

English translation

Identification of technical bankruptcy in joint stock companies and its legal consequences

1. Introduction

In the article published in the August issue of our journal, we had stated that shareholders' financial liability in joint stock companies was limited to the capital they subscribed, and this situation did not prevent shareholders from being liable with their personal assets even if the creditors of joint stock companies could not collect their receivables due to insufficient company assets, while we had also analyzed the outcomes and conditions related to the identification of technical bankruptcy and its consequences in joint stock companies under article 376 of Turkish Commercial Code no. 6102 ("TCC").

The mentioned article and its following provisions discuss technical bankruptcy as well as the identification of indebtedness and the legal consequences of this issue. According to the legal ground of this article, the purpose of this provision is to protect shareholders, creditors, investments of capital market actors and general economic interests.

The duty of the board of directors in technical bankruptcy is to identify the extent of loss and immediately submit the issue as well as appropriate recovery measures to the attention of the General Assembly, eliminate the situation caused by the technical bankruptcy situation by ensuring a decision on replenishing the capital or proceeding with the lost capital, whereas its role in case of technical bankruptcy is to ensure technical bankruptcy liquidation so as to treat all creditors equally.

In this article, we will analyze the identification of technical bankruptcy in joint stock companies and its legal consequences;

2. Identification of technical bankruptcy

2.1. General definition of technical bankruptcy

Pursuant to Turkish Commercial Code, technical bankruptcy is defined as the case which a company's creditors cannot recover their receivables even if the company's assets are valued at their market values rather than their registered values.

Technical bankruptcy in joint stock companies and legal consequences thereof are regulated in the section "Duties and Authorities of Board of Directors" and article 376/3 and article 377 of TCC. According to article 376/3, in case there are signs raising suspicions that the company is heavily indebted, the board of directors shall draw up an interim balance sheet based on the going concern principle and the contingent selling prices of assets i.e. fair market price. If the board of directors has identified indebtedness through this interim balance sheet, before the call for general meeting, it shall promptly notify the commercial court of first instance located under company's headquarters and request either (i) declaration of the technical bankruptcy or (ii) technical bankruptcy. Otherwise, the board of directors shall have legal and criminal liability because of harming creditors' rights.

But when does the board of directors take action on the basis of a suspicion of technical bankruptcy?

2.2. Grounds for suspicions of indebtedness

Although the signs related to indebtedness vary depending on each concrete case it is generally possible to reach a conclusion about technical bankruptcy if certain signs exist. For instance, technical bankruptcy can be identified in a year-end balance sheet prepared on balance sheet basis or in an interim balance sheet. Besides, an increase in liabilities while there is a decrease in equity can also be deemed as a sign of technical bankruptcy. Differently from the foregoing, loss of the elements considered necessary for the operational continuity of the company can also be regarded as a significant sign as it gives rise to suspicions of indebtedness. On the other hand, it can be said that bankruptcy of the debtor of one of the company's major receivables or non-conclusion of the debt enforcement of this debt, a sharp decline in the value of capital market instruments held for investment purposes, excessive increase in debt or impairment in the value of foreign exchange reserves due to the sharp fluctuations in exchange rates also give rise to suspicions of technical bankruptcy.

In case of suspicions of technical bankruptcy arising in this way, the board of directors shall immediately prepare an interim balance sheet on the basis of going concern principle and market values of assets, identify indebtedness and notify the court if necessary.

2.3. Preparation of an interim balance sheet for the identification of technical bankruptcy

If there are signs of technical bankruptcy, the board of directors is obliged to prepare two different balance sheets according to both the going concern principle and the fair market values of assets. If the board of directors does not prepare the said two interim balance sheets although there are signs indicating that the company is deeping in debt, it shall become liable under the Turkish Commercial Code. Yet, the purpose of the preparation of an interim balance sheet by the board of directors is to determine whether the company's debts are payable if the assets are converted into cash on the balance sheet date. Indeed, it is a preparation of balance sheet for liquidation. This liability of the board of directors is related to its obligation to continuously monitor the company's financial and economic situation.

The valuation shall be based on the date of the balance sheet. The lawmaker has not brought any restriction on the assessment of the market value of assets. In doctrine, the valuation is not affected by whether the company is able to continue operating in case the essential assets for the company's activities are sold as a whole. Given that the ultimate purpose is to protect creditors' rights, it can be concluded that this approach is accurate.

2.3.1 Preparation of interim balance sheet according to the going concern principle

Going concern principle refers to the evaluation made in consideration of the results of business activities while the enterprise is still active i.e. both on the balance sheet date and the upcoming period. In the evaluation made for going concern principle, assumptions are made on a certain date about future results which are indefinite due to the nature of events or conditions. Size and complexity of the enterprise, nature and condition of the activities, degree of susceptibility to external factors affect the assumption to be made in connection with the result of events or conditions.

The value of an entire enterprise that continues its activities serves as a basis in the interim balance sheet prepared according to the going concern principle. Going concern principle requires the consideration of not only the value at the moment of valuation, but also the value that might be generated in the future based on realistic assumptions. For this purpose, assets, debts, incomes-expenses and the opportunities to be derived by the enterprise are evaluated by being taken into account according to possibilities.

As also stated above, evaluation of assets and liabilities according to the going concern principle refers to an evaluation made on the basis of an enterprise that will continue its activities. Such an evaluation demonstrates whether the company is likely to survive due to certain facts, expectations and factors losing their influence despite the company's debt-ridden status. For example, an expert business manager can differently evaluate that although a company is debt-ridden because of an investment made in its start-up period, there is a high possibility to generate profit in following years.

If publicly held companies are not obliged to prepare interim financial report, an interim balance sheet must be prepared both according to the going concern principle and the possible selling prices of assets in line with the legislation within 30 (thirty) days from the emergence of suspicions of technical bankruptcy.

2.3.2 Preparation of an interim balance sheet according to the market prices of assets

Preparation of an interim balance sheet according to the actual values of assets refers to the evaluation of assets according to their market price rather than their registered values. Therefore, contrary to the annual balance sheet, registered values do not serve as a basis in the preparation of interim balance sheet. The main purpose of the interim balance sheet prepared according to the market values of assets is, differently from the annual balance sheet, to realistically demonstrate the market value of the company's assets and determine whether the company's assets are sufficient to pay its debts.

For publicly held companies, the interim balance sheet to be prepared according to the possible selling prices of assets must be prepared no later than 30 (thirty) days from the emergence of suspicions of technical bankruptcy.

As some of the company's properties might be sold at lower prices if they are separated from their integral parts (e.g. an integral part of a plant or apparatus of a machine), this issue should be considered during the valuation.

The company's payment instruments (cash, check etc.) shall be capitalized at their nominal value, while foreign currencies shall be capitalized at the exchange rate applicable on the balance sheet date. The company's marketable securities on the other hand should be separated according to whether they have a market value; those with a market value should be valued at the market value on the balance sheet date, while others should be valued at their estimated selling prices.

On the other hand, the company's receivables shall be recorded in the balance sheet as collectible amounts rather than being recorded on their registered values. Assets such as license, patent, brand etc. which can be converted into money shall be booked as asset items.

2.4. Reporting technical bankruptcy to the court and claiming the said bankruptcy

As we mentioned above, upon the identification of the signs indicating technical bankruptcy, the board of directors shall prepare an interim balance sheet both according to the market value of assets and the going concern principle. If the board of directors concludes that the company's assets are not sufficient to pay debts upon reviewing both interim balance sheets, it is obliged to notify the commercial court of first instance located under company's headquarters and request the company's technical bankruptcy. Otherwise, the board of directors shall have legal and criminal liabilities.

At this point, there is the question of how the board of directors should act if these balance sheets contradict with each other, which can give rise to doubts in practice. Yet, if both balance sheets indicate technical bankruptcy or none of them indicates this technical bankruptcy situation there would not be any hesitation. However, the lawmaker has not clarified whether the board of directors should apply to the court according to the interim balance sheet prepared as per the going concern principle or the interim balance sheet prepared as per the market value of assets in case these balance sheets contradict with each other.

However, under the Resolution dated 10.4.2014 and numbered 11/352, promulgated by the Capital Market Board in respect of the implementation of article 376 of TCC for publicly held companies, it is stated that while the interim balance sheet prepared according to the going concern principle indicates the loss of whole capital, if the assets in the interim balance sheet prepared according to the market values of assets are sufficient to pay the receivables of creditors, there is no need to take the measures specified in the mentioned article; this statement has formed a basis for the issue in question.

As per our understanding, that the court need not be notified if the balance sheet prepared according to the market value of assets does not indicate technical bankruptcy since it can be considered that such a balance sheet presents a conclusion closer to material facts.

Besides, various decisions of the Supreme Court state that market values must serve as a basis during the determination of technical bankruptcy.

In an opposite case i.e. whereas the interim balance sheet prepared according to the going concern principle is positive the interim balance sheet prepared according to the market value of assets is negative, the board of directors must notify the court and apply for the technical bankruptcy since one of these balance sheets does not indicate technical bankruptcy.¹

From this aspect, it is significant to have an independent audit firm conduct the valuation. Yet, the creditors might claim that the company is in technical bankruptcy which has not been identified properly.. In this case, it will be compatible for the board of directors to act in this direction.

3. Prevention of the technical bankruptcy decision

3.1. Listing the creditor last on the list of creditors

In the case of an application of technical bankruptcy with a notification about indebtedness to the court submitted by the board of directors, in order to prevent the technical bankruptcy decision about the

¹ Kırca, İ./Şehirali Çelik, F. H./Manavgat, Ç.: *Anonim Şirketler Hukuku*, sf:587, Cilt 1, Ankara 2013

company, some creditors of the company shall agree in writing that their receivables will rank behind the receivables of other creditors.

If there are sufficient creditors who commit to being transferred from initial ranks to last ranks to eliminate indebtedness prior to the application to the court, the board of directors shall still notify the court about technical bankruptcy and ask for the review of statements or agreements on ranking last by submitting these documents to the court. In this case, the board of directors shall notify the court about technical bankruptcy, yet shall not request bankruptcy due to transition to the last rank. If the documents submitted to the court reflect the truth and there is not any condition for technical bankruptcy, the court shall rule that the company is not deep in debt and shall reject the request.

On the other hand, if these statements or agreements are submitted to the court after the technical bankruptcy request (or delay of bankruptcy request) but still before the court decision, the court shall rule that there is no need to determine that the company is in technical bankruptcy.

As it is seen, transition of the creditor(s), to the last ranks in the list of creditors whose receivables are sufficient to eliminate indebtedness prevents the court's decision about the company's technical bankruptcy but does not prevent the board of directors application to the court.

3.2. Postponement of technical bankruptcy

The decision of postponement of bankruptcy is given after the determination of the deeping in debt of the Company.

Furthermore, under article 377 of TCC, the board of directors or any creditor can request the postponement of technical bankruptcy to the court a recovery project indicating the objective and actual sources and measures, including the new capital contribution in cash.

The decision of postponement of technical bankruptcy is given as a result of the consideration as serious and persuasive by the Court of the recovery project. There are many decisions of Court of Appeal, regarding the form of the recovery project that will be presented for the postponement of technical bankruptcy or extension of the postponement, which measures can be included in the recovery projects by companies and how serious and persuasive the recovery project can be ensured. Accordingly, in order for the court to decide the postponement of technical bankruptcy;

- The measures stated under the recovery project should be material, precise and measurable measures,
- Matters presented in the recovery project should be documentable,
- An expert witness should determine that the recovery project is serious and convincing.

4. Liability of the board of directors

As it has stated at the beginning of the above mentioned article, if the interim balance sheets shows that the company is deep in debt, the board of directors must immediately notify the commercial court of first instance which is in charge of the location where the company's head office is based and request the company's bankruptcy. This duty of the board of directors is indispensable and non-assignable. Board of directors is responsible for the breach of article 376 of TCC. If board members do not immediately notify the court about the bankruptcy they become liable to the company, creditors and shareholders. However, the significant point here is that such a liability arises only if the notification is not timely sent and the company becomes subject to loss because of this delay.

The obligation of the board of directors to notify the court about the technical bankruptcy situation is also regulated under article 179 of Bankruptcy and Enforcement Law ("BEL"). Furthermore, according to article 345/a of the Law, if the board of directors does not immediately request the company's bankruptcy stating that the company's assets are not sufficient to cover its debts, there will be a sanction of imprisonment from ten days to three months upon the complaint of any creditor.

On the other hand, in case of deep in debt, the company might be recoverable in a short period of time. In principle, there are some doubts whether the board of directors should fulfill its liability to notify the court about the situation. According to an opinion, the notification is not needed, while according to another opinion; the board is obliged to apply to the court if it is identified that the company is deep in debt. .

Although it is thought that recovery measures can be implemented upon the application filed to the court, board members will not be liable if the lack of this notification has not caused any loss. However, failure to send this notification has been regulated as a crime under article 345/a of BEL. However, any trial on the grounds of this crime depends on the complaint of creditors.

Tax aspects of vehicles purchased with loans in vehicle rental companies

I. Introduction

Companies prefer renting the vehicles they use for business purposes, due to reasons such as maintenance and insurance costs, inability to book the motor vehicles tax paid for passenger cars as expense, follow-up of examination processes, etc. As the number of vehicles increases, so does the financing burden, becoming more difficult to monitor and control and the costs also increase due to personnel employed for these works.

II. Legislative provisions

Under the article 269 of the chapter titled “Revaluation” of the Tax Procedures Law, it is stated; “All real estates included in economic enterprises shall be revalued at their cost price. According to this Law, the assets specified below shall be revalued as real estate:

1. The integral parts and accessories of real estate;
2. Facilities and machinery;
3. Ships and other vehicles;
4. Intangible rights.”

Under the article 270 of the same Law on the other hand, it is stated that in case of real estate, the cost price includes the following items in addition to the purchase price:

- Customs duties, transportation and assembly expenses of machinery and equipment; and,
- Expenses arising from the purchase and demolition of an existing building and grading of the land.

Subsequently, the article states that taxpayers are able to include the notary public, court, value assessment, commission and goodwill expenses as well as Real Estate Acquisition and Special Communication Taxes in the cost price or include them in general expenses.

The Tax Procedures Law General Communiqué series no. 163 states that:

“1. The interests related with the loans used in financing the investments, which pertain to the period of incorporation, may be added to the investment cost to be redeemed through depreciation along with the fixed assets, whereas those pertaining to the period of operation may be booked directly as expense in the years they are related with or subjected to depreciation by being included in the cost,

2. The exchange rate differences which arise during or after importation of fixed assets by using foreign currency loans, due to the revaluation of the debt installments relating to these assets, and which are related with the period when the fixed asset is acquired, shall be added to the cost of the asset; exchange rate differences related with these assets and arising after the period in question may be booked directly as expense in the years they are related with or subjected to depreciation by being included in the cost.”

Under the part III of the Tax Procedures Law General Communiqué series no. 334, of the favorable exchange rate differences, the part arising until the end of the period when the capitalization process is realized shall be associated with the cost, while those pertaining to the period after capitalization should be treated as foreign exchange income or depreciated by being deducted from the cost. Furthermore, the Communiqué states that the taxpayer shall continue to operate according to the method he preferred initially in the following periods.

On the other hand, the article 320 of the Tax Procedural Law describes the depreciation application period as follows: “Depreciation period starts from the year when the assets are capitalized. For yearly calculation of this period, the figure (1) shall be divided by the rate applied by the taxpayer.”

In the part 6.1 of the list attached to the General Communiqué series no. 333 of Tax Procedures Law, the useful life and depreciation rate of automobiles and taxis are determined as 5 years and 20% respectively.

III. Exchange rate differences and loan interests subject to capitalization

Within the framework of the aforementioned legislative provisions, loan interests and exchange rate differences arising for vehicles purchased with foreign currency loans must be added to the cost price of the first year. Afterwards, taxpayers are free to add them to the cost price or book them directly as expense. Taxpayers must make their choice in this regard at the beginning. The method selected at the beginning cannot be changed later.

IV. Capitalization applications for loan interests and exchange rate differences

First of all, the vehicles which are purchased with the loan and the vehicles which are purchased with the equity must be determined. After determining the vehicles purchased with loan, the loan with which the vehicle is purchased should be determined.

a. Applications in case loan interest and exchange rate differences are added to the cost price of the first year and then booked as expense

A distribution should be made based on the vehicles' asset values. Loan interests paid and exchange rate differences incurred in the subsequent year would not be included in capitalization and could be booked directly as expense.

b. Applications in case loan interests and exchange rate differences are added to the cost price

The difference between the rate at which the foreign currency loan was last revalued and the rate at the end of the period shall be included in the capitalization calculation. Furthermore, the loan interest paid and the interest accrued shall be capitalized. In case the amount calculated through accrual and included in the cost in the previous year is paid in the year in question, it shall be deducted from the total loan interest amount paid and the remaining amount shall be capitalized.

c. Applications in case vehicles purchased with loans are sold before the loan maturity expires

- i. If the vehicle is sold within the first year, the interest paid and accrued and exchange rate differences incurred until the sales date of the vehicle should be included in the cost while the remaining loan interests and exchange rate differences should be directly booked under expense accounts, regardless of the method selected.
- ii. In case it is preferred to include the loan interests paid and exchange rate differences incurred in the cost in the initial year and to book them directly under expense accounts in following years and the vehicle is sold after the initial year, the interests paid and accrued and exchange rate differences incurred from the end of the initial year until the sale date of the vehicle shall be booked directly under expense accounts.
- iii. If it is preferred to add all loan interests paid and exchange rate differences incurred to the cost price, the loan interest paid and interest accrued and the exchange rate difference that arose until the date of the vehicle sale would have to be added to the cost price when the vehicle is sold. Afterwards, the interests and exchange rate differences corresponding to the vehicle would be booked directly under expense accounts.

V. Depreciation practice

In case loan interests and exchange rate differences are added to the cost price in subsequent years, the amount to be capitalized would be depreciated based on the related vehicle's remaining life.

VI. Conclusion

Whether the interests paid and exchange rate differences incurred in relation with obtained loans shall be added to the cost price or shall be directly treated as expense is an important consideration while taking investment decisions.

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