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Liability of Controlling Company for Debts of Controlled Company

INTRODUCTION

Though legally independent from each other, organizations formed on the basis of control relationship by more than one company are called a group of companies. Turkish Commercial Code No. 6762 lacked a specific regulation related to organizations that are formed as such. However, frequent encounters with these organizations have, in time, led to the requirement of legislative regulations related to group of companies and regulations regarding group of companies have introduced for the first time in Turkish Law under Turkish Commercial Code No. 6102 (hereinafter referred to as "TCC"). In terms of the group of companies that provided legal basis for the first time, TCC also contains comprehensive regulations in the context of the liability of controlling company.

I. CONCEPT OF CONTROL

Group of companies, formed by controlling company and companies which are directly or indirectly controlled by a controlling company, subjects to a special regime under articles (hereinafter referred to as "art.") 195 to 209 of TCC.

Art. 195/I of TCC regulates control relationship under two major categories. In the first category called "actual control" in doctrine, a commercial company either directly or indirectly, (i) hold the majority of voting rights, or (ii) have the right to appoint members to the management organ which can make up the quorum of decision as per the articles of association, or (iii) make up the majority of the voting rights, individually or together with the other shareholders as per a contract, of another commercial company.

In the another category called "conventional control" in doctrine, a commercial company controls another commercial company as per a contract based on law of obligations. In both of the aforementioned categories, the former is regarded as controlling company and the latter is regarded as the controlled company. If the registered office of at least one of these companies is located in Turkey, the provisions of TCC regulating group of companies apply.

Moreover, as per art. 195/II of TCC, except for the circumstances stipulated above, if a commercial company holds the majority of the shares or the shares that are sufficient to pass managerial decisions in another commercial company, the former is presumed to have control over the latter, unless and until proven otherwise.

On the other hand, “indirect control” occurs where a controlling company controls an other company through one or more controlled companies.

When looked in terms of its scope, control is examined under two main categories as “full control” and “particial control”. In the full control, a commercial company, directly or indirectly, holds hundred percent of the shares and voting rights of another commercial company (art. 203 of TCC). On the other hand, particial control means control of a part of the share or voting rights. Therefore, particial control includes circumstances of control other than full control.

II. LIABILITY FOR UNLAWFUL USE OF CONTROL

Regardless of the category of control, it does not give controlling company the right to unlawfully use of its control. Liability for unlawful use of control is regulated under art. 202 of TCC.

Paragraphs 1 and 2 of art. 202 of TCC, set forth two main circumstances which would constitute a contravention of the law. In fact, these circumstances are not unlawful, unlawfulness arises from the context of the use and implementation of the control.

A. LIABILITY FOR LOSSES OF CONTROLLED COMPANY

The controlling company may not exercise its power in a way that would make the controlled company incur loss. It may not direct the controlled company to enter into transactions such as transfer of business, asset, funds, personnel, receivables or debt, to reduce or transfer its profits; to encumber its assets with real or personal rights; to undertake liabilities such as standing surety, guaranty or bill guaranty; to make payments; without relying on a just cause, to take decisions or measures that have a negative effect on its productivity or operations such as not renewing the facilities, restricting or ceasing the investments or; to avoid measures that will help the company crow. Otherwise, the controlling company is obliged to compensate for this loss (art. 202/I,b of TCC).

Loss has been actually compensated within that fiscal year or an equivalent claim right, with specific information as to the time and method, has been granted to the controlled company no later than the end of that fiscal year (art. 202/I,a of TCC). This regulation indicates that controlling company can cause controlled company loss by compensating.

The scope of the concept of "loss" used in the provision is wider than the concept of "damage". Loss is all kinds of transaction that reduces or puts at risk the controlled company’s assets or profitability. On the other hand, damage can be defined as all kinds of involuntary loss of material or moral legal values; which means that there must be a decrease of legal values in order to mention of damage. However, it is not necessary to have a decrease in legal values in the unlawful use of control under art. 202/I of TCC. As stated in the justification of the provision, it is sufficient to understand that legal transactions can cause loss.

If the loss has not been compensated within that fiscal year or an equivalent claim right has not been granted within the specified time, any shareholder or creditor of the controlled company may demand that the controlling company and the board members of controlling company, who caused the loss, compensate the company’s loss (art. 202/I, b, c of TCC). Contrary to the art. 556 of TCC related to legal liability in a joint stock company, the condition of bankruptcy of the company is not stipulated for the compensation lawsuit to be filed by the creditors.

For the compensation lawsuit to be filed by the shareholders, an exceptional regulation is stipulated in terms of the principle of commitment to demand. According to the regulation, instead of compensation, the

court may, per se if it is equitable in that specific case or upon request, order that the shares of the claimant shareholders be purchased by the controlling company or may decide on another suitable or acceptable solution (art. 202/I, b of TCC).

The compensation claim is rejected if it is proven that the transaction causing the loss would have been undertaken or abstained from being undertaken by the board members of an independent company, who would, under the same or similar circumstances, act diligently as prudent director and protect the rights of the company in compliance with the principle of honesty (art. 202/I, d of TCC).

Article 553, 555 to 557, 560 and 561 are applied, by analogy, in the lawsuit filed by the shareholders and creditors (art. 202/I, e of TCC).

Also, the provision also stipulates a special rule in terms of authority. According to art. 202/I, e of TCC, if the registered office of the controlling enterprise is located overseas, the lawsuit may be initiated before the commercial court of the controlled company's domicile.

B. LIABILITY FOR DAMAGE OF CONTROLLED COMPANY SHAREHOLDERS

Second category of unlawful use of control is regulated under the art. 202/II of TCC. According to the provision, with respect to the transactions such as merger, division, conversion, dissolution, issuance of securities and important amendments to the articles of association, which are carried out by application of the control power without no well-accepted just cause; the shareholders who have voted against the decision and has their dissention recorded in the minutes, or the shareholders, who have objected to the board resolutions in writing on the abovementioned transactions and similar matters, may ask the court to order that the controlling enterprise pay compensation for the damages or purchase the shares at least with their stock market value or, if such a value is not available or equitable, with their real value or with a value that will be determined by a generally accepted method. The data, as available at the closest date to the court order, is considered while determining the value. The lawsuit for compensation or share purchase is time-barred two years from the date the general assembly resolution in question was passed or the board resolution was announced.

Once the lawsuit is filed, a security amount covering the potential damages of the plaintiffs or the purchase price of the shares, is deposited at a bank designated by the court. If the security amount is not deposited, no action may be taken against the resolution of the general assembly or board (art. 202/III of TCC).

If a lawsuit specified in paragraph 1 and 2 of art. 202 of TCC is taken in bad faith, the defendant may demand that the plaintiffs compensate his damages jointly and severally and deposit a security amount to the court (art. 202/III of TCC).

Finally, it is stipulated in art. 202/V of TCC that the directors of the controlled company may demand that the controlling enterprise undertake, by a contract, all the legal consequences of the liabilities that may arise towards the shareholders and creditors pursuant to art. 202 of TCC.

III. LIABILITY FOR CONTROLLED COMPANY'S DEBTS TO THİRD PARTIES

A. LIABILITY IN ACTUAL CONTROL

1. Lifting The Veil of Incorporation

In accordance with "limited liability principle" that is valid in capital companies, the "principle of separation", which means that the legal entity of the company and the shareholders have independent personalities and assets, is applied and no application can be made to the shareholders due to company debts. However, the malicious use of the principles of limited liability and separation in the context of art. 2 of Turkish Civil Code No. 4721, to the detriment of the creditors, is a frequently encountered situation. In order to prevent this, "lifting the veil of incorporation theory" is applied. Lifting the veil of incorporation is an exceptional theory in which the principle of limited liability and separation is ignored.

Lifting the veil of incorporation may occur in three different ways. First one is the expansion of the liability area of legal entity, which is liable to its creditors only with its own assets, to include the members and partners forming the legal entity. Second one is that the creditors of the partners are given the opportunity to directly apply to the company assets due to the personal debts of the partners. The last one is that the creditors of the affiliated companies can apply to the controlling company or another controlled company under the control of the controlling company, when the group relationship is abused in the group of companies.

2. The Relatıonship Between Group Of Companıes And Lıftıng The Veıl Of Incorporatıon

As explained above, pursuant to art. 202/I of TCC, in the event that the control is used in a way that causes loss of controlled company and the loss has not been compensated by the controlling company, the liability of the controlling company and its managers arises. In this case, the shareholders and creditors of the controlled company have the right to sue for compensation of the loss in favor of the controlled company (art. 202/I, b, c of TCC). However, this right will not be useful, especially in terms of the creditors' access to their receivables. For this reason, it is stated in the doctrine that shareholders and creditors should have the right to sue for compensation for the losses incurred in their assets. Otherwise, since there is no compensation to be awarded in their favor, no one who has the title of plaintiff will need to open the said case.

On the other hand, it is seen that the right to file a lawsuit in the art. 202/II of TCC is only given to the shareholders who have voted against the decision and had their dissention recorded in the minutes or the shareholders who have objected to the board resolutions in writing on the abovementioned transactions and similar matters. However, mentioned decisions regarding corporate reorganizations such as mergers, divisions, conversions are of a nature that may adversely affect the company's assets, which means that the interests of creditors may be harmed. As a matter of fact, there are some regulations in favor of the creditors regarding the reorganization decisions of the companies in TCC. For instance, art. 157 and 175 of TCC have given the right to demand deposit for company creditors in mergers and divisions.

In this respect, if there is a merger or division in the group of companies, although the creditors of the company demand their receivables to be secured as stipulated in the provisions, if the debts of the controlled company cannot be secured due to the instruction of the controlling company, it should be accepted that the creditors can file a lawsuit against the controlling company by applying art. 206 of TCC by analogy.

Because in group of companies, especially in case of full control, the controlled company is obliged to comply with instructions of the controlling company. In this case, it is possible for the shareholders and/or creditors of the controlled company to incur losses in line with the instructions given by the controlling company.

Without prejudice to the provisions regarding unlawful use of control, it is common practice for the controlled company to be emptied and remain a paper company. In this case, it is reasonable for the creditors to want to apply to the controlling company to collect their receivables. For this reason, in addition to legal regulations, the theory of lifting the veil of incorporation should be applied in a complementary way in the group of companies.

B. LIABILITY IN FULL AND PARTICIAL CONTROL

1. Liability in Full Control

Pursuant to art. 203 of TCC, in case of full control, the management organ of the controlling company may give instructions regarding the direction and management of the controlled company. The organs of the controlled company have to comply with these instructions. It is sufficient that these instructions are required by pre-determined and substantial policies of the group; the fact that they may cause loss of the controlled company does not abolish the right to give instructions and the obligation to comply with the instructions.

The exception of the rule regarding giving instructions is stipulated in art. 204 of TCC. Pursuant to this provision, no instruction may be given exceeding the solvency level of the controlled company or endangering the existence of the company or making the company lose its significant assets. Therefore, the management organ of the controlled company is not obliged to comply with such instructions.

According to art. 205 of TCC, the board of the controlled company, its directors and other potentially liable persons are not liable to the company and shareholders for complying with the instructions given as per art. 203 and 204. Since this provision only regulates the nonliability against the company and the controlling enterprise that is the sole shareholder of this company directly or indirectly, it does not abolish the right of the creditors of the controlled company to file a liability lawsuit against the managers of the controlled company. Furthermore, it should be reminded that, pursuant to art. 202/V of TCC, the directors of the controlled company have the right to demand that the controlling enterprise undertake, by a contract, all the legal consequences of their liabilities that may arise towards the shareholders and creditors.

In art. 206 of TCC, the creditors of the controlled company are given the right to legal action. Pursuant to this provision, if the losses, which have been incurred by the controlled company as a result of the instructions given by the controlling company and its directors within the framework of art. 203 of TCC, have not been compensated in the relevant fiscal year or if no equivalent claim right, with specific information as to the time and method, has been granted; the creditors who have incurred losses may file a lawsuit for the losses against the controlling company and its board members who are responsible for the losses.

The defendants may predicate their argument on art. 202/I, d of TCC to avoid liability against the company creditors (art. 206/I of TCC). Accordingly, the compensation claim is rejected if it is proven that the transaction causing the loss would have been undertaken or abstained from being undertaken by the board members of an independent company, who would, under the same or similar circumstances, act diligently as a prudent director and protect the rights of the company in compliance with the principle of honesty.

Furthermore, pursuant to art. 206/II of TCC, the defendants may be released from the liabilities arising from loans and similar kind of debts if they prove that the plaintiff has agreed that no compensation is payable, or no claim right is available for the transaction giving rise to his claims or if they prove that the plaintiff should have known the foregoing as a matter of course.

Whether the compensation to be awarded as a result of the lawsuit to be filed pursuant to art. 206 of TCC will be paid to the company or directly to the creditor as in art. 202/I of TCC, is a controversial issue in the doctrine. One of the opinions in the doctrine argues that the creditor shall directly compensate its own loss in this case.

The view that we agree with, on the other hand, is that the purpose served by the indemnity is to compensate the loss of the controlled company, and therefore, the indemnity should be paid to the company, as it is understood from the wording and reasoning of the provision. However, in this case, since there is no provision similar to art. 202/I of TCC, creditors cannot file a liability case based on art. 206 of TCC before the bankruptcy of the company.

Art. 206 of TCC does not regulate time bar and authorized court. However, the last sentence in art. 206/I of TCC provides that art. 202/I,e of TCC is apply in this lawsuit. Accordingly, art. 553, 555 to 557, 560 and 561 are applied, by analogy, in the lawsuit. Pursuant to art. 560 of TCC, the right to claim compensation against liable parties is time-barred two years after the date the claimant became aware of the losses and the liable parties but in any event five years after the date of the cause of action. As a matter of fact, if the cause of action is a criminal offense for which the Turkish Penal Code No. 5237 stipulates a longer statute of limitations, the longer period shall also apply to the lawsuit for compensation.

In terms of authorized court, pursuant to art. 561 of TCC, liable parties may be sued before the commercial court of the controlling company's domicile.

2. Liability In Particial Control

In partial control, the controlling company's control is in the form of guidance. The guidance does not have a binding effect on the controlled company. This is because the controlled company has the initiative to comply with the guidance of the controlling company. In the event that the controlled company complies with the guidance, the controlling company will be liable for the transactions performed or measures taken, limited only to those within the framework of the direction. Therefore, if the controlled company that has complied with the guidance of the controlling company has made other transactions on its own initiative, the controlling company will not be liable for the losses of the controlled company arising from transactions outside the framework of its directions. However, at this point, attention should be paid to the causal relation between the directions and the actions taken by the controlled company. For example, if a material that is not in the controlled company's inventory is acquired in order to comply with the directions of the controlling company and a loss is incurred in this case, it can be said that there is a causal relation between the direction and the transaction and the liability of the controlling company will arise.

An intervention causing a loss in the controlled company may affect the controlled company itself, its shareholders and its creditors. Due to this intervention, both the controlling company and the managers of the controlled company may be liable. However, as stipulated in art. 202/I, d of TCC, liability cannot be mentioned, if it is proven that the transaction causing the loss would have been undertaken or abstained from being undertaken by the board members of the independent company, who would, under the same or similar circumstances, act diligently as a prudent directors and protect the rights of the company in compliance with the principle of honesty. As stated in the reasoning, this regulation is a requirement of justice.

Furthermore, pursuant to art. 202/V of TCC, the directors of the controlled company may demand that the controlling enterprise undertake, by a contract, all the legal consequences of the liabilities that may arise towards the shareholders and creditors.

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