UNIVERSITY OF CALIFORNIA, DAVIS SCHOOL OF LAW

Corporations Purchasing Their Own Shares: A Comparison of Turkish and American Corporate Law

Dissertation

Nazım Can IŞIKTAÇ

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This study focuses on corporations, including corporations with only one shareholder, purchasing their own shares especially with regards to restrictions on transferability of shares from a Turkish and American corporation's law comparison.

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I. Introduction

With this study we will try to provide a comparative research between Turkish and American corporations about purchasing their own shares. As to be clear this study will only be focusing on *Anonim Şirket* ("Turkish Corporations") and *Corporations* ("American Corporations"). Accordingly other types of commercial entities will not be covered in here.

Excluding partnerships [without separate legal entities] law there are five types of commercial associations in Turkish law. The most prevalent ones are *Limited Şirket* and *Anonim Şirket*. *Limited Şirket* has more partnership characteristics, somehow similar to Limited Liability Companies, particularly with regards to relation of shareholders and transferability of shares. *Limitet Şirket* tends to be the type of commercial association that is being used by small to medium size businesses.

Anonim Şirket on the other hand, whose name can be translated to English as "anonymous partnership [or company]", is less dependent on partners. *Anonim Şirket* shareholders do not have to have a relation with other shareholders or the corporation itself at all and they can transfer their

shares as easy as possible [this may be changed with the articles of association] just like American corporations. Because of this similarity *Anonim Şirket* is the type of organization that is more appropriate to compare with the American corporations.

Corporations are historically exists to courage individuals to invest with a minimum risk. Limited liability and a separate legal entity are the most important features of corporations. Even though some writers impose bigger roles to corporations[1] almost everyone seems to agree on that corporations are commercial entities and their main goal is to make profit. This is accurate for both jurisdictions. Nevertheless it is also possible to find significant differences in corporate law as a result of the difference in legal, political and cultural approaches. Despite those differences both countries need to interact with each other and hopefully this study will be useful for businessmen and lawyers by pointing out the differences and giving an idea on how to do business in the other jurisdiction.

II. The New Turkish Commercial Code

Historically and similarly to some continental European countries, in Turkey the main principles of business associations law is covered in and under Commercial Code. The new Turkish Commercial Code numbered 6102 ("Commercial Code") has been enacted in 01.13.2011 by the Grand National Assembly of Turkey and entered into force effective from 07.01.2012.[2] New Code amended many aspects of the Turkish commercial law significantly. One of the

[1] Conscious Capitalism movement can be shown as an example to this. More information can be found at http://www.consciouscapitalism.org/

[2] 6102 Sayılı Türk Ticaret Kanunu http://www.tbmm.gov.tr/kanunlar/k6102.html

amendments is that the Commercial Code now allows Turkish corporations to purchase their own shares. Another long expected amendment was corporations with one shareholder. Old commercial code mandates a minimum number of five shareholders for *Anonim Şirket*. Two mentioned modifications in the commercial law makes it more important to understand the American interpretation of law as these are concepts that has been applied by American law for a long time and there are not enough Turkish law reviews and interpretations yet in this subjects.

III. Corporations Purchasing Their Own Shares

a. The Concept of Share

Shares are the principle concept of corporate law.[3] Therefore to define "share" regarding to each jurisdiction shall be an important part of this study especially to point out the different approaches regarding to the general subject of this paper.

From the American law perspective we should first remark that as a consequence of United States being a federal regime it is not possible to say there is a nationally unified corporate law in the United States. "[C]orporate law consists of four major modules: state statutory law; state judge-made law, federal law, such as the Securities Acts and Sarbanes-Oxley; and private ordering, or "soft law", such as stock-exchange rules for listed companies".[4] This complexity forces us to consider state law while defining the shares. Since, "[o]f the corporations that make

[3] REHA POROY et al., ORTAKLAR VE KOOPERATİFLER HUKUKU 439 (2005)
[4] MARVIN A. EISENBERG & JAMES D. COX, CORPORATIONS AND OTHER BUSINESS ORGANISATIONS 193 (2011)

up the Fortune 500, more than one-half are incorporated in […]"[5] the State of Delaware, Delaware is considered to be the most important corporate jurisdiction in the United States.

Delaware statutory law regarding to formation of corporations is as follows;

§ 102. Contents of certificate of incorporation

"(4) If the corporation is to be authorized to issue only 1 class of stock, the total number of shares of stock which the corporation shall have authority to issue and the par value of each of such shares, or a statement that all such shares are to be without par value. If the corporation is to be authorized to issue more than 1 class of stock, the certificate of incorporation shall set forth the total number of shares of all classes of stock which the corporation shall have authority to issue and the number of shares of each class and shall specify each class the shares of which are to be without par value and each class the shares of which are to have par value and the par value of the shares of each such class."[6]

As can be seen from the statutory law a Delaware corporation has to express within its articles of association the allowed number of shares [for each type of share if there are more than one] that can be issued and if the shares have a par value or not. Keeping in mind that articles of associations can be amended by majority vote or as it is regulated in the articles of association itself; a Delaware corporation does not have to have a par value for shares and the number of

[5] LEWIS S. BLACK Jr., *Why Corporations Choose Delaware*, (Dec. 7, 2012) *corp.delaware.gov/whycorporations_web.pdf*

[6] 8 Del.C. § 102 (Westlaw)

shares can be increased by issuing more shares or can be lowered by buying back from the shareholders at board's discretion regarding to § 152.[7] Simple definition is that in Delaware corporation's law "[a] share represents an equity or ownership interest in [a] corporation or joint-stock company".[8]

On the other hand capital – share connection is slightly different in Turkish law. Turkish law considers determinability of the declared capital as a general principle of corporations. As Professor Pulaşlı defines, a corporation's capital should be predetermined and must be divided into shares.[9] Determinability is the nature of declared capital.[10] Therefore Turkish legal academia tends to define share, considering the determinability of declared capital principle. Share's definition regarding to a well-respected group of professors in Turkey is "a part of the declared capital of the corporation which has been divided into predetermined number and value of particles".[11]

The practical difference in the share concept can be seen as we investigate through Commercial Code. Except for banks, publicly-held corporations and other highly capital-oriented and differently regulated businesses Article 332 of the Commercial Code mandates Turkish corporations to have TL 50,000 (which is around USD 28,000 as of today) declared capital, to be established. This amount is TL 100,000 for closely-held corporations with registered capital system. According to articles 335 and 344 of the Commercial Code, founders of a corporation has

[7] 8 Del.C. § 152 (Westlaw)
[8] Black's Law Dictionary, 9th ed. 2009 (Westlaw)
[9] HASAN PULAŞLI, ŞİRKETLER HUKUKU: TEMEL ESASLAR 439 (2011)
[10] Id.
[11] Id. 386

to pay at least 25% of the capital before registration of the corporation and have to irrevocably undertake to pay the remaining amount within 24 months of the registration.

Another differentiation from American law can be seen from the paragraph above about Turkish corporation's law is that Turkish law mandates a certain minimum amount of par [or nominal] value. At least the minimum legal amount should be invested in to incorporate. Article 347 forbids issuing shares below the par value. Obviously the goal of accommodating par value is to protect third parties, particularly, creditors and employees of the corporation. Especially when it is considered with article 376 where the board is obliged to gather the General Assembly [shareholders] in case half or more of the declared capital is unrequited, the mentioned third party protection notion can be perceived more clearly.

Another rule about the capital structure of Turkish corporations that aims to protect third parties is Article 473. Article 473 (2) forbids lowering the declared capital of the corporation unless there are enough assets to cover corporations obligations to third parties in full. That setting of Turkish law creates a more pro third parties law compared to American law.

Strict application of declared capital system and par value can be criticized from a practical point of view with regards to the third party protection they provide. First, the mandatory minimum capital amounts the law mandates are relatively low for most businesses that they do not fulfill third party obligations in most cases. Second even if the declared capital is high enough to fulfill the third party obligations, declared capital is just a paper value and does not mean the corporation has any assets whatsoever. Latter one is particularly true for the corporations that are financially in bad shape.

As [corporations] approach insolvency, shareholder incentives to siphon away value or gamble on risky projects grow rapidly.[12] To cabin these incentives, all jurisdictions have devised ways to induce insolvent firms to file for bankruptcy with reasonable promptness.[13] Germany and Switzerland as well as Turkey require board to initiate bankruptcy proceedings upon onset of insolvency[14] and we believe this provides a better and more reasonable protection to creditors compared to strict application of par value and declared capital.

As a final point on the subject we should also mention that there are two types of share certificates in Turkish corporation's law. First type is registered in the name of the holder other type is to the holder. Those two types of share certificates have different transferability rules which covered in the restriction on transferability of the shares section below.

b. The Rules about Corporations to Purchase Their Own Shares

Regarding to the previous Commercial Code[15], a Turkish corporation was not allowed to purchase its own shares, moreover was not allowed to accept its own shares as pledge and if it does so such actions were to become void.[16] The reason for this codification is that the lawmakers believed that the declared capital of the corporation weakens as the corporation acquires its own

[12] [12] REINER R. KRAAKMAN et al., ANATHOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 73 (2004)
[13] Id.
[14] Id.
[15] Commercial Code numbered 6762
[16] PULAŞLI, 404

shares.[17] Other reasons shown for this prohibition are to meaningfully force the law that regulates how to lower the declared capital of the corporation and to prevent stock speculation.[18] Latter is debatable. We believe that this prohibition's sole objective is to protect creditors and employees of the corporation as mentioned in the previous subchapter of this study and especially for closely-held corporations purchasing its own shares to speculate stocks is not a threat since the shares of a closely-held corporation do not have a determined market value and a wide-enough network of prospective investors. Speculating share prices can be named as a substantial threat for publicly-held corporations. However if there is such risk, as this risk is only for publicly-held corporations, it should be covered in Capital Markets Code[19][20] not in the Commercial Code.

The new code on the other hand has a different approach to this. Law makers, to harmonize with European Union Directive 77/91[21], codified a more elastic and detailed law that is completely different from the old code with regards to corporations purchasing and accepting as pledge of their own shares.[22] Article 379 prohibits a corporation to purchase or accept as a pledge of more than 10% of its declared or issued shares. As from the opposite a corporation is allowed to purchase [or accept as a pledge] its own shares up to 10% of the outstanding shares. In the same article it is clearly expressed that this prohibition covers third parties purchasing shares as their own name but in the benefit of the corporation. Furthermore, 379 (2) mandates an authorization from the General Assembly to be given to Board that cannot be longer than 5 years for a corporation to purchase its own shares. Additionally article 338 (3) prohibits a corporation

[17] Id.
[18] Id.
[19] http://www.resmigazete.gov.tr/eskiler/2012/12/20121230-1.htm
[20] This code regulates Securities Law as Securities Acts of American law
[21] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31977l0091:EN:HTML
[22] KENDIGELEN, 231-232

to purchase its own shares in a way that it converts the corporation to a corporation with only one shareholder.

It is true that allowing corporations to buy their own shares provides some elasticity to businesses. However from our opinion with such limitations above the new code does not construe a "completely different" rule from the old code.

Delaware statutory law allows corporations to purchase their own shares by saying;

> *"§160 (a) Every corporation may purchase, redeem, receive, take or otherwise acquire, own and hold, sell, lend, exchange, transfer or otherwise dispose of, pledge, use and otherwise deal in and with its own shares* […]*23"*

As can be seen above the rule in Delaware is that corporations can deal in with their own shares. This is especially an important feature for closely-held corporations as their shares typically do not have a market and in most cases corporation itself is considered to be one of the best potential purchasers of the shares amongst with the other shareholders of the corporation. This elasticity can be used as in many ways from a retirement for a shareholder or as a venture capitalist's exit plan to re-structuring a corporation's management. It is obvious that making another potential share-purchaser available legally and meaningfully, at least in economic theory, should increase the value of closely-held corporation's shares.[24] If this is true that would motivate entrepreneurs to establish business and so on.

[23] 8 Del.C. § 160

[24] For brief information about the share price theories ANDREW KEAY, THE CORPORATE OBJECTIVE 49-50 (2011)

However corporation's dealing in with their own shares is also a feature that can be abused easily by the management, board of directors, or shareholders; particularly against smaller shareholders of the corporation and for that reason §160 (1) to (3) sets the limits of the principle rule.

§160 (1) forbids a corporation to enter into purchase of its own share transaction that would impair the corporation's capital structure unless corporation's capital stock is reduced in accordance with retirement stocks[25] or §244[26].

§160 (2) is about the valuation and pricing of the redeemed shares. Unless there is a fair pricing and bona fide purchase timing for the redeemed shares or unless otherwise stated in the articles of associations; the actions of the corporation, therefore the directors, could be subject to a derivative action.[27]

Fair pricing is the most important point of a share-purchase by the corporation of its own. With regards to Turkish law a litigant can claim only his real loss. Therefore in derivative action or other "fair pricing" litigation, the potential verdict of a Turkish court shall be the difference between the price paid and the fair price [and interest, court costs such as Taxes, and a reasonable potential loss for the upcoming years]. Therefore, from a practical point, if a fair price is paid to the purchased shares it would minimize the litigation risk with respect to Turkish law. For both jurisdictions there is no pre-determined "fair price" calculation method and usually this method tends to be very arbitrary in a dispute. For handling this risk, parties should better agree on a fair price calculation method with a pre-dispute or a post-dispute written agreement.

[25] 8 Del.C. § 243 (Westlaw)
[26] 8 Del.C. § 244 (Westlaw)
[27] 8 Del.C. § 160

Besides pricing, the legality of the decision is also an important point of this subject. A corporation to purchase its shares, a management or board decision is required. With regards to American corporation's law, actions of directors are protected by business judgment rule to a certain degree. "[B]usiness judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[28][29] The deciding court needs self-dealing directors and/or conflict of interest of the directors with regards to the transaction to avoid business judgment rule and to judge the case.

The conflict of interest or self-dealing for a director could be a variety of actions from purchasing his own shares using corporation's resources for protecting her position[30] at the cost of shareholder interest. Mentioned actions can be gathered under "Duty of Loyalty". Duty of loyalty "[…]forbid[s] directors, officers, and auditors from entering unfair or illicit self-dealing transactions or otherwise misappropriating company assets"[31] In most cases a fair valuation and timing, or consent of an independent board or shareholders would remedy such actions.

c. Corporations with One Shareholder

[28] R. Franklin Balotti and Jesse A. Finkelstein, Del. L. of Corp. and Bus. Org. § 4.19 Balotti and Finkelstein's Delaware Law of Corporations and Business Organizations (Westlaw)

[29] For more information about business judgment rule *In re the WALT DISNEY COMPANY DERIVATIVE LITIGATION,* 906 A.2d 27 (Del. 2005)

[30] *Cheff v. Mathes* 41 Del.Ch. 494 (Del. 1964)

[31] KRAAKMAN et al.114-115

Corporation with only one shareholder is a brand new form of business entity that has been enacted with the Commercial Code. One of the many reasons for this new institution is to attract foreign direct investors to Turkey.[32] Regarding to the new rule, Article 338 allows corporations to be established with one shareholder. When a corporation established by only one shareholder or if the corporation converts to a corporation with one shareholder the shareholder's name and address shall be publicized on the Trade Registry Gazette.

For the corporations with one shareholder, the rules for purchasing their own shares should be applied differently. First difference is that even though the corporation purchases its own share the ownership percentage does not change. Secondly, as there is only one shareholder "fair pricing" is not an issue among shareholders but with the third party creditors of the corporation. Third parties may challenge the legality of a corporation's share dealings of its own only in case they prove that such wrongdoings affected their situation.

Piercing the corporate veil could be used to cure such third party damages. Delaware law explains *piercing the corporate veil* as; "the use of a corporate form to perpetrate a fraud," in which case "equity will look behind the formalities and fix liability upon the active wrongdoer."[33][34]

[32] For general information SERPİL YAŞAR, TÜRKİYE'DE YATIRIM ORTAMININ İYİLEŞTİRİLMESİ, DOĞRUDAN YABANCI YATIRIMLAR VE İŞ YAPMA KOLAYLIĞI(DOING BUSINESS), http://www.spk.gov.tr/yayin.aspx?type=yay03&submenuheader=-1

[33] Irwin & Leighton, Inc. v. W.M. Anderson Co., 532 A.2d 983, 987 (Del. Ch. 1987)

[34] See Also; Stauffer v. Standard Brands Inc., 40 Del. Ch. 202, 178 A.2d 311, 316 (1962); Sonne v. Sacks, 1979 WL 178497 (Del. Ch. 1979)

Turkish law allows piercing the corporate veil in cases that the corporate veil is abused with *dolus* by the shareholders.[35] However as per corporation with one shareholder it is harder to separate the legal entity from the owner therefore piercing the corporate veil rules should be interpreted differently.

Sole-shareholder should be more careful with the corporate procedures such as article 408 (3)[36]. Article 408 (3) gives the sole-shareholder the power of the general assembly; however orders the decision to be written. A corporation purchasing its own shares, where there is only one shareholder, is more likely to be seen as an abuse to third parties. To avoid a reparation in a potential *piercing the corporate veil* dispute, the sole-shareholder should obey corporate procedures on corporations purchasing their own shares, such as giving the authorization to the board as the general assembly [even though they are the very same real person] in writing, fair pricing and fair timing and 10% purchase limit and so on.

d. Restrictions on Transferability

Fully transferable shares are yet another basic characteristic of the business corporations that distinguishes the corporation from the partnership and from various other standard-form legal entities as well.[37] The transferability permits the [corporation] to conduct business uninterruptedly as the identity of the owners changes, thus avoiding the complications of member

[35] Yargıtay 19 H.D. E. 2005/8774, K. 2006/5232 [Supreme Court of Turkey 19th Law Office, file number 2005/8774, decision number 2006/5232]
[36] http://www.resmigazete.gov.tr/eskiler/2011/02/20110214-1-1.htm
[37] REINER R. KRAAKMAN et al., ANATHOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 11 (2004)

withdrawal that are common among, for example, partnerships, cooperatives, and mutuals.[38] Transferability of shares is a very important feature of corporate law since it provides liquidity for shareholders and also when thought along with corporations being a separate legal entity from their shareholders, transferability makes conducting business easier for third parties too since otherwise they would have to judge the credit-worthiness of the shareholders.

Transferability of shares can be restricted. Regarding to Delaware law, transferability of shares can be restricted by imposing in certificate of incorporation[39], bylaws, or by an agreement between shareholders and/or an agreement between shareholders and the corporation.[40]

Turkish corporation's law allows transfer of share restrictions that is written in the articles of association.[41] After establishment of the corporation, seventy five percent of the shareholder's votes are required to restrict transferability of shares that is in the name of the holder.[42]

Regarding to Commercial Code, the only limitation to transferability of shares may be requiring the corporation's consent.[43] As an example to this; a share that is registered in the name of the holder and whose contribution has not been paid in full can only be transferred with corporation's consent and a corporation may refuse to give such consent if there is a reasonable doubt that transferee's financial strength is not adequate to pay the remaining share contribution.[44] Besides that Commercial Code sets other rules on restriction of transferability of

[38] Id.
[39] different word for articles of association
[40] 8 Del.C. § 202 (b) (Westlaw)
[41] Article 339 (2) (d) of 6102 numbered Commercial Code http://www.tbmm.gov.tr/kanunlar/k6102.html
[42] Article 421 (3) (c) of 6102 numbered Commercial Code http://www.tbmm.gov.tr/kanunlar/k6102.html
[43] Kendigelen 346
[44] Article 491 of 6102 numbered Commercial Code http://www.tbmm.gov.tr/kanunlar/k6102.html

shares between articles 491 to 501, and providing different rules for publicly-held corporations amongst them, that the corporation's consent can be requested for the transfer of the shares.

Those rules seem to ignore transfer of shares where the corporation is a party of such transfer. As this is a new institution of Turkish corporation's law we have to wait and see the Turkish Supreme Court's decisions and interpretations regarding to this. However Swiss Supreme Court decisions can be analyzed to have an opinion about the future interpretation of the subject "as this part of the commercial code is basically translated from Swiss Obligations Code § 685 to 685 (g)"[45]

We believe that to interpret restrictions on transferability of share's general principles such as rule of fairness and equal treatment to shareholders should be used among fiduciary duties. In any case corporation itself should be treated equally to other shareholders.

IV. Conclusion

Corporations purchasing their own shares is a very important feature for closely-held corporations. As defined above closely-held corporations usually do not have a market for their shares. Usually the potential market for those shares is limited with the other shareholders of the corporation. Modernized Turkish law, with the new Commercial Code, allows corporations to purchase some of their own shares under certain conditions. This provides a bigger market and value for the shares which is obviously good for shareholders, as long as this feature is used

[45] Kendigelen 344

fairly, and for the businesses since a better potential share-value and easier-to-sell shares motivates entrepreneurs to invest and do business. Other than those this feature also creates a better investment environment for foreigners. Even though it is limited, investors invest with an exit strategy and selling the shares to the corporation is a common exit strategy.

On the other hand we still question if the change that Commercial Code provides is adequate or not. Rules on corporations purchasing their own shares in Turkish law provide lesser elasticity as an exit strategy of a shareholder from a closely-held corporation when compared to American and Delaware law in particular. When the elasticity of a corporation to purchase its own shares is limited, the options of corporation to re-structure its ownership are also limited. This may be critical in some cases such if shareholders are in a conflict in a way that it affects corporation's performance. With but not limited to those reasons we believe the limitations on share purchase transactions are bad for investment environment and fiduciary duties, duty of loyalty, piercing the corporate veil, fair pricing, fair timing and such more vague rules provide adequate protection to third parties that can be interpreted by courts over time instead of one-size-fits all rules.