Chapter 11

Legal Effect of Economic Turmoil: Technical Insolvency Problem in Turkey

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ABSTRACT

For companies that have been unable to succeed in transforming the economic turmoil into opportunities for growth, it is not surprising to observe either higher losses or lower profits in comparison to their previous years. Apart from efforts to struggle against the economic crisis, management teams also have legal responsibility to manage the technical insolvency position of their companies. In Turkey, “technical insolvency” mainly occurs when one-third of a company’s capital is lost as a result of their losses and increases bankruptcy pressure on financial management. Moreover, it also causes other difficulties such as losing legal grounds for increasing capital or carrying out various structuring plans such as mergers and spinoffs. Accordingly, it is crucial for companies to resolve technical insolvency. There are alternatives for overcoming technical insolvency problems, but each alternative also has disadvantages that need to be carefully taken into consideration.

INTRODUCTION

Economic crises that are experienced by the entire business world can result in the contraction of the market, ambiguity of sustainability, lower revenues, higher costs and depreciation of local currencies against foreign currencies. Each country and each industry goes through its own experience and attempts to find the most feasible and efficient way to deal with their recessions. In line with the expectations of the globalised economy, the number of companies is increasing in each of the countries, which also means that a higher number of companies have to battle against the effects of economic crises. For companies that could not succeed in transforming the crisis into an opportunity for growth, it is expectable to see either higher losses or lower profits in comparison with previous years. Unfortunately, the statistics related to bankruptcy applications show
that companies facing troubles due to economic turmoil increased significantly in the last three years (U.S. Bankruptcy Courts, 2012).

Especially for companies that have made significant losses there exists another risk, and that is dealing with a situation called “technical insolvency”. Being in a technical insolvency position does not mean that a company is actually going to go bankrupt, nor does it refer to distress in the company’s liquidity. It is perfectly possible to be technically insolvent while still being able to repay debt. It is also perfectly possible to be technically solvent and unable to repay debt. This is because technical insolvency is based only on the balance sheet and ignores cash flows. In addition, book value is very different from resale value (Moneyterms, 2011).

The definition of the term “technical insolvency” is regulated under Article 324 of the Turkish Commercial Code (TCC) which states that when one-third of a joint stock company’s capital is lost as a result of losses according to the latest financial statements, the company falls into a “technical insolvency” position. Although it is not an automatic procedure, being in a technical insolvency position causes bankruptcy pressure on the financial management of the companies. Moreover, due to legal constraints that may arise as a result of this technical insolvency status, the ability to use potential solution sets that can be preferred for struggling against economic turmoil will be lost.

Within the content of this study, the effects of the technical insolvency problem are analysed in detail and solution alternatives are compared by emphasising both their advantages and disadvantages.

**RESEARCH METHODOLOGY**

During this research, primarily the definition of technical insolvency across various territories was analysed together with scientific research carried out by various international institutions. In particular, the regulations in the Turkish Commercial Code were examined to identify the local understanding of the technical insolvency concept. During this analysis, companies that are subject to the Turkish Commercial Code were mainly taken into consideration. Accordingly, companies listed on the Istanbul Stock Exchange or banks and insurance companies that have their own specific regulations apart from the Turkish Commercial Code were not the focus of this research. As per the current legislation applicable in Turkey, since there is no obligation for privately held companies to publicly share their information, in order to obtain information from unlisted companies, either internal or external audit reports of the companies were used. Moreover, the financial statements attached to corporate income tax returns and the tax certification reports written by the companies’ sworn financial advisors were used for further data gathering and verification purposes.

During the analysis of advantages and disadvantages of alternatives that can be used when struggling against technical insolvency, real-life experiences and other potential positive and negative effects of the applicable alternatives were analysed.

**TECHNICAL INSOLVENCY STATUS**

**Definition of Technical Insolvency**

Insolvency exists when an enterprise that possesses a greater total of liabilities than assets is unable to meet its obligations. This type of insolvency is sometimes called “technical” insolvency or “financial” insolvency (Newton, 2009). It can easily happen that a successful business enterprise may in this sense become insolvent (Lough, 2009).

During a technical insolvency analysis, the balance sheet is taken as the base financial statement. However since the cash flows statement is ignored in such an analysis, the conclusions that are reached should be interpreted carefully. In other words, since the cash flow statement is
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