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Directors' Liabilities For Public Debts In A Turkish Joint Stock Company

Tax and public debt legislation

According to the Tax Procedural Law No. 213 ("TPL"):

"Taxpayer is the real person or the legal entity, that is imposed tax duty according to the tax legislation."(TPL Art.8/1)

"The tax responsible is the party that is the addressee of the tax office with respect to the payment of the tax." (TPL Art.8/2)

Article 10 of TPL with the heading "duty of the legal representatives" explains the liability of the taxpayers' legal representatives:

"In case the taxpayers or tax responsible are legal entities, minors, restricted persons, and institutions such as foundations and congregations without a legal personality, the duties of these according to the law are fulfilled by their legal representatives, managers of the unincorporated entities or representatives of those, if any.

In case of failure of the above written representatives in fulfilling such obligations, tax and corresponding receivables that could not be collected in part or as a whole from the assets of taxpayers or responsible parties, are collected from the assets of those who have failed to fulfill the legal obligations.

This provision shall also apply to local representatives of taxpayers who are not resident in Turkey.

Legal representatives or the managers of the entity may take recourse against the actual taxpayers for the taxes paid in this manner [...]"

Another provision regulating the liability of legal representatives is Article 35 (bis) of Law No.6183 on Procedure of the Collection of Public Receivables ("Law No.6183"):

"The public receivables which cannot be collected or when it is clear that the collection will not be possible as a whole or in part from the assets of the legal persons, minors and disabled persons, or institutions such as foundations and congregations without a legal personality, will be collected according to the provisions of this Code from the personal assets of the legal representatives and the managers of the institution without legal personality.

The provision of this article will also be applied to the representatives of the foreign persons and institutions in Turkey.

The fact that the legal persons have entered into liquidation or have been liquidated does not release the legal representatives of their responsibilities for the times prior to the date of entry into liquidation.

The representatives, the persons that manage the institutions or the representatives can take recourse against the real debtor of the public institutions for the amounts they have paid according to this article. In case the legal representative or the manager of the institution on the accrual date of the public receivable is different than the persons when the public receivable became payable, they shall be jointly liable for the payment of the public receivable.

The provisions regarding the liabilities of the legal representatives set forth under the Tax Procedure Law No. 213 shall not remove the liability regulated in this article."

Article 88 of the Social Security and General Health Insurance Code No 5510 also stipulates similar liabilities for legal representatives for outstanding social security premiums debts.

Who qualifies as legal representative?

Although it is not specifically stipulated in both old and new commercial codes, the Turkish corporate life is constructed and operates based on signature circulars. All the joint stock companies (and other forms of companies) are using signature circulars to define and show their signature authorities' i.e. their legal representatives. After the election of the board of directors, the signature authorities are elected among the directors and/or sometimes among other persons who are not in the board of directors (for example among CEOs, key employees, attorneys, etc.).

As the above mentioned legislations are not defining the legal representatives clearly, Ministry of Finance has issued General Communiqué No. 386 and 390 in order to define the scope of legal representatives of a joint stock company and to give guidelines to the tax authorities while determining those legal representatives. According to these communiques, the main criteria for the Ministry of Finance and tax authority concerns the articles of

association and the signature circular registered with the relevant Trade Registry and announced in the Turkish Trade Registry Gazette showing the current signature authorities of that company and if the representation of the company is at the hands of certain executive director(s) or manager(s), the collection of the unpaid public debts cannot be made from the remaining board members, who do not have any signature authority.

Accordingly, one would conclude that any member of the board of directors, who has no signature authority according to the signature circular, should not be deemed a legal representative and would not be liable for the public debts that the company has failed to pay.

Moreover, a legal representative shall be released from any liability which arises after his resignation, provided that his resignation is registered with the Trade Registry and announced in the Turkish Trade Registry Gazette.

Scope of liability of legal representatives

The critical point is that the liability of the board of directors is born when such tax and public debts are due. For example, a board member is appointed as a member on January 1, 2013, and the company's tax payments for the financial year that ended on December 31, 2012 are due on April 1, 2013, then, newly appointed board member will be liable for such payment even he/she was not a member in 2012.

The liability of the board of directors and managers arising from the outstanding tax and public debts of a legal entity is of secondary (in Turkish, *ferî*) nature. The directors may only be pursued by the tax authority if it is understood that it is not possible for that authority to collect its receivables from the legal entity but such secondary liability is joint and several among the directors and managers who have the power to manage and represent the company.

However, for social security obligations, there is a difference: The liability of responsible parties regarding the unpaid social security premium payments is joint and several. Therefore, the Social Security Institution may directly pursue the responsible parties, without initiating execution proceedings against the legal entity first.

According to Article 10 of the TPL, a payment order can be notified to the legal representative only when the tax administration fails to collect its receivables from the assets of the company, in other words, all the routes for collecting the debts from the company must be exhausted.

However, the liabilities described under Article 35 (bis) of Law No.6183 are broader than Article 10 of the TPL. Pursuant to this Article 35 (bis), legal representatives are liable for public debts which cannot be collected from the assets of the company and in addition in

cases where the tax authority is convinced that such debts are not likely to be collected from the company.

As the TPL and Law No.6183 stipulate two different and conflicting approaches regarding the liabilities of the board members in case of tax and public debts, there have been many cases taken before the Council of State, the highest court for these types of disputes.

As both TPL and Law No.6183 conflict with each other, similarly, there are also conflicting precedents ruled by the different courts of Council of State. Some courts of Council of State ruled that the tax authority cannot initiate execution proceedings against the directors unless such debts cannot be collected from the company first. On the other hand, some courts of Council of State ruled on the contrary. It is fair to say that there is no consensus regarding this issue.

With the Communiqué No.387, Ministry of Finance tried to bring some sort of explanation to the implementation of Article 35 (bis). According to this communiqué, in order for the tax authority to pursue legal representatives before exhausting the enforcement procedures against the company, the tax authority must be convinced that the valuation of the ceased assets of the company is not adequate to cover the public debts or in case of the insolvency of the company, upon the correspondences with the bankruptcy estate if it is understood that such debt cannot be collected from the bankruptcy estate. The examples mentioned in this communiqué are not exhaustive, therefore, there is a room for the tax authority to use its discretion while evaluating each case and most of the times, tax authority pursue the legal representatives at the same time, along with the company, based on this legislation.

One should conclude that the collection of the tax receivables from its legal representatives should be made under the Tax Procedural Law and only after the legal remedies towards the actual taxpayer entity is exhausted. However (and, one should conclude, in violation of the law), in practice, tax authorities tend to send payment orders to legal representatives pursuant to Article 35(bis) without waiting the finalization of the execution proceedings.

Remedies for legal representatives in case of personal liability claims for unpaid public debts

In case the company fails to make the tax payment, the tax authority is entitled to collect the tax receivables from the directors and/or managers regardless of the existence of fault or negligence.

Even the filing of a lawsuit by the company against the tax authority cannot prevent the tax office from sending a payment order to the legal representatives of the company and initiating an enforcement and execution procedure.

In such case, members of the board of directors have the following options:

I. pay the tax debt and then ask for recourse from the company for the amount paid by the legal representative.

ii. initiate a lawsuit within 7 days starting from the notification of the payment order to such director against the tax authority for the invalidation of the payment order claiming that:

a. the tax liability had not arisen (i) due to director's fault or negligence, or (ii) during such director's term as the case may be, or (iii) such director had no signature power thus no control over the payments by the relevant taxpayer entity; and/or

b. the tax authority must initiate the execution proceedings pursuant to Article 10 of the TPL and such a payment order may not be notified until all remedies available to collect the tax debt from the assets of the company have been exhausted.

The objection to the payment order does not suspend the payment obligation unless a security covering the entire debt has been deposited.

Recommendations in order to mitigate risk of personal liability

Before the new commercial code that entered into force on July 1, 2012, it was not possible for legal entity shareholders to directly be board members in joint stock companies and real persons determined by the shareholders of the legal entity were elected in the boards of directors.

The question to be asked is whether the liability arising from the position of the real person, who is the legal representative of the company being participated in, affect the company being represented by means of tax-related liability or not.

At this point there are two different approaches:

I. The real person who is elected as the board member of the subsidiary company to represent the parent company shall be evaluated separately from the parent company once he/she became a board member of the subsidiary. Therefore, in terms of the tax liability the real person director must be liable.

ii. The real person is on duty as a member of the subsidiary's board of directors in order to represent the parent company. Consequently, the parent company may be held directly liable for duty and title of the legal representative.

It should be noted that the Council of State's decisions were in line with the first approach both in terms of the application of Article 10 of the TPL and Article (bis) 35 of Law No.6183.

With the new Turkish commercial code, a legal entity can be appointed directly as a member of the board of directors but this legal entity must be represented by a real person again. However, this real person will not be deemed a "legal representative of the taxpayer entity" and therefore, one should conclude that such person should not be liable for any public debts. Further, considering that the persons having signature power within the framework of the signature circular are also potentially liable for public debts, in the event that such legal entity shareholder's representative is named as a signatory within the signature circular in his/her capacity as only such shareholder's representative, again (although this is a new system in Turkish corporate law it is not tested until now), one should conclude that such person would not be deemed a "legal representative of the taxpayer entity" and therefore, such person should not be liable for any public debts.

Accordingly, appointing board members and signatories not in their personal capacity but as representatives of a legal entity board member of the taxpayer entity would mitigate the risk of personal liability of real persons who act as board members and/or signatories.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.