Leveraged Buyouts in Turkey

Introduction

A leveraged buyout (LBO) is a term used for a variety of transactions in which buyers (usually private equity firms) use leverage to acquire a company's shares. The purpose of an LBO is to allow companies to make large acquisitions without having to commit a lot of capital, with the aim of increasing the target's value over the original purchase price.

LBO transactions involve the acquisition of another company using a significant number of loans to meet the cost of acquisition. The target's assets are used as security for the loans in addition to the acquiring company's assets and the acquirer relies on the target's cash flow to repay the debt.

In the event of the acquisition of shares in a company, the Commercial Code 6102 prohibits acquirers from obtaining financial assistance from the target. This rule also affects the use of the LBO model in acquisitions.

Pursuant to Article 380 of the code, any advance payment, loan, collateral, security or guarantee transaction entered by the target with any party for the purpose of acquiring the target's shares will be deemed null and void (the prohibition). The transactions listed under Article 380 are not exhaustive and any direct or indirect attempt to provide such assistance will fall under this prohibition (eg, participation in the payment of the purchase price). Article 380 will apply if:

- a third party acquires shares;
- financial assistance is provided in favour of the third party acquiring the shares; and
- financial assistance is provided for the acquisition of shares.

Granting loans or providing securities or guarantees by a target to a third party that acquires the target's shares is prohibited regardless of the amount or timing of such financing or the number of shares. The prohibition will apply with respect to the transactions carried out before or after the completion of the share purchase; therefore, the securities or guarantees to be provided in favour of the lenders as conditions precedent and conditions subsequent within the context of a financing transaction will be deemed to fall under the scope of the prohibition.

The prohibition applies to public and private joint stock companies; however, it does not apply to limited liability companies.

Types of security that fall within the scope of Article 380 are any types of security over the assets of the target (ie, mortgages, pledges over the movables, liens and guarantees). The establishment of share pledges over the shares of the target do not fall within the scope of the prohibition, as it is argued that the shares are owned by the shareholders and not the target. The share pledge could be established in favour of the lenders simultaneously with the funding and acquisition of the target's shares.

The prohibition is subject to the following exceptions:

- transactions carried out by banks and financial institutions in their ordinary course of business; and
- advance payments, loans, collateral, security or guarantee transactions entered into in order to facilitate the acquisition of the target's shares by its employees.

The first exception does not apply to all banking transactions. Rather, it applies only where the target is a bank or financial institution. As for the second exception, employees should not be board members or high-level executives of the target in order to benefit from this exception. The exceptions are also subject to the fulfilment of certain conditions regarding the legal reserves (ie, the legal reserves of the target should be preserved in accordance with its articles of association and the Commercial Code).

Legal consequences of non-compliance

Failure to comply with Article 380 of the Commercial Code will result in all advance payments, loans, collaterals, securities, guarantees or similar transactions provided by the target to be deemed null and void. Borrowing facilities from banks or financial institutions for the acquisition of the target's shares will constitute a valid transaction; however, transactions that aim to secure the acquisition of finance facilities will be deemed invalid. In addition to the securities provided by the targets, some authors are of the view that, in cases where the costs and expenses in relation to the due diligence, audit, transaction fees to be paid to the investment banks and other consultancy services provided in connection with the share purchase transaction are paid by the target, these payments will also be deemed as a violation of the prohibition.

There are conflicting opinions as to whether Article 380 should apply to share purchase transactions and whether they are subject to invalidity. The majority view is that, even if funded by unlawful financial assistance, share purchase transactions will still be valid; however, there are no established court precedents to confirm this view.

Suggested solutions to circumvent the prohibition

Share pledge

The prohibition does not apply to the establishment of a share pledge over the target's shares as they are not among the target's assets.

Conversion into a limited liability company

The prohibition applies only to private and public joint stock companies and not to limited liability companies. In this respect, if the target is a joint stock company, it can be converted into a limited liability company following the share purchase transaction and it may be possible to obtain the appropriate securities over its assets and cash flow. Another solution would be to spin off the target's assets into a limited liability company and grant securities over its assets and cash flow to finance the acquisition.

Upstream merger

During a post-acquisition upstream merger, the target merges into the acquisition vehicle, which will be the surviving entity. In these types of merger, where the target is to be merged into the acquisition vehicle instead of remaining as a separate entity, the target will cease to exist after being merged with the acquirer entity and anything done thereafter should not be characterised as financial assistance granted by the target.

The common view is that the upstream merger will not fall within the scope of the prohibition, as there is no circumvention of the law and no assistance for the acquisition of the target's shares. However, if the upstream merger is made a condition for the acquisition financing from the beginning or is otherwise expressly foreseen or intended as an integral part of the acquisition financing, there may be a risk of the merger being viewed as an unlawful circumvention of the prohibition.

In the event of a post-acquisition downstream merger, the acquisition vehicle merges into the target, which will be the surviving entity. All assets and liabilities of the acquisition vehicle will be transferred to the target through a statutory universal succession mechanism and, given that the liabilities of the acquisition vehicle also include the acquisition finance debt, the target will become the borrower of the acquisition financing as a result of the downstream merger. This method is deemed to be more controversial regarding the substantive effect of this type of merger in the sense that the target's assets are used as security for the acquisition financing and there is thus an increased risk that the merger might be characterised as an artificial transaction designed to circumvent the financial assistance prohibition.

Dividend distribution

The target's dividends can be used to repay the acquisition loan without falling within the prohibition on financial assistance provided that there are dividends available for distribution and the provisions in relation to legal reserves are complied with.

Alternative financing structures

Another alternative is making the target a party to the loan agreement to be executed with the acquisition vehicle in relation to the acquisition financing, where the acquisition vehicle is granted with the acquisition loan while the target obtains a capital expenditure or a working capital loan. In this scenario, the target and the acquisition vehicle act as the joint and several debtors and the guarantors in the loan agreement. In the event that the acquisition vehicle is in default, the lenders will be entitled to foreclose the security package granted by the target through the cross-default provisions. However, arguably cross-default provisions can be interpreted as a way of circumventing the prohibition.

Debt push down and capital increase/decrease

If the target holds undistributed dividends or retained earnings, it can capitalise these values through an unpaid share capital increase prior to the share purchase by the acquisition vehicle. Once the acquisition vehicle has acquired the desired percentage of shares, the target can proceed with a subsequent share capital decrease in order to extract the proceeds of the share capital reduction and distribute them to the acquisition vehicle.

Alternatively, if the target does not have enough funds to finance the capital increase, it can obtain a secured loan that can be used to increase the target's share capital. Subsequently, a share capital decrease can be operated at the target level and capital reduction proceeds distributed to the acquisition vehicle. Thus, the financing weight of the acquisition facility will be pushed down onto the target. The acquisition vehicle can use these proceeds to pay the interest payments over the acquisition loan.

Some authors, interpreting the prohibition restrictively, argue that repayment after capital reduction could also be deemed as a violation of the prohibition under the Commercial Code if:

- the limit of the distributable net assets can be exceeded through the repayment; or
- the use of the proceeds of a capital reduction is effected with the exclusive objective of paying the target's acquisition price.

Financial assistance by group companies

The prohibition applies directly to the target and not the other group companies. The acquirers may use other group companies to structure the LBO, including sister companies or subsidiaries, or involve another entity to the transaction in order to indirectly acquire the target's shares. As a general rule, controlling entities which are entitled to give instructions to subsidiaries within the group company context, cannot exercise their dominance in a way which may cause a loss for the subsidiaries unless they actually equalise or provide a right for the equalisation of such loss within the same fiscal year. Pursuant to Article 204 of the Commercial Code, controlling entities cannot give instructions to subsidiaries which exceed the target's ability to pay, endanger the existence of such subsidiary or may result in the loss of material assets of the subsidiary.

Accordingly, if the financial assistance provided by a subsidiary, as per the instructions of the controlling company, causes a loss for the relevant group company, the controlling entity may need to provide an equalisation to the group company.

Comment

It is impossible to fully mitigate the risk that a target is deemed to provide financial assistance for the purchase of its own shares if the acquirer uses an LBO and the target provides guarantees or securities over its own assets due to lack of established precedents. The uncertainty around this legal issue requires a diligent analysis for each transaction.

For further information on this topic please contact Kaan Demir at Kayum & Demir by telephone (+90 212 291 1002) or email (kaan.demir@kayumdemir.av.tr). The Kayum & Demir website can be accessed at www.kayumdemir.av.tr.