

# Voluntary Subordination of Claims In Case of a Possible Bankruptcy

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## Introduction

Under Article 376 of the Turkish Commercial Code ("TCC"), the board of directors (BoD) is required to create an interim balance sheet which serves basis for implementing necessary measures to safeguard the company's financial stability. In the event of a capital loss, if there's a sign of a possible insolvency, the BoD has to prepare two distinct interim balance sheets—one based on the likely sales price of company assets and the other focusing on the ongoing business operations.

1 If the interim balance sheets reveal the company's insolvency, the BoD is obligated to apply the Commercial Court of First Instance and request for the bankruptcy. However, if the creditors agree on the subordination of their claims during the bankruptcy proceedings, the court will refrain from issuing a bankruptcy decision.

This article will briefly examine the subordination of claims under Turkish law.

## Subordination of Claims

The matter is governed by Article 376/3 of the TCC which is derived from Article 725 of the Swiss Code of Obligations. Article 725 of the Swiss Code of Obligations underwent amendments in 2020 which came into effect on January 1, 2023. Under the Swiss law, if the BoD can take certain measures to prevent bankruptcy before notifying the court, it must comply with a 90-day deadline for taking the prescribed measures.

Under Turkish law, if the creditors agree in writing that the order of their claims will be ranked below of all other claims, and if their

commitment is verified by the experts appointed by the court hearing the bankruptcy claim, then court will refrain from issuing bankruptcy decision. The rationale of this article is that some creditors may choose to subordinate their claims in order to overcome the financial distress of the company and protect it from bankruptcy.

In this case, a company which is in debt does not become insolvent, and subordination allows the company to continue operating and ensures that the claims of creditors can be satisfied at a later stage.

For instance, in a scenario where the company's shareholders are also creditors, it is mutually beneficial for both the creditor (i.e. shareholders) and the company to subordinate the claims instead of relinquishing the company's receivables. Creditors' delaying their claims to the bottom of ranking benefits the debtor company by enabling it to sustain its operations instead of facing insolvency.

While this action may not directly affect the company's insolvency, it simplifies the process for the company to settle its debts with other creditors. Within the timeframe obtained through the deferral, the company can formulate a sound plan to address its debts and strengthen its financial standing.

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It's important to emphasize that when a creditor's claim is subordinated, the creditor does not forfeit its receivable. However, the debts assigned to the bottom of ranking are excluded from the company's insolvency calculation. Nonetheless, details about the subordinated claims should be disclosed in a dedicated section at the company's financial statements.

In addition, the agreement between the creditor and the debtor regarding the subordination of claims remains in force until the insolvency or liquidation process is completed. If the creditor commences enforcement proceedings to recover its receivables in defiance of the subordination agreement, the debtor company has a right to raise an objection to the payment order.

## **Conclusion**

In cases of a possible insolvency, the request of bankruptcy is delayed if creditors agree to place their claims at the bottom of all other creditors. This prioritization must be formalized through a written agreement, involving mutual declarations from both the company and the creditors. Consequently, the creditor, by way of

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subordination, allows the company to overcome insolvency which increases the likelihood of the creditors ultimately recovering its receivables.

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