

31 The term “private limited liability company” is used to refer to a “*limited şirket*” and not reference to companies with limited liability under Turkish Commercial Law.

32 This interpretation is consistent with the *ratio legis* interpretation of law. (for detailed information, look at **Arıcı/ Veziroğlu,** p. 43.

33 **Bezen/Cansun/Özilhan/Ündar,** p. 3.

B. European Union Regulations on Financial Assistance Prohibition

In Europe, the financial assistance prohibition was introduced at the request of the UK in the 1973 negotiations on the Second Council Directive[34], after the UK joined the European Economic Community (EEC) in 1973. Article 23 of the Second Council Directive prohibited a public company with limited liability to advance funds, make loans, or provide security, with a view to the acquisition of its shares by a third party. Articles 18-24a of the Directive regulate in detail the acquisitions of joint stock companies to acquire their own shares. Following its date of introduction, problems relating to financial acquisitions began to surface in European countries subject to the Directive. To overcome these problems, the Directive was revised and an amended Directive published on 6 September 2006 numbered 2006/68/EG[35]. Under this new approach, financial assistance must be facilitated under fair market conditions (the financial assistance to be provided must not depreciate the value of the target company); a report about the transaction must be prepared by the management body and submitted to the company; the company shall approve this financial assistance transaction with the votes cast of two thirds of shareholders; both the target company and the acquiring company must calculatingly approve the financial assistance; and the target company must reserve an amount that is equal to the prospective financial assistance provided.

In this context, we can conclude that if the purpose of a loan consists of acquiring shares of a target company, then EU Directive forbids company to grant credit to anyone. According to national law, the prohibition would lead to the transactions' being held null and void, and liability of the directors.

The financial assistance prohibition is a typical case of a rule addressing company conduct in terms of capital maintenance. There are different reasons for a board not to grant a credit:

- It should determine the beneficiary's creditworthiness,
- It should not extend credit beyond its own financial capacity,
- It should avoid being conflicted, especially if the beneficiary is or is planning to become the controlling shareholder.

[34] Second Council Directive of the ECC numbered 77/91 and dated 13 December 1976 (the 'Directive'), to a degree that could be considered almost a direct translation. You can reach 77/91/ECC: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31977L0091&from=EN (Last Access Date: 11.11.2020).

[35] Let us point out that the Second Directive was abolished in 2012 and the Directive 2012/30/EU was adopted instead. This Directive was also repealed in 2017 and the Directive 2017/1132/EU was accepted instead. However, in the current Directive No 2017/32/EU, the content and the protection of capital system in the abolished directives are generally protected. So, parallel provisions continue to exist in the context of financial aid prohibition.

All of these reasons are valid reasons, and can cause responsibility of board of directors due to the fact that they violate their fiduciary duty of care and loyalty.

C. Provisions Relevant to Financial Assistance Prohibition in Turkish Commercial Code

LBO may be referred to as "acquisition by way of indebtedness" from a legal point of view. In fact, the company acquires another company, as mentioned above, by using the money it has owned through a loan. This acquisition method was freely applied in Turkey without any legal restriction until 1 July 2012, which is the date of entry into force of the Turkish Commercial Code (TCC). The justification of the Article 380 of the TCC, imposing ban on financial assistance states that the Second Council Directive numbered 77/91 of the European Union with respect to companies has been taken as basis for this article. Thus, the source of the financial assistance prohibition is the European Union corporate law and Turkey has adopted this prohibition within its jurisdiction in line with the harmonization with EU legal framework.

In Turkish Law, joint stock companies are prohibited from acquiring their own shares according to the Articles 379 and 380 of TCC. In this respect, the financial assistance prohibition includes all share acquisitions from a target company regardless of the shares being controlling shares.

With new TCC, especially with the enactment of Article 380, acquisition financing for mergers and acquisitions in Turkey has become a new challenge for investors who would like to enter the Turkish market. Let us elaborate the reasons of this consequence:

While Article 329 of the previous Turkish Commercial Code numbered 6762, only regulated certain exceptions to share buy-backs or acceptance of pledges over company shares, the New TCC, via Article 379, introduced a new perspective on share buy-backs. Article 379 of the TCC stipulates that a company cannot acquire or accept as pledge its own shares in an onerous manner, in an amount exceeding, or which will exceed at the end of a transaction, one tenth of the principal or issued capital of the company. In order to prevent the circumvention of the prohibition for the companies to acquire their own shares, Article 380 of the TCC (entitled "Fraud against the law") stipulates that "*legal transactions involving advance payments, provision of loans or security, which are carried out by a company with another person for the purpose of acquisition of the company's shares, shall be null and void*". The main purpose of this Article is to prevent Article 379 from being ineffective or being circumvented by invalidating the legal transactions in which a joint stock company supports a third party by providing financing, loan or security or by other means for the acquisition of its shares by such third party. In fact,

such support is considered as indirect acquisition by a joint stock company of its own shares under the mentioned articles of TCC.

However, the TCC, adopted the primary regulation of the EU which restricts companies to provide financial assistance without introducing any gateways to cover up the prohibition. Given these developments, the TCC Art. 380 had already been an "outmoded" prohibition even by the time it came into force.

D. Exceptions

Related part with Article 380/1 of TCC is:

"(1) Legal transactions which the company performs with a person for the acquisition of its shares with regard to granting an advance, a loan or security, shall be null and void. This nullity provision shall not be applied to transactions within the scope of activity of credit and finance organizations and to legal transactions in regard to granting an advance, a loan or security to the employees of the company or of its dependent companies for the purpose of acquiring the company's shares. .."

In this context, the exceptions can be enumerated:

1. Financial Services Exception: The ban does not apply to funds provided as part of the normal course of business by credit institutions, which are used to acquire their own shares by a third person. In addition, funds provided as part of the normal course of business by financial institutions, which are used to acquire their own shares by a third person as part of their normal trading in securities business are also immune to the ban[36]. There are some academicians saying that this exception was designed to reassure the Turkish market and prevent it from opposing the new prohibition provisions by entertaining the belief that financial support would still be permitted if a traditional lender was to sit on the receiving end of the transaction that constitutes financial aid[37]. Some even argue that this exception would apply to all banking transactions in general.[38]

The exception has a very narrow scope of application, encompassing only credit lines and advances granted by banks and other financial institutions in the ordinary course of business which subsequently are used to purchase shares in that bank or that other financial institution, not any joint stock company. In other words, in this context, the bank or the other financial institution would become the "*company*" that is providing the financial assistance.

2. Specific Purpose Exception: The second exception is for financial assistance granted to an employee of the target or a subsidiary of the target.

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[36] **Arıcı/ Veziroğlu,** p 137.

[37] **Poroy,** Reha/ **Tekinalp,** Ünal: Ortaklıklar ve Kooperatifler Hukuku, 2009, p. 446.

[38] **Arıcı/ Veziroğlu,** p. 64.

3. Restrictions: We should note here that the exceptions are not absolute but subject to the quantitative test which can be explained shortly;

IF the financial assistance,

(i) reduces the restricted reserves or

(ii) breaches the rules of utilization of restricted reserves,

(iii) the company does not have sufficient distributable reserves in an amount equal to the financial assistance granted, THEN the exception does not apply and the financial assistance is thus declared NULL and VOID.

E. Consequences of the Breach of the Financial Assistance Prohibition in Turkish Commercial Law

Where a financial assistance is concerned, there are two transactions, one being the transfer of shares and the other being the financial assistance for the payment of the share price. Article 380 only foresees that the financing transaction shall be null and void, and does not regulate any consequences to the share transfer. Therefore, we are in the opinion that the share transfer transaction carried out with the financial assistance transaction shall continue to be valid and binding. Furthermore, Article 385 of the New TCC foresees the obligation to dispose of shares purchased in violation of articles 379. 380 and 381 governing company share buybacks, rather than rendering such transactions invalid (void). From this expression, it is understood that the share purchases in violation of article 380 may be realized. Therefore the only transaction that is invalid is the financing transaction.

According to some academicians[39], the legal effect of an unlawful financial assistance is the invalidity of the financial assistance transaction. This involves both the promissory and the disposal transactions. The breach does not per se render invalid the share acquisition. However, as long as it is accepted that these transactions constitute a "combined contract", both transactions deemed invalid.

CONCLUSION

As an acquisition and financing method Leverage buyout (LBO) is a transaction when a company is purchased with a combination of equity and significant amounts of borrowed money, structured in such a way that the target company's cash flows or assets are used as the collateral to secure and repay the borrowed money. That is to say, the buyer can obtain high return on assets by investing lower amount of equity capital.

One of the most controversial issues of LBOs is associated with its economic result, often perceived as example of financial assistance provided

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39 **Arıcı/ Veziroğlu,** p. 56-57.

by the target company for the purchase of its own shares, to the detriment of its assets and stakeholders. As it is known, "protecting the capital" principle is the main principle in joint stock company law. In LBO models, since the ultimate source is the target company's capital or assets, some countries have banned this transaction directly to the extent that it is associated with the financial assistance prohibition and some countries have completely released LBOs due to the high economic return.

This acquisition method was freely applied in Turkey without any legal restriction until 1 July 2012, which is the date of the New Turkish Commercial Code's entry into force. With the article 580 of TCC, such transactions are considered invalid to the extent that they are associated with the financial aid prohibition. Pursuant to this article, the provision of advance funding, loan or securities to third persons by target companies in order for such third persons to acquire shares of the company is prohibited. However, the same article brings forth two limited exceptions to this strict prohibition. The first exception is that the referred prohibition shall not apply to transactions contemplated by banks and financial institutions with regard to their ordinary course of business. According to second exception, transactions effected with a view to the acquisition of shares by the target company's employees or the employees of its subsidiaries are not subject to the prohibition.

The justification of the Article 380 of the TCC imposing ban on financial assistance states that the Second Council Directive numbered 77/91 of the European Union with respect to companies has been taken as basis for this article. Although the EU Directive regulating the financial assistance prohibition was issued in 1976 but the amendments made to that Directive in 2006 adopted a more reasonable approach on the implementation of the financial assistance rules. By enacting prohibition that is not based on the latest amendment to the EU Directive, the TCC will undoubtedly be deemed as a step backwards on the road to EU membership and required legislative harmonization with the EU.

Lastly to say, LBO method is commonly used in merger and acquisition (M&A) environment and according to recent surveys almost 50 percent of M&A transactions are financed by banks. Whereas the rigid approach of the regulation (Art. 580 of TCC) narrows the practice of banks and financial institutions providing financial assistance. As a consequence, investors generally look elsewhere when deploying their capital, towards countries that offer financial flexibility in their legislation. So, an amendment similar to the Second Directive may be considered in the Article 380 of the TCC, and thereby the strict ban is softened.

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