

Exceptions Announced to F/X Restrictions in Contracts Between Turkish Residents

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The Ministry of Treasury and Finance announced the exceptions to recently introduced restrictions on F/X denominated or indexed contracts between Turkish residents

Although the Ministry of Treasury and Finance (the “**Ministry**”) introduced various exceptions to the general prohibition, there remain a large number of contracts that are subject to the mandatory requirement to be denominated in Turkish Lira - impacting both prospective and existing contracts. With existing contracts now needing to be converted into Turkish Lira within 3 days, the dust is yet to settle.

General Restriction

Decree No. 32, the primary Turkish regulation governing foreign exchange transactions in Turkey, was earlier amended by [Decree No. 85](#) to introduce restrictions on the denomination of payment obligations under contracts to be executed between persons residing in Turkey for:

- (i) sale of movable and immovable property,
- (ii) leases (including financial leasing) of movable and immovable property;
- (iii) employment;
- (iv) services (*hizmet*); and
- (v) construction (*eser*)

in foreign currency (or their indexing to foreign currency), subject to the exceptions to be determined by the Ministry.

The amendments also required existing foreign currency denominated or indexed contracts to be converted into Turkish Lira no later than 30 days from September 13, 2018 (i.e., October 13, 2018).¹

Exceptions

With the restrictions having such wide impact on commercial dealings many market players rushed to submit comments and exception requests to the Ministry in the past several weeks.

The Ministry addressed many of these requests in the list of exceptions announced on October 6, 2018 (the “**Communiqué**”), but left out some of the exceptions that were earlier hinted at in public statements, such as

¹ Please follow this link for our [Client Update](#) on Decree No 85.

the exceptions for Turkish residents who have outstanding F/X denominated financing costs and are eligible to borrow in F/X.

I. Excluded Matters and Parties

The F/X pricing restriction applies to contracts between any two (or more) Turkish residents across a number of subject matters. We can classify the exceptions to the restriction as subject-matter exceptions and exceptions by party. We have summarized these exceptions by subject matter or party in the table below.

SUBJECT MATTER EXCEPTIONS	General Restriction	Excepted Subject Matter	
	Sale	<ul style="list-style-type: none"> - of movable property, other than vehicles and construction equipment; - software produced outside of Turkey; - (or establishment or issuance) of capital markets instruments; 	
	Lease	<ul style="list-style-type: none"> - of movable property, other than vehicles and construction equipment; 	
	Employment	<ul style="list-style-type: none"> - if services are performed abroad; 	
	Services	<ul style="list-style-type: none"> - relating to export, transit trade, sale/deliveries considered export, F/X generating services and activities²; - relating to activities to be performed abroad; - relating to electronic communication originating in Turkey and ending abroad, or vice versa; - including licensing of software or hardware; 	
	Construction	<ul style="list-style-type: none"> - of ships (including their maintenance and repair)³ 	
	Financial Leasing	<ul style="list-style-type: none"> - of ships; - if permitted under articles 17 and 17/A of Decree No 32 governing F/X denominated financial leasing of equipment and devices listed in the relevant customs tariff categories. 	
EXCEPTIONS BY PARTY	Restricted Party	Excepted Party	Excepted Subject Matter for the Excepted Party
	contracts executed between Turkish residents	Non-Turkish citizens	employment contracts and service contracts (including consultancy, agency or transportation)
		(1) public entities and institutions; and (2) companies of the Turkish Armed Forces Foundation	all contracts except for sale or lease of immovable property
		Awarded bidder or counterparty of public entities and institutions	all contracts for performance of F/X denominated or indexed tenders, contracts or international agreements or treaties executed with public entities and institutions except for those for sale or lease of immovable property or employment
		Banks	all contracts relating to the Ministry's transactions under Law No. 4749 on Regulating Public Financing and Debt Management
		(1) branches, representative offices, offices, liaison offices and companies, 50% or more of whose share capital is held by non-Turkish residents; and (2) companies operating in free trade zones, within the scope of their activities in the zone	employment and service contracts

² These services and activities are defined by the Capital Movements Circular and by reference by Communiqué no. 2017/4. While these include detailed lists of F/X generating services and activities, the contents of these lists either overlap with the exceptions already provided by the Communiqué or are not otherwise material.

³ For this purpose, "ships" are those in the scope of Law No. 5590. Such ships are all kinds of cargo, passenger, open sea fishing, special purpose and specially-built ships which are used for commercial purposes.

	<ul style="list-style-type: none"> (1) commercial airline operators in the passenger, cargo or postal carriage business (2) companies providing technical maintenance services for aircraft, engines and their parts and accessories (3) public or private legal persons licensed or commissioned under civil aviation legislation for ground operations in airports ("ground operators") (4) companies and enterprises founded by, or companies with 50% or more of their shares held by ground operators 	<p style="text-align: center;">all contracts except for those for sale or lease of immovable property or employment</p>
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II. Who is a “Turkish resident”?

- Turkish residents are defined as all real or legal persons with a statutory residence in Turkey. This includes Turkish citizens with legal residence in Turkey, even if they are freelance workers, employees or independent business owners living abroad.
- For the purposes of the F/X restrictions of Decree No. 32. the Communiqué also deems the following to be “Turkish residents” even if they are located outside of Turkey:
 - (1) branches, offices, representative offices, liaison offices of Turkish residents;
 - (2) offshore funds operated or managed by Turkish residents;
 - (3) companies 50% or more of whose shares are owned by Turkish residents; and
 - (4) companies directly or indirectly owned by such persons,

III. Repricing/Conversion of Existing Contracts

- The Communiqué requires existing contracts affected by the restriction to be repriced or converted into Turkish Lira by no later than October 13, 2018, which was the original 30-day period foreseen in the recent amendment to Decree No. 32. Any amounts already collected or that are overdue under these contracts will be excluded from this requirement.
- Parties who fail to agree on the repricing or conversion terms will be subject to the provisions of statutory conversion described below.
- Statutory conversion will be based on the exchange rate (selling rate) as at January 2, 2018 of the Turkish Central Bank for the relevant foreign currency and must be adjusted on the basis of the monthly consumer price index (CPI) (announced by the Turkish Institute of Statistics) between January 2, 2018 and the conversion date.
- For residential or roofed workplace lease contracts, the converted amount applies until the expiry of the first lease year, which is followed by further CPI-based increases for the first two lease years, if the parties do not agree otherwise.
- The Communiqué also grandfathers vehicle (including construction equipment) lease contracts executed before the introduction of the amendments under Decree No 85.

Analysis

I. Selected Case-Specific Implications

- The Communiqué seems to intend to cover and except from the restrictions F/X pricing in agreements entered into with public entities or institutions, such as the implementation agreements executed for PPP or BOT-type concessions of the government (e.g., airport, motorway, bridge, hospital projects). However, because these project structures are hybrid ones and cannot be identified only by way of a single type of contract or project party, as there are many different parties and transactions that form part of the structure, the Communiqué would benefit from further clarification to refer and except explicitly the PPP,

BOT and other similar project structures to avoid uncertainty and unintended effects. Such clarification would also be useful to identify the peripheral impact on sub-contract relationships and other ancillary activities included in these projects.

That said, the Communiqué provides that contractors of projects included within the scope of the exception may include F/X pricing in the contracts they execute with third parties, save for contracts for the sale or lease of real property or employment, to perform under their agreements with the relevant public entity or institution such as EPC and O&M contracts.

However, sub-contracts such as EPC or O&M contracts in projects which are not signed with public entities will not be able to benefit from the exception, unless one of the parties qualifies for any other exception in the Communiqué.

- While F/X restrictions generally applied to all sale contracts of immovable and movable property under Decree 85, the newly introduced exceptions under the Communiqué remove the sale or lease of most movable property (excluding vehicles), sale of foreign-produced software or of capital markets instruments from the scope of the initial restrictions. In this context:
 - energy sales should be considered movable sales that may be subject to F/X denominated sale transactions, as all transferrable natural forces are considered “movables” under the Turkish Civil Code; and
 - shares, as movable assets, may also be subject to F/X denominated contracts between Turkish residents.
- Financing charges such as security agent or account bank fees charged customarily by lenders acting as agents within transactions can be affected by the restriction on service contracts. Unless the lender or the borrower qualifies for any other exception under the Communiqué, pricing for these charges will have to be denominated in Turkish Lira.

II. Commentary

- While the exceptions that have been introduced are a good start, they appear to be a bare minimum list and the specific and disconnected structure of the exceptions unfortunately fails to address the expectations of some industry sectors and participants.

Supported by the public statements of the authorities, the market anticipated that the Ministry would follow the exceptions to [F/X borrowing rules](#). However, the exceptions do not reflect the rules allowing Turkish companies to undertake F/X-denominated financial obligations which were introduced earlier this year. This may ultimately lead to discrepancies between the financial obligations of companies and the commercial transactions from which they derive their income to meet their financial obligations. By way of example, owners of shopping malls or commercial and industrial real estate, whose lease agreements are not excepted, will be impacted. These market players were permitted to and typically borrowed in F/X. The changes in the currency of their cash flow due to the restriction may require them to restructure their financial models and lenders to restructure the terms of their loans to them.

- The exception for employment and service contracts executed by the Turkish branches or offices of non-Turkish residents or companies who have a foreign shareholding of 50% or more addresses significant concerns of foreign investors in Turkey. However, it does not extend to all transactions entered into by foreign investors and such transactions, which are not excepted, will be impacted by the restriction.
- The competitive effects of making certain exceptions available only to foreign investors and subjecting Turkish persons to these restrictions should also be considered. By way of example, a Turkish person without a non-Turkish controlling stakeholder may be at a disadvantage hiring skilled professionals compared to its foreign-owned competitor in the Turkish market as it will not be able to enter into employment contracts denominated in F/X.
- The parties are required to comply with the repricing or conversion requirement within 30 days from the date of Decree No. 85 which means October 13, 2018.

While the market could not act on existing contracts until the exceptions were announced, the Communiqué does not extend the time period granted for repricing or conversion, which leaves very little time for the repricing to be agreed in Turkish Lira or absent agreement to implement the requirements for conversion.

The mandate of the restriction is, by itself, capable of fundamentally altering the commercial agreement between parties.

This short period available to parties makes it even less likely that parties can negotiate acceptable repricing terms and will allow a party to force application of the statutory conversion provisions if these are more favorable to it.

It is also not clear whether a party may rightfully terminate the contract due to the forced repricing on the grounds that the pricing changes constitute a change in the material components of the contract.

It is important to note that application of the forced conversion formula based on CPI from January 2, 2018 would yield a very different result to a payment obligation using the current conversion rate. You can see the results in the table below on the basis of a calculation as of date:

Date	USD/TRY	EUR/TRY
January 2, 2018	3.77	4.55
October 9, 2018	6.13	7.03
October 9, 2018 (CPI-applied / approx.)	4,50	5,40

When statutory conversion replaces the original commercial intent of the parties to these contracts, the result is that the Communiqué has retracted some of the devaluation impact on the Turkish Lira that has been suffered due to the high volatility since the beginning of 2018.

Since existing contracts were not grandfathered and excepted from the restrictions, this raises questions about freedom of contract and the ability of parties to rely on their vested rights in Turkey.

- This mandatory repricing or forced conversion of existing contracts remains one of the most criticized aspects of the Communiqué. While it may have been introduced to strike a fair balance amongst obligors facing an unexpected burden due to the drastic appreciation of foreign currencies against the Turkish Lira, the mandatory repricing or conversion is “one size fits all” and by its timing and its provisions fails to permit different approaches for different types and scale of contracts.
- In many cases, parties will be unable to have a meaningful and fair renegotiation of price in the remaining week, so they are likely to end up with statutory conversion. This makes the repricing method and its fairness from a commercial and legal perspective especially important. A single CPI-based increase applied globally on all contracts, especially when the gap between CPI and the actual value of the Turkish Lira at this time is materially different, seems inappropriate for many contracts including contracts that have considerations that are linked to imported goods and other products that can be denominated in foreign currencies.
- All in all, this wide impact of the restriction with its narrowly-constructed exceptions, does not seem to offer the commercial predictability and legal certainty that was hoped for. We would therefore, hope and expect that further amendments will be made to the Communiqué in order to reflect the commitment of Turkey to the fundamentals of a free market economy.

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