CONDITIONAL CAPITAL INCREASE SYSTEM AS A NEW CORPORATE FINANCING STRUCTURE

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Abstract: Conditional capital increase system is a novelty introduced to the Turkish commercial practice by virtue of the New Commercial Code. This new system enables holders of certain debt instruments (and in the context of an employee stock option plan) employees of a company to be able to exercise an option to exchange debt claims against an issuer company with shares of the issuer. Upon exercise of their options, these call option holders will benefit from the conditional capital increase system which must be formerly devised by the issuer company and adopted into its articles of association by a shareholder vote. By virtue of this new system affording legal protection and certainty to interested parties, investors will be able to structure new instruments leading to a deepening of the commercial lending market and issuers will benefit from such new financing method.

Özet: *Şartlı sermaye artırımı, yeni Türk Ticaret Kanunu vasıtası ile ticaret hayatına ve uygulamasına giren bir yeniliktir. Bu yeni sistem belirli bazı borç araçları sahipleri ve (çalışanlar için hisse opsiyonu planı dahilinde) şirket çalışanları adına söz konusu tarafların ihraççı şirkete karşı haiz oldukları alacak haklarını şirketten alacakları paylar ile değiştirmek veya şirket payları alımı konusunda opsiyon elde etme hakkına sahip olurlar. Söz konusu opsiyonların kullanımına bağlı olarak bu hak sahipleri, daha önceden ihraççı şirket tarafından belirlenen ve genel kurul kararıyla şirket ana sözleşmesine dercedilen şartlı sermaye artırımı sisteminden yararlanırlar. Hak sahibi taraflara hukuki koruma ve belirlilik imkanı sağlayan bu sisteme göre yatırımcılar, ticari borç piyasasını geliştirecek yeni borç araçları yaratma imkanı bulacak, ihraççılar ise bu yeni finansman metodundan faydalanmak imkanı bulacaklardır.*

Keywords: New Commercial Code, conditional capital increase, provisional capital increase, convertible bonds, convertible debt instruments, bonds with share options employee stock option plan

***Anahtar Kelimeler**: Yeni Ticaret Kanunu, şartlı sermaye artırımı, hisse senedi ile değiştirilebilir tahvil, değiştirme opsiyonlu borçlanma aracı, hisse senedi opsiyonlu tahvil, çalışan hisse opsiyon planı*

I. Introduction

Turkey is in the long lasting process of renewing and transforming its commercial laws and regulations to its fast changing and growing financial markets. Without any doubt the surmountable attempt of adopting a completely new Commercial Code ranks top among the many legislative changes that have recently been made. The current Turkish Commercial Code ("TCC"), which was enacted in 1957 was in some respects insufficient to meet the legal challenges brought by the complex financial structures of today. Therefore, a new Commercial Code becoming effective as of July 1, 2012 (the "New Commercial Code") was prepared after a five-year effort together with active contributions from professional organizations, universities, and NGOs. The goal is to meet the demands of contemporary commercial life, respond to today's business requirements and achieve compliance with the standards and regulations as generally applicable in the EU.

Significant changes are introduced by the New Commercial Code, especially regarding regulation of electronic transactions, consumer protection issues, bolstering minority shareholders' rights and introduction of new corporate governance rules. Among many other important changes, the New Commercial Code introduces three major revisions on corporate capital structure: the ability of companies to acquire their own shares in other words creation of "*treasury stocks*", a registered capital system for privately held (non-

listed) joint stock companies, and a conditional capital increase system[1]. This Article will focus on the new system introduced by the New Commercial Code for the provisional or conditional capital increase mechanism and potential benefits this change may yield in fund raising attempts of domestic corporations. The conditional capital increase system is regulated under Articles 463-472 of the New Commercial Code.

II. Conditional Capital Increase System

1. Potential Beneficiaries of the Conditional Capital Increase System

The existence or in other words the primary need for a conditional capital increase system is very much intertwined with the existence of convertible bonds or similar debt instruments that entitle holders the right to demand an exchange of such debt instruments with company shares or simply allow the holders to buy company shares as envisaged by the terms of such debt instruments. It is precisely because of these interested parties having legal right to acquire company shares, a new system must be devised so as to be able to ensure legal certainty that these interested parties will in fact become a future shareholder in the company.

According to Article 463 of the New Commercial Code, shareholders of a company may decide to conditionally increase the share capital of the company[2] in order to enable holders of newly issued convertible notes, similar debt instruments or employees to exercise their exchange rights or purchase options giving them the right to obtain shares

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[1] All these methods have been previously discussed by the Capital Markets Board as methods that will not only benefit the deepening of the Turkish Capital Markets Board in general but specifically as methods that will incentivize issuance of convertible debt instruments. Treasury stocks as well as the conditional capital increase system were seen as essential tools to unravel the problem of procuring actual shares to investors as a result of the exercise of the exchange rights. Firm capital increase system fails to address the need to provide the investors with equity interest effectively and in a fast fashion, playing also a role in the inability for a local convertible debt market to foster. See *Özdemir*, Özlem; *Hisse Senedi ile Değiştirilebilir Tahviller, Türk Sermaye Piyasasında Uygulanabilirliği, Öneriler, Sermaye Piyasası Kurulu, Yeterlik Etüdü, 1999*

[2] As per Article 456 (1) conditional capital increase may only be carried out if all the outstanding capital subscription amount of the existing shareholders was paid

of the company[3]. Therefore, as per the New Commercial Code, only the employees and (qualified) creditors of the issuing company or its group companies may be a prospective beneficiary under the conditional capital system[4]. We will visit the case as for employees and holders of convertible notes issued by the company which are by definition the primary beneficiaries/addressees of the proposed system. However, the relevant provision also mentions holders of "similar debt instruments" in addition to newly issued convertible notes and employees (in the context of a stock option plan). Inevitably a debt instrument or a borrowing tool suggests not an ordinary credit between a claimant and a debtor but in specific a lending relationship between an issuer borrower and a lender. It seems to us that this reference will enable lenders in a term or revolving facility to be able to benefit from the conditional capital system and devise an exchange or a settlement provision in what is otherwise a standard term facility agreement. By virtue of a repayment clause in a term facility agreement, a lender may devise a system where it may require repayment of the principal at maturity to be made by the borrower in cash or at the election of the lender, *in rem* with actual shares of the company. This being the case, a lender of a term facility may structure a right of exchange by virtue of a "similar borrowing tool" reference[5].

In our opinion, the primary focus of the conditional capital increase system or in other words the actual venue that is envisaged to be used thereby is a full scale debt offering of convertible notes by an issuer company. This type of an offering will surely needs to be accomplished in line with the Turkish Capital Markets legislation and legal requirements for public offering such as listing of the convertible notes with the Capital Markets Board and the Istanbul Stock Exchange, preparation and registration of prospectus to the extent required will have to be fulfilled. On the other hand, we don't believe the goal here is to limit the application of this system to only full scale debt offerings that will be subject to capital markets legislation. As mentioned in the above paragraph, the reference to "*similar debt instruments*" clearly enables the system to be used on a much smaller

[3] For purposes of this article the exchange rights or the purchase rights depending on the nature of the convertible debt instrument having been issued by the company will be collectively referred to as the "call option"
[4] *Pulaşlı*, Hasan; pg 46
[5] For a similar analysis, please see *Kaya*, Mustafa Ismail, pg 75

scale in connection with granting call option rights to one or few creditors without necessarily committing a public offering or even a private placement of debt. This system can and should be used in any private lending transaction if the parties wish to do so[6].

2. How the System Works

2.1 General Conditions

The way the system is envisaged to work is by virtue of first convening a formal shareholders meeting and amending the company's articles of association in order to provide for the relevant details of the contractual call option. Meeting quorum for such a shareholders meeting will be the presence of shareholders holding at least half of the share capital of the company, unless a higher quorum is determined by the articles of association. If such meeting quorum is not achieved at the first meeting, the meeting quorum for the second meeting will be one third of the company's total share capital. In either case, the decision quorum is simple majority of those present at the meeting[7]. Article 465 (1) sets forth the relevant details that must be included in the articles of association by way of an amendment in order to give effect to the call option; i) nominal

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[6] *Biçer* also discusses the same issue and discusses the opinions raised under mostly Swiss law and doctrine See, *Biçer*, Levent pg 179-185. These opinions refer to certain factors if a debt instrument is to qualify as an accepted form of debt instrument within the meaning of Article 463. These are referred to as the debt being easily determinable, debt being eligible to be converted into share capital of the company by virtue of a conversion clause accepted by the company's articles of association and finally debt being eligible for a set off. All these factors in our opinion also backs our argument since each of these qualities exists in a standard term loan agreement between a borrower and a lender. On the other hand *Saraç* tends to be more conservative and argues that ordinary notes, negotible instruments or loan agreements that do not have the characteristics of a "security" shall not be regarded within the meaning of "similar debt instruments" Author suggests that similarity must be in the sense of a similarity to the characteristics of a "note offering". He also states that to include other borrowings that are not "securities" in the context of this provision will result in the loss of shareholder control See *Saraç*, Tahir pg 123-128. We disagree with this analysis for the reasons mentioned above but most importantly from the perspective of this opinion having the effect of an unintended limitation as to usage of the conditional capital increase system. As referred to above we dont believe that sysem should be confined only to sizeable (debt) securities offerings. If the shareholders see a corporate benefit in terms of making a deal using this system they shall well be able to use it for bilateral loan agreements. Also we are unable to understand how shareholder control will be lost in a case where the terms of the very issuance is adopted by an amendment to the articles of assicoation which is implemented solely by a shareholders meeting and voting.

[7] Turkish doctrine criticizes the application of ordinary meeting and decision quorums otherwise applicable for any amendment to the articles of association to such a substantial transaction and argues that the quorum under Article 461 (2) requiring a minimum of 60% vote to be also applicable in this case. *Saraç*, Tahir pg 229

value of the conditional capital increase[8], ii) number, nominal value, and type of each share to be conditionally issued, iii) groups who will be entitled to exercise the right of conversion/purchase, iv) privileges to be afforded to some of the share groups, v) restrictions on transfers of new registered shares[9], and vi) restriction of the statutory preemption right of the existing shareholders and the content of such restriction. Just like the case in any other amendment of the articles of association, the board of directors will need to prepare a draft amendment incorporating all the above issues and invite the shareholders to convene a formal shareholders meeting in line with the generally applicable invitation procedure otherwise provided under the New Commercial Code.

[8] As per Article 464 (1), such nominal value may not be more than half of the company's registered capital. Also, the payment to be made in return of the purchase option must be at least equal to the nominal value of the shares so purchased. The rationale of this limitation is explained in official transcript of the draft law as the need to set a limitation to the exception of the basic rule that the capital may be increased only by a corporate body and that capital shall not be increased unlimitedly by third parties. In our opinion, this limitation as for the nominal value of the capital increased conditionally does not serve a great deal of interest for any of the parties involved. We are struggling to understand the harm a corporation may suffer in case a value which is more than half of the registered capital is injected into the company as a result of such conditional capital increase. At the end of the day, the initial decision to amend the company articles of association and set the ground rule for the proposed issuance of the debt instruments thus the details of the conditional capital increase is made by the existing shareholders at a formal shareholders meeting. In addition the existing shareholders are also afforded the right of first call as mentioned herein. Had this been a non conditional straight capital increase there would be no limitation either for the amount of increase or the ability of the existing shareholders preemption rights to be restricted (considering of course such restriction is made bona fide for a real and reasonable financial end). That being the case, we don't see any reason why such a limitation shall be introduced here, barring the amount of the capital increase eligible to enter into the company. The existing shareholders always have the initial and primary decision making ability to limit or set the amount of the issuance for a convertible debt issuance or the terms of a stock option plan. If that is the case the limitation seems to be a redundant control mechanism. According to *Biçer,* this limitation is addressed to protect existing shareholders. See *Biçer*, Levent pg 128. Also *Saraç* indicates that the limitation is to maintain the current corporate control balance and prevent a sudden change of control in the company as a result of high volume exercises of the call option. See *Saraç*, Tahir pg 83. Yet in our opinion it is still unclear as to why there is such a pressing need for such limitation. Existing shareholders are already afforded statutory protection by means of right of first call as mentioned above. It is the existing shareholders who by virtue of amending the articles of association by a formal shareholders meeting who decide to adopt a conditional capital increase system. They have the legal ability to decide on any applicable limitation as for the type or size of a possible offering but if they decide not to do so and intentionally choose to invite a larger size of outside capital or funds into the company they are not able to do so due to this restriction.

[9] This is rather interesting as this provision implicitly suggests that the new shares to be issued and given to those exercising their call option right may be subject to a different transfer mechanism and regulation as opposed to those shares already held by the existing shareholders. This mechanism could be functional in cases where the company chooses to restrict the new shares given to the employees to be transferred to third parties i.e so long as the employee continues to be employed by the company. In addition, the existing shareholders may introduce yet another level of self protection and may bound the transfer of the newly issued shares to a condition that they are first offered to the existing shareholders before they are transferred to a third party. In this way, despite the fact that new shareholders are somehow welcomed to the company by means of the exercise of the call options, a further transfer of those shares to third parties may be blocked and existing shareholders may retain the right to purchase those shares back.

Such call option will be exercised by the holders thereof by means of a written notice making a reference to the relevant amended provision of the company's articles of association. Thereafter, the exchange or the purchase aspect of the call option will be implemented by means of, as the case may be, making the underlying payment for the exchange right or making the settlement for conversion by using a payment/settlement bank for this purpose. It is clear that this requirement under Article 468(2) aims to provide transparency to the process in terms of requiring payments by the holders of right of exchange to be made to a bank instead of such payments being made directly to the company[10]. *Pulasli* argues that this requirement imposes upon the intermediary bank a specific obligation of investigation. The bank not only needs to investigate and review the written notice given by the call option holder but also will decide upon whether the relevant exchange or purchase conditions have been met before executing the settlement[11]. Upon executing the relevant settlement with the bank as per the above which points out to capital subscription having been paid, shareholder rights will be bestowed upon without having the need to register the capital increase (Article 468 (3)).

As per Article 469 (1), after the closure of financial period or earlier when requested by the company's board of directors, a transaction auditor is required to audit the issuance of the new shares in terms of compliance of such issuance with the law, the terms of the (amended) articles of association and if existing, any prospectus issued for this purpose. Once the transaction auditor's opinion is rendered, the board of directors will adjust the articles of association, most importantly the "capital" provision according to the share capital status of the company occurring after the exercise of the call option. Clearly, the written opinion of the transaction auditor as a precondition for amending back the articles

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[10] A rightful criticism has been raised to the effect that intermediary institutions (brokers) also could have been an appropriate agent to fulfill this role in addition to banks. Please see *Uzunhasanoğlu*, Defne, pg 8. We agree with this opinion in the sense that intermediary institutions would have been a much more efficient settlement institution between the company and the call option holders given their experience in stock markets as compared to banks.

[11] *Pulaşlı,* Hasan, pg. 86. We believe that the banks will act rather reluctant to assume such responsibility especially in early years of practice. This is yet another reason why intermediary institutions acting under the jurisdiction of the Capital Markets Board should have also been designated as an authorized entity for this purpose.

of association will serve as an additional protection for the holders of the call option. As per Article 471 (1), the board of directors will be required to register the amendment to the trade registry within three months of the closure of the company's accounting period accompanied by declaration of the board of directors and transaction auditor report. Declaration of the board of directors will contain a status report as to the number, value, type of the newly issued shares and the then existing capital structure (adjusted as per the ongoing exercise of the call options). The process will be consummated by formally deleting the relevant provision of the articles of association detailing the right of exchange or conversion which after having been exercised became void.

Article 472 of the New Commercial Code refers to "board of directors removing the provision relating to conditional capital increase from the articles of association" which raises a question as to whether an amendment can be made to the articles of association directly by the board of directors without the need to convene a formal shareholders meeting. As mentioned before, the initial introduction of the provision creating the call option and the terms relating to its exercise must be made by virtue of a formal shareholders meeting as mentioned in Article 463. The right of the board of directors with respect to revising the company's articles of association may be regarded as an exception to the general rule captured under Article 408 (2)(a) of the New Commercial Code stating that amendment of the articles of association is a nontransferable right and duty of the shareholders meeting. In our opinion, technically the amendment to the articles of association is made by virtue of the initial decision taken by the shareholders meeting with respect to infusing the call option rights to the articles of association. What is actually done by the board of directors at the end of the process shall not be regarded technically as an "amendment" but rather a necessary correction formality as the provision relating to the call option would be void after exercise of the same rights by the call option holders. Any entry made thereafter is simply a revision to reflect the actual capital status of the company as opposed to an amendment that touches upon the rights or obligations of any shareholder or any other interested party. This view is also supported by the fact that the correction to be made by the board of directors is conditional upon the

written audit report of the special transaction auditor and not made in the sole discretion of the former[12].

2.2 Employee Stock Option Plans

The new system also paves the way to create a legal structure for employee stock option plans. Foreign corporate practice shows us that corporations often use stock option plans granted to employees as an important source of an employee benefit scheme[13]. Before the New Commercial Code, Turkish law lacked the sufficient legal structure and means to be able to form a self functioning employee stock option plan. In these structures, employers undertake to grant a certain number or percentage of shares to its employees either as part of their regular payment scheme or as an alternative bonus compensation plan where (and in certain cases if the company exceeds certain financial performance) a group (or all) of employees are given the right to obtain a number of company shares. This way the employer will be able to limit or control the cash drain that will otherwise be applicable if a cash bonus or compensation plan is adopted thus maintaining the profitability and liquidity of the company in addition to a morale boost to employees in general[14]. On the flip side, the employee will have the opportunity to benefit from the upside of a good corporate financial performance where the employee's compensation will not necessarily be limited with a ceiling amount as in the case of a salary and he will

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[12] For the same opinion please see *Pulaşlı* Hasan; pg.89. Pulaşlı rightfully indicates that the act of the board of directors is a mere "adoption" that ensures the real capital status to be reflected into the articles of association. Such adoption in the form of a board of director's decision will not need to be approved by a shareholders meeting.

[13] Stock options became increasingly popular type of compensation for executives and other employees in the 1990's and early 2000s in the western financial world. In a typical arrangement, an executive is granted a certain number of call options on the stock of the company for which he or she works. The options are "at the money" on the grant date. They often last for 10 years or even longer and there is a vesting period of up to 5 years. The options cannot be exercised during the vesting period but can be exercised any time after the vesting period ends. If the executive leaves the company during the vesting period, the options are forfeited. If the executive leaves the company after the end of the vesting period, "in-the-money" (if the value of the asset is greater than the exercise price at maturity) options are exercised immediately while "out-of-the-money" (if the value of the asset is less than the exercise price at maturity) options are forfeited. Options cannot be sold to another party by the executive. For further info, see *Hull*, C. John, pg 199 and *Choper/Coffee/Gilson,* pg 216.

[14] Often there are restrictions imposed by the issuer company in the context of such an option plan. Shares granted to employees may be restricted in terms of being transferred by the employee to third parties as the issuer's goal is not to create a free floating share group and welcome outsiders. Similarly when the employee is terminated it may be conditioned upon the employee to sell his or her shares to the company. For a greater discussion please see *Kaya*, Mustafa Ismail pg 86-87

be able to participate in the equity value of the company. Prior to enactment of the conditional capital increase system, any undertaking between the employer and the employee on this basis was limited to a mere contractual promise, the violation of which would have given the employee a right of claim under breach of employment contract. However current Article 463 specifically mentions "employees" as prospective holders of call option with the aim to capture employees as potential benefitting parties from the new conditional capital increase system. By virtue of the new system, employees will enjoy more than a mere contractual claim given by the employer, the violation of which lacked the aspect of providing specific performance.

3. Protection of Existing Shareholders

As mentioned briefly above, the New Commercial Code revolutionizes the corporate capital increase system and explicitly acknowledges and bolsters the right of call option holders to exercise their option and obtain shares of the company in return of exchanging their debt claim with equity of the company. Having said this, the New Commercial Code also attempts to balance the rights of the call option holders with those of the existing shareholders of the company. By virtue of the exercise of the option, a call option holder will become a shareholder of the company, eventually resulting in the dilution of the existing shareholders' equity interest. This being the case, it is evident that the status of the existing shareholders must also be protected against the call option holders. Article 466 (1) of the New Commercial Code attempts to form this balance in terms of requiring the convertible debt instruments entitling its holder the call option right to be first "offered" to the existing shareholders. In this way, existing shareholders will be given a *pro rata* priority right to purchase such convertible debt instruments and prevent a possible dilution of their equity interest. In fact, this statutory opportunity in the case of issuance of convertible debt instruments is a reflection of the existing shareholders having statutory preemption right to obtain new shares being issued by the company as a result of a registered or ordinary capital increase. That being the case, even the right of first call of the existing shareholders to purchase the convertible debt instrument as mentioned above may also be abolished or limited in case of "just reasons"

as per Article 466 (2). In our opinion, the existence of the just reasons shall be construed in line with the underlying reason for the conditional capital increase. In any way, such limitation shall not be used in a discriminatory way to dilute any one or a specific group of shareholders but shall effect all shareholders or shareholder groups equally, aiming to achieve a financially viable end result for the benefit of the company and not that of a specific shareholder or a shareholder group. If the right of first call has in fact been restricted by the shareholders based on just reasons in this case no shareholder group either be damaged or benefitted from this decision without a justifiable and reasonable ground. This decision shall be in line with the principal of "equal treatment"[15] and in any case shall be directed to a corporate (as opposed to personal) gain. Another principle that must be referred in this context is "principle of exercising rights in the least detrimental fashion". This principle is generally construed as affording a protection to minority and used in vast majority in cases where a capital increase is supported by the majority to deliberately dilute and oppress the minority shareholder who is unable to finance such an increase. Some events that may be given as examples that justify a limitation of existing shareholders rights would be; granting call option rights (instead of cash) to minority shareholders being squeezed out, a sizeable convertible debt offering made in line with market conditions locally and internationally, using conditional capital increase system as part of an acquisition structure where a new shareholder is planned to be welcomed to the company, issuance made due to financial distress and need for immediate cash injection etc[16].

4. Protection of Call Option Holders

On the flip side of the existing shareholders are the holders of the call option. In effect, the call option holders have a right of becoming a shareholder in the company as a result

[15] *Pulaşlı* Hasan, pg 82, *Biçer* Levent pg 241. In the case of equal conditions, a shareholder must be treated equally with the other shareholder(s).

[16] For a further discussion on this please see *Kaya*, Mustafa Ismail pg 180-187. However in our opinion these examples shall be considered also with the basic principle of who can be the beneficiary of a conditional capital increase system. The rule is that only (qualified) creditors and employees may be beneficiaries according to the definition of Article 463 (1). This being the case, it is questionable as to how this system can be used (except as an employee stock option plan) out of the context of a lender-borrower relationship where the existence of a convertible note or similar debt instrument is a must.

of exercise of their rights and such legal expectation must be afforded a statutory protection.

Current commercial practice shows us that an overwhelming majority of company articles of associations contain provisions limiting the right of a shareholder to transfer his shares to a third party who is not an existing shareholder of the company. These limitation clauses often arise from the need to control or prevent an outsider to acquire shares and reflect a protective measure introduced by existing company shareholders against outsiders. This being the case, an obvious tension arises in case a company's articles of association requires i.e shares of a shareholder to be first offered to the existing shareholders before being sold to a third party or otherwise what is commonly known as a contractual right of first refusal. On one hand lies the expectancy of the call option holder to own shares in the company as a result of the exercise of the call option and on the other hand the existing restriction in the company's articles of association in form of such a contractual right of first refusal. At this point according to Article 467 (1), the right of the call option holders to exercise their right of conversion/purchase, as the case may be, may not be impaired due to any existing restriction applicable to the transfer of registered shares of such company unless such impairment is due to a reservation in the company articles of association or the prospectus. By virtue of this clause a generally applicable transfer restriction available in the company's articles of association either in the form of an existing right of first refusal or in any other form may not block the right of call option holders to obtain company shares. If any restriction is specifically designed as for the call option holders as part of the conditional capital increase, this restriction shall be delineated in the amended form of the company's articles of association bringing the conditional capital increase terms alive or disclosed in the prospectus issued for the offer of the newly issued shares. These restrictions, if existing, must be explicitly and sufficiently disclosed so as to be able to taken into account by the holders of the call option holders before they make the investment decision of purchasing such convertible debt instruments or pricing the purchase thereof.

More importantly, the call option holders must be protected against a possible dilution of their expected shareholder status. Article 467 (2) solidifies such protection by stating "right of exchange or option may not be impaired by means of a capital increase, granting new exchange or purchase options or any other way unless the exchange price is reduced, a counterbalancing measure is given to the right holders or rights of the existing shareholders are also subjected to a detriment in a similar way". This is rather a self explanatory and extremely basic yet important form of protection for call option holders. Such clause aims to prevent any dilution or detrimental transactions that may decrease the value of the company shares, therefore the expected value for the call option holders. In fact this statutory protection is a standard "anti dilution" covenant clause in many of the warrant or option issuances for corporations. As mentioned in Article 467 (2) a new capital increase or a new call option issuance are two explicit examples where the former call option holders can be diluted. Other less subtle examples would be a possible merger of the issuer company, a possible liquidation decision, conversion of a joint stock company to a limited liability company, legal challenges to the terms and articles of the conditional capital system decision etc. In any of these or "similar actions" taken by the issuer company as a result of which the call option holders are diluted, the law grants a statutory remedy where it requires either the exchange price (conversion right) to be reduced or a counter balancing to be made in order to compensate the dilution effect[17].

One other form of protection under Article 465 (3) is that any right of exchange or purchase granted before the registration of the amendment of the articles of association concerning the conditional capital increase with the trade registry is void. In our opinion this provision also indirectly serves as a protection for the call option holders against any last minute endeavors by the company management to grant separate contractual options to third parties which may, when exercised conflict with the call option to be granted

[17] *Kaya* suggests that call option holders may be granted a right of first refusal or preemption right if a new issuance is being made or a capital increase is undertaken, respectively. This of course raises a new level of issue which is having to deal with the already existing preemption rights of the already existing shareholders of the company. Another suggestion is to change the originally agreed exchange time and allow the former to use their exchange right before the new issuance which again carries inherent problem of taking away the right of the call option holder to exercise its right at his discretion where these rights could have been used at a more favorable time to the right holder. Finally, payment of mutually agreed cash compensation to the existing call option holders is another form of counterbalancing.

under the conditional capital increase mechanism. Imagine a case where right before the issuance of the conditional capital increase, the management having the right to represent the company in all matters signs an agreement with a third party giving such third party a right to obtain company shares at a different value than what will be soon proposed to the holders of the call option[18].

5. Practical Effect of the Conditional Capital System on Money Lending Business

5.1 Financial Viability Aspect

No doubt, the conditional capital increase system will enhance local but more so the foreign sourced debt market for Turkish companies. Foreign institutional lenders are sometimes able to provide cheaper financing to local companies, taking into account in return growth potential of borrowers. These lending institutions carry out extensive research with respect to emerging markets in general and in specific certain business sectors that promise potential and growth. Their business model is somehow different than those of local banks and financial institutions which in someway have to focus on short term scheduled fixed income and make their profitability calculations thereon. Many international or overseas financial institutions or funds have the ability to settle for a competitive rate on the fixed income component of their debt instruments. This however does not mean that they are eager to settle for a less profitable debt investment in Turkey. On the contrary, they may be extracting a greater value from a local borrower but the key is to be able to adjust the timing, more so return on investment according to the growth potential of the enterprise and business they are lending. Conditional capital increase system, augmented with issuance of convertible bonds will no doubt serve to this purpose. Also remember the earlier discussion herein as to “similar debt instruments” also being eligible to source a conditional capital system where we argued that even lenders of a straight term or revolving loan credit facility may be designated within the agreement to have an option to request borrower shares in return of repayment as

[18] One must remember that by virtue of the New Commercial Code, the company may be owning what is known under common law as “treasury stocks” and may subject these shares (temporarily held by the company) to a transaction as mentioned above irrespective of the existence of call option holders due to a conditional capital increase.

opposed to (or in addition to) full or partial cash repayment of the debt and shareholders of the borrower may structure such option by adopting a conditional capital increase. This means we are not necessarily bound with triggering a whole scale debt offering which inevitably requires a sizeable debt issuance given the cost and offering process. Undoubtedly this will offer new structural opportunities for lenders and deepen the debt market. The New Commercial Code sets forth a robust legal structure and addresses the need for debt investors legal protection.

The conditional capital increase system is indeed a novelty in terms of the never-ending financing seeking effort of companies. From the investors and creditors' perspective, convertible bonds have a value-added component built into them since they have an embedded share purchase/conversion to equity option promising the investor a possible sharing of the increase in issuer's fair market value. Therefore, convertible bonds tend to pay a lower rate of interest reducing short term financing cost on the issuing company. This downside is compensated by the fact that call option component of a convertible bond may be additionally priced[19]. Investors will accept a lower interest rate on a convertible because of the potential gain from conversion. Convertible bonds will also accrue in value as the share price of the company rises. Convertible bonds will also continue to earn fixed scheduled interest even when the shares of the company are trading down. Therefore, the bonds may offer protection against a decline in share price. In this respect, the yields on straight bonds reflect the risk of a possible default whereas yields on convertibles are not sensitive to default risk[20].

Also from the perspective of the issuing company, there is a financial logic in terms of issuing convertible bonds as well. If financing is costly, it makes sense to issue securities whose cash flows match those of the firm. A young and growing firm might prefer to issue convertible bonds or warrants because these will have lower initial interest cost. In addition at the date of redemption, the issuer may avoid a substantial cash drain (and a possible refinancing) by means of offering shares to investors instead of redemption

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[19] According to financial analysis, five factors determine the value of a call option: (1) the current value of the underlying asset, (2) the exercise price, (3) the time value of money, (4) the variability in the value of the underlying asset and (5) the time to expiration. See *Choper/Coffee/Gilson,* pg 217-220.

[20] *Ross/Westerfield/Jaffe,* pg 614

price. Also, convertible bonds and warrants are useful when it is very costly to assess the risk of the issuing company. These instruments can protect somewhat against mistakes of risk evaluation. If the company turns out to be a low risk company, the straight bond component will have high value and the call option will have low value. A reverse analogy is applicable for the flip side as well[21]. Another huge practical advantage for issuers is that convertible bonds have less restrictive debt covenants than straight bonds. This is due to the agency risk mitigation effect of the convertible bonds[22]. We also observe that many convertible issuances are subordinated and unsecured issuances therefore from the perspective of the issuing company they left company assets unencumbered.

5.2 Legal Robustness Aspect

Financial institutions lending money to corporations almost always demand collateral for non-payment risk such as a mortgage, share pledge, account pledge, share transfers or assignment of receivables etc. In re-financing and re-structuring deals, in addition to the collateral package against payment risk, financial institutions also require to have control in management of companies leading to purchase of a certain portion of the borrower shares. A company may also have to increase capital in order to distribute shares to lenders either to constitute repayment. Consequently, when the New Commercial Code enters into force, financial institutions may choose to structure a convertible bond issuance and on the maturity, retain an option to become shareholders of the company without executing any other supporting document such as an undertaking, a share purchase agreement with future effectiveness etc. Essentially, the legal downside of any transaction involving a call option drawn upon the shares of a Turkish company was the lack of a specific performance remedy covering the option holder in case the option

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[21] *Ross/Westerfield/Jaffe,* pg 614

[22] *Ross/Westerfield/Jaffe,* pg 615. Creditors, such as folders of staright bonds have an incentive to force the borrower into low risk activities. In contrast, shareholders have incentives to adopt high risk projects. High risk project with negatibe NPV (net present value) transfer wealth from bondholders to shareholders. If these conflicts cannot be resolved, the borrower may be forced to pass up profitable investment opportunities. However, beacuse convertible bonds have an equity component, less expropriation of wealth can occur when convertible debt is issued instead of straight debt

grantee failed to deliver. In addition any deals of this nature had to be executed by a shareholder as opposed to the company, the shares of which were the subject of the deal since there was no legal framework that could have been laid down to bind the company to own or deliver its own shares. The option holder's only remedy was to sue counterparty shareholder for damages in case such promising shareholder changed his mind and decided to walk away from delivering company shares despite the existence of an otherwise perfectly valid and duly exercised call option. One must remember that in a firm capital increase system, the actual implementation of a capital increase requires shareholder and company approval, contribution and action on part of both. Inevitably performance of an undertaking to deliver new shares of a company means the company to start a capital increase process and shareholders eventually moving along with this process where the third party option holder has absolutely no saying or contribution. Even in cases of full shareholder and company action and contribution a firm capital increase system requires many procedural actions associated with convening a formal shareholder meeting which may take up many days to consummate. This significantly hampers the interest of a call option holder where he or she may obtain equity many days or weeks after the actual exercise of the option. The New Commercial Code will eliminate this lack of legal uncertainty entirely. By virtue of Article 463 (2) and Article 468 (3), when conditional capital system is used, capital of a company will be automatically increased without the need to take any further constructive action as and when the conversion right or the purchase option is exercised and the relevant settlement of the debt instrument or the option payment is made, as the case may be. That being the case, a holder of a convertible bond or a purchase option grantee will have legal certainty that upon realization of the relevant conditions reflected in the articles of association of the company he or she will gain shareholder status. No action or inaction on the part of the company (board of directors failing to register the new capital status, trade registry failing to register the new capital etc) will hamper the newly attained shareholder status of the holder of a call option provided that a due exercise thereunder has been made.

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