Major changes to Turkey's bankruptcy postponement regime

Orçun Çetinkaya and Burak Baydar explain the changes

ORÇUN ÇETINKAYA
Partner, Moroğlu Arseven, Istanbul, Turkey

BURAK BAYDAR
Senior Associate, Moroğlu Arseven, Istanbul, Turkey

Share your views!

Turkey's bankruptcy postponement mechanism has been regularly criticised for failing to fulfil its intended goals.

Bad-faith debtors would regularly exploit the legislative arrangements and court processes, using them to threaten or bargain with their creditors by depriving them of enforcement and execution avenues for a significant and uncertain amount of time. However, drastic legislative amendments enacted in August 2016 appear to go a significant way towards evening up the balance between creditors and debtors in this area.

The Turkish bankruptcy postponement regime

Companies which have debts exceeding their assets can request the commercial court postpone their bankruptcy[1] (Article 179[2] of Turkish Execution and Enforcement Code). The requesting company must submit a recovery project report, which outlines how and when the company will recover from insolvency. However, Article 179 previously did not specify required content for the recovery project, nor which accounting data or criteria the report should use to evaluate the chances of recovering from insolvency.[3] Rather, bankruptcy postponement would simply be granted if the court found the report to be compelling and serious.[4]

In practice, the prior legislative mechanism would allow applicants with very low chances of financial recovery to postpone their bankruptcy by providing a recovery report based on questionable accounting principles, outlining mythical routes for the company's financial recovery.

When agreeing to postpone bankruptcy, courts are empowered to take any precautions necessary to protect the applicant's assets (Article 178(a) of the Turkish Execution and Enforcement Code) and can issue almost unlimited types of injunctive orders to protect the applicant from creditors. In practice, applicants would take advantage of this and file injunction requests in conjunction with their bankruptcy postponement requests.[5] In this way, applicants commonly request the court halt all ongoing execution proceedings against the applicant, as well as seek to prevent any further execution proceedings being initiated. Thus, the legislative framework would allow an insolvent applicant to become protected from its creditors during the litigation process, including public creditors.

If the court finds the recovery report compelling, it can postpone the bankruptcy for one year. The court also appoints a trustee to the applicant, to replace the board of directors, or to approve the board of directors' decisions. Based on reports given by the trustee, the court could previously extend the postponement period for up to four further years. Another practical factor to consider is that the judicial procedure generally takes around two years in itself, before the court will give a postponement decision.

Therefore, the reality of the legislative regime was that a company in serious financial difficulties could halt creditors' execution proceedings for up to seven years:

- Two years for the judicial processes;
- One year postponement (initial court decision); and
- Four years of extension (based on trustee reports).

Between 2009 and 2014, 3,524 companies applied to postpone bankruptcy in Turkey.[6] However, from the applicants which were ultimately granted a postponement, only 2% were subsequently able to recover from insolvency. The remaining 98% of postponement recipients were ultimately declared bankrupt, despite the court's postponement decision.

Accordingly, it is beyond doubt that the Turkish bankruptcy postponement route was failing to fulfil its intended goal and was vulnerable to abuse. It had become a serious obstacle for banks and other creditors, preventing proper maintenance of commercial activities.

Amendments to the bankruptcy postponement regime

In June 2016, Turkey's Ministry of Finance and the Ministry of Justice put forward draft legislation to reform this area. The draft legislation introduced drastic amendments, seeking to turn the system into a tool which equally addresses both creditors' and debtors' interests. The draft legislation passed parliament on

15 July 2016 and was enacted on 9 August 2016, with approval from the president.

Key amendments under the new legislative mechanism include:

- *Specific document and data requirements:* Under the amendments, legislation now specifies the exact documents and data which companies must submit when applying to postpone bankruptcy. The aim is to eliminate the discretionary power currently held by experts who prepare recovery reports. If the applicant fails to submit the required information within a two-week grace period, the applicant will be immediately declared bankrupt. Accordingly, applicants are now required to submit a list showing:
  - Payment terms and amounts of due debts.
  - Creditors' addresses.
  - Stocks.
  - Waiting periods and amounts.
  - The last balance sheets submitted to tax authorities.
  - Income table.
  - Trade registry certificates.[7]
- *Meeting management expenses and working capital during postponement period:* Under the amendments, the recovery project report must now demonstrate how management expenses and working capital will be met during the postponement period. The demonstration should include tangible sources and precautions, including, but not limited to, adding new funds.[8] The intention is to increase transparency and eliminate bad-faith applications.
- *Codified opportunity for creditors to object to postponement:* Under the amendments, creditors now receive the legislative basis for objecting to bankruptcy postponement, within two weeks of its announcement in the trade registry.[9] Creditors receive two weeks to object (request the application be rejected) on the sole ground that the applicant does not meet the statutory conditions for bankruptcy postponement. A similar mechanism already existed, but courts would apply this inconsistently and only by analogy with other provisions. The amendment codifies the topic and eliminates uncertainties in prior practice.
- *Single revision to recovery report:* Under the amendments, applicants are now only permitted to submit a revised recovery project once during proceedings.[10] The intention is to limit the practice of making bad-faith or non-essential revisions to these reports, in order to extend proceedings.

> **THE PRIOR LEGISLATIVE MECHANISM WOULD ALLOW APPLICANTS WITH VERY LOW CHANCES OF FINANCIAL RECOVERY TO POSTPONE THEIR BANKRUPTCY**

> **A FOUR YEAR EXTENSION TERM HAS PROVED TO BE NOTHING BUT A TOOL TO THREATEN CREDITORS**

- *Postponement period reduced from four years to one year:* Under the amendments, extensions to the postponement period are reduced from four years to one year.[11] Four year extension periods have proved to be statistically unlikely to help applicants recover from insolvency.
- *Postponement not available within one year of prior bankruptcy postponements:* Under the amendments, applicants which have already benefited from a bankruptcy postponement cannot apply for a further postponement within one year of the earlier postponement period ending (including extension periods).
- *Requirements and workload limitations for trustees:* The amendments introduce detailed regulations for trustees. Clear and detailed trustee duties are intended to eliminate uncertainties which arise in current practice. Notable aspects include:
  - The court can now appoint multiple trustees if it believes a single trustee will not be capable to handle all necessary duties.
  - A single trustee is limited to appointment to three companies. Under prior practices, a trustee could be appointed to 50 or 60 companies, making it impossible to reasonably evaluate and control the recovery process for all companies.
  - Courts can now terminate a trustee and appoint new trustees, if necessary.
  - Trustees must now submit a quarterly evaluation report to the court about whether the applicant shows improvements.[12]
- *The fate of injunctions are clearly determined if the postponement decision is later quashed:* Under the amendments, if the Supreme Court reverses the previous court's decision to postpone bankruptcy, measures applied to the debtor's assets are not directly lifted.[13] If the Supreme Court makes such a ruling, it was previously unclear whether injunctions granted by the lower court should remain intact, or be deemed to be quashed along with the court's award.

Will the amendments successfully balance creditors' and debtors' interests?

The legislative amendments are undoubtedly drastic, but outline necessary and overdue changes to Turkey's bankruptcy protection legislation.

Limitation of the postponement extension period is long overdue. A four year extension term has proved to be nothing but a tool to threaten creditors and has statistically proven to have negligible positive effect on an insolvent company's recovery.

It should be borne in mind that bankruptcy postponement, by its nature, is not a debt restructuring institution. Rather, it aims to get the applicant back on its feet and support insolvent companies to continue business. Therefore, the first step in a postponement application should be to determine whether the applicant will be in better shape in one or two years.

The amendments require postponement applicants to submit the same balance sheet which they submitted to the tax authority. Previously, insolvent applicants would submit different balance sheets to different institutions, whilst still complying with financial regulations.

The amendments will undoubtedly have an impact on reducing bad-faith applications. However, related tax regulations continue to allow bad-faith

applicants to prepare and submit balance sheets to the tax authorities which do not reflect the real situation. Therefore, despite the amendment, misleading documents can still become admitted during bankruptcy postponement.

Therefore, although the amendments specify the documents and data to be submitted during postponement applications, this measure will likely be insufficient on its own to completely prevent bad-faith applications. Related financial regulations must also be strictly reorganised in parallel, to introduce sanctions for preparing different balance sheets with regard to the same time period. ■

Footnotes:

1 Supreme Court 19th Civil Chamber Decision dated 20.03.2008 (E. 2008/9249) – "*It is stated in the expert report that the assets of the Company are enough to cover its debts. Granting bankruptcy in such a case is against the law and the procedures. The first instance court should have rejected the requests of the claimant*"

2 Article 179. – If and when it is declared by the management and representative bodies or if the company or the cooperative society is in liquidation, by its liquidators or a creditor, or it is determined by the competent court that the liabilities of the capital company or the cooperative society are more than its assets, the capital company or the cooperative society will be adjudged bankrupt without a prior bankruptcy proceeding. Provided, however, that any one of the management and representative bodies or the creditors may demand adjournment of adjudication of bankruptcy by filing to the court a project of recovery proving that the company or the cooperative society may be recovered. If the project of recovery is found serious and persuasive, the court will adjourn adjudication of bankruptcy. Information and documents proving that the project of recovery is serious and persuasive must also be presented to the court. The court may, if deemed necessary, hear the management and representative bodies and the creditors. Demands for adjournment of adjudication of bankruptcy will be tried with priority and as a matter of urgency.

3 Supreme Court 19th Civil Chamber Decision dated 13.06.2002 (E. 2002/1267) – "*The Court shall decide on postponement in the event that it is convinced the measures to be taken are enough for the Company to recover. The Court may request a report from an expert team in order to decide whether or not the measures to be taken are sufficient.*"

4 Supreme Court 19th Civil Chamber Decision dated 25.11.2010 (E. 2009/9027) – "*In the event that the recovery report has been found compelling and serious, the Court shall grant postponement to the Company. Compellingness and seriousness of the recovery report shall be determined on solid facts.*"

5 Supreme Court 23rd Civil Chamber Decision dated 06.05.2013 (E. 2013/3126) – "*In bankruptcy postponement cases the courts are empowered to take any precautions necessary to protect the applicant's assets if they find the reasons presented for it by the claimant compelling. When deciding for the measures, the Court should protect benefits of the creditors as well as the Company. However the Court should not eliminate legal ways enabling creditors to claim their receivables.*"

6 According to main opposition party report dated 22 June 2016 submitted to parliament. *See http://www2.tbmm.gov.tr/d26/2/2-1267.pdf (only available in Turkish)*

7 Article 179/3 of Enforcement and Bankruptcy Law numbered 2004

8 Article 179/2 of Enforcement and Bankruptcy Law numbered 2004

9 Article 179/a-2 of Enforcement and Bankruptcy Law numbered 2004

10 Article 179/a-8 of Enforcement and Bankruptcy Law numbered 2004

11 Article 179/b-4 of Enforcement and Bankruptcy Law numbered 2004

12 Article 179/b-6 of Enforcement and Bankruptcy Law numbered 2004

13 Article 179/c-2 of Enforcement and Bankruptcy Law numbered 2004

> **BANKRUPTCY POSTPONEMENT, BY ITS NATURE, IS NOT A DEBT RESTRUCTURING INSTITUTION**