

Major Security Mechanisms under Turkish Law and the Effect of Bankruptcy

Few would deny that “security” is a key term in business. Whatever activity a company carries out, there is always a risk that its debtors do not or cannot fulfill their payment obligations, which may trigger an “event of default”¹. Events of defaults are undesirable situations, but they do happen. Thus, it is up to the creditor of any agreement to take the necessary precautions against a potential failure of its debtor in performing its payment obligations. Such precautions would certainly be in the nature of solid security provided by debtor. Although it is possible for creditors to secure their receivables by using various methods, some of the foreign-imported practical inventions (e.g., trust) rarely lead to success. Below, you may find summary information on the most widely used security mechanisms in Turkey.

- **Mortgage on Real Property (*ipotek*)**

Mortgage is one of the most common and secure tools for a creditor to guarantee its receivables. In order to duly establish a mortgage, an official mortgage deed must be executed in accordance with the recent “Regulation on the Principles and Procedures as regards the Official Deeds to be Prepared by Title Deed Registries”² before the title deed registry where the real property subject to mortgage is located, and such mortgage deed must be registered with the same registry.

Foreclosure of mortgages is subject to the procedure set forth under the Execution and Bankruptcy Law No. 2004 (the **Bankruptcy Law**).

Finally, the real property on which a mortgage is to be established does not have to be owned by debtor. In other words, one may consent to the establishment of a mortgage on his/her real property as a security not only for his/her own debt but also for a third party debt (e.g., Company A, which fully owns Company B, may grant a mortgage in favor of Bank C as a security of the debt of Company B. In this example, although the underlying contractual relationship is between Company B and Bank C, Company A enters into a separate mortgage agreement with Bank C.).

- **Pledge on Movables (*tasinir rehni*)**

Pledge on movables is permissible under Turkish law. As a general rule, in order to validly establish a pledge on a movable property, the actual transfer of the possession (*zilyetlik*) (i.e., delivery) of the movable to the pledgee or to a third party such as an escrow agent is a must. On the other hand, Article 940 of the Turkish Civil Law (the **Civil Law**) provides that pledge may also be established on movables, which have to be registered with a registry by law (e.g., motor vehicles registered with the Traffic Registry, construction machinery registered with the relevant registries held by the Chambers of Industry), without delivery of the same.

In order to circumvent the above mentioned delivery requirement, in practice, parties to pledge agreements also enter into tripartite “collateral management agreements”. The structure in collateral management agreements is as follows: Debtor (i.e., pledgor) leases the portion of land on which the movables to be pledged (e.g., raw materials in a plant, mineral ores extracted out of a mine) are located to a collateral manager acting as creditor’s (i.e., pledgee’s) agent. As long as the movables remain in the leased portion of land, they are deemed to be delivered to the pledgee since the collateral manager takes delivery of the movables on behalf of the creditor. It should be noted that the validity of collateral management agreements has not been tested so far before any Turkish court.

- **Pledge on Receivables (*alacak rehni*)**

Pursuant to Turkish law, a pledge cannot be established on an agreement but on the receivables arising out of it. The pledge on receivables is governed by the same rules as the pledge on movables explained above.

¹ “Event of default” is a commonly used term especially in term loan facility agreements, which includes the circumstances thoroughly described under such agreements where the debtor fails in performing its payment obligations.

² Published in the Official Gazette dated 10 November 2009 and numbered 27402.

- **Bank Account Pledge (*banka hesap rehn̄i*)**

The above rules governing the pledge on movables are also applicable to pledge over bank accounts of a debtor. Yet, in bank account pledge, apart from the bank account to be pledged, the creditor must also assure the existence/deposit of a minimum amount of money therein. Otherwise, such pledge may be useless. Needless to say that the bank holding the pledged account plays a crucial role in the management of bank account pledge agreements. In this respect, acknowledgment letters are signed by banks.

- **Share Pledge (*hisse rehn̄i*)**

Pledge over shares of a company is another type of pledge on movables and should be structured in accordance with the company type that the creditor is dealing with. There are two major company types used in Turkey by foreign investors. Thus, establishment of share pledge should be analyzed by considering the legal form of the debtor company (whose shares are to be pledged) in question and its share types.

- *Joint stock companies*: The rules governing share pledge vary, among others, according to (i) whether or not shares are represented *via* share certificates (*hisse senedi*) or temporary share certificates (*ilmuhaber*); and (ii) their forms (*i.e.*, bearer or registered form).
- *Limited liability partnerships*: Although it is not possible to issue share certificates in such companies, unless otherwise provided under their articles of association, share pledge in limited liability partnerships is doable according to the general provisions stipulated under the Civil Law.

- **Commercial Enterprise Pledge (*ticari isletme rehn̄i*)**

The delivery requirement in pledge on movables caused the Turkish legislator to create a new security mechanism in 1971: Commercial enterprise pledge (**CEP**). Regulated by the Law No. 1447 on Commercial Enterprise Pledge (the **CEP Law**), CEP is intended to establish a security on a pledgor's movable properties and intangible rights, which are dedicated to the operation of a certain commercial enterprise owned by itself. CEP differs from pledge on movables discussed above, since there is no actual transfer of possession (*i.e.*, delivery) of the pledged property to the pledgee.

In accordance with the CEP Law, the creditor party in CEP agreements (*i.e.*, the pledgee) may be banks³. As for the pledgor, any physical person (*gercek kisi*) or legal entity (*tuzel kisi*) owning a commercial enterprise may be pledgor under a CEP agreement. With its Article 3, the CEP Law determines the scope of CEP. Accordingly, items including but not limited to commercial title (*ticaret unvani*), business name (*isletme adi*), and machinery, equipment, tools and motor vehicles (i) dedicated to the operation of the commercial enterprise and (ii) existing at the time of pledge shall be within the scope of CEP.

- **Assignment of Receivables (*alacagin temliki*)**

Under Turkish law, in order to realize a valid assignment of receivables, *inter alia*, a written agreement must be executed between the debtor assignor and the creditor assignee. Although the assignor's debtor (*i.e.*, the third party person/entity that is not party to the assignment of receivables agreement) must pay the debt to the assignee, its consent to such assignment is not required. Once such agreement is executed, the assignor's right to the relevant receivable is transferred to the assignee. An overwhelming majority of the Turkish scholars are of the view that even future receivables may be assigned provided that their subject matter is determinable. For instance, an agreement under which a party would assign all of its future receivables to the other party would be invalid. However, an agreement under which a party assigns the rentals of a certain real property owned by itself to the

³ There are two other types of pledgee stipulated under the CEP Law, but in practice only banks resort to CEP as security for loans that they extend to their clients.

other party would be valid because in such case which specific receivables are to be assigned is determinable from the outset.

In case of an assignment of receivables, some elements relating to the original debtor-creditor relationship are not transferred to the assignee and thus persist. As such, assignment of receivables differs from transfer of agreement (*sozlesmenin devri*).

- **Guarantee Agreement (*garanti sozlesmesi*)**

According to Turkish law, there is no specific legislation as regards to guarantee agreements. Therefore, guarantee agreements are subject to the general provisions of the Turkish Code of Obligations No. 818 whereby the obligation of the guarantor is characterized by its independent (*bagimsiz*) nature. In other words, the guarantor does not only guarantee the debtor's ability to pay but also the existence and suability of its debt. Thus, the validity of the underlying contractual relationship does not affect the enforceability of the guarantee obligation. No need to say that making sure of the guarantor's solvency is crucial when entering into a guarantee agreement.

Finally, it is worth to mention that bank letters of guarantee (*banka teminat mektuplari*) are pure guarantee agreements, with banks being always the guarantor party.

- **Suretyship (*kefalet*)**

Although the suretyship appears to be similar to guarantee agreement, the security obligation of the surety (*kefil*) depends on the validity of the debtor's debt. This is to say that in case debtor's debt becomes invalid for any reason whatsoever; the surety is -contrary to guarantee agreement- entirely released of all its obligations. Accordingly, surety's liability is always ancillary (*fer'i*) in nature. A future or conditional debt may also be secured *via* suretyship.

- **What happens in case of bankruptcy?**

Same as in most jurisdictions, a bankrupt debtor ceases to have right to dispose over its own assets. Instead, the bankruptcy administration (*iflas idaresi*) takes over the authority to manage all of debtor's assets, which all together constitute the bankruptcy estate (*iflas masasi*). The main duty of the bankruptcy administration is to liquidate the bankruptcy estate through public auctions and to distribute the sales proceeds to the debtor's creditors. The ranking among such creditors depend on the type of their receivables. What kind of receivables are to be paid first is determined by the Bankruptcy Law as follows:

1. Tax receivables as regards commodities and real property;
2. Conservation and sales costs of the pledged property, receivables arising out of maritime lien (if any), certain receivables arising out of the Civil Law;
3. Receivables secured *via* pledge;
4. Privileged (*imtiyazli*) receivables (*i.e.*, employee receivables, custody and curatorship receivables, etc.); and
5. Unprivileged (*imtiyazsiz*) receivables.