MEMORANDUM

Re: Composition upon the winding-up of financial undertakings

This memorandum discusses composition with creditors according to Icelandic law, the claims which are affected by composition, the implementation of composition following the winding-up of financial undertakings, voting on a compulsory arrangement, ratification of composition and the conclusion of winding-up. In closing, several points are examined which can cause difficulties in seeking composition following winding-up proceedings.

In preparing this memo, regard was had for a Bill of Legislation amending Act No. 90/1989, on Execution, and Act No. 21/1991, on Bankruptcy etc., as subsequently amended, Doc. no. 768 – Item 447, of the 138th legislative session 2009-2010. The Bill was adopted by the Icelandic parliament *Althingi* on 15 June 2010.

I.
Composition under Icelandic law

Composition basically comprises a contract for payment or settlement of debts, concluded between a debtor and a specified majority of creditors, which is subsequently ratified by a court. Composition concluded in this manner is also binding on the debtor's other creditors. Composition in Iceland is governed by Act No. 21/1991, on Bankruptcy etc. (BA), while in the case of financial undertakings in winding-up proceedings, consideration must also be had for Act No. 161/2002, on Financial Undertakings (AFU).

The third paragraph of Article 103 a of the AFU specifically states that if a financial undertaking's assets do not suffice for full payment of those claims which have not been finally rejected in the winding-up proceedings, the Winding-Up Board may, when it considers the time appropriate to do so, seek composition with creditors to conclude the proceedings. The Winding-Up Board shall then draft a compulsory arrangement with creditors, following the rules of Article 36 of the BA, convene a creditors' meeting and put this arrangement to a vote. The provisions of the second paragraph of Article 149 and of Articles 151-153 of the same Act shall apply *mutatis mutandis* when seeking composition with creditors. If a compulsory arrangement is approved, the Winding-Up Board shall request its ratification in accordance with the rules of Chapter IX of the same Act. If a compulsory arrangement is ratified the Winding-Up Board shall, as necessary, fulfil any obligations to creditors it includes and conclude the winding-up proceedings as provided for in the first and second paragraphs of Article 103 a of the AFU.

From the legal references quoted above, it should be clear that the AFU refers for the most part to the BA concerning the implementation and legal effect of composition in winding-up. This applies in particular to provisions of Chapter XXI on composition in

insolvency proceedings, as this Chapter refers to a considerable extent to Part 3 on Composition with Creditors without a Prior Declaration of Bankruptcy.

II.
Claims covered by composition

Composition covers only so-called contractual claims. The concept of contractual claims is defined negatively in Art. 29 of the BA as a claim against the debtor which is neither exempt from the effects of composition nor cancelled by it, as provided for in the provisions of Art. 28 of the BA. Contractual claims can therefore be said to be those claims on which the provisions of a compulsory arrangement are binding.

Those claims which are listed in the first paragraph of Art. 28 of the BA and are outside the scope of composition are as follows:

1. claims which have arisen after a court order was issued authorising a debtor to seek composition;
2. non-monetary claims which will be satisfied according to their main claim;
3. claims which would enjoy a status as provided for in Art. 109, 110 and 112 if the debtor’s estate had been placed in liquidation on the date the court order was issued authorising the debtor to seek composition;
4. claims secured by a charge on a debtor’s asset, to the extent that such a charge is not cancelled by composition;
5. claims which would be satisfied by set-offs if a debtor’s estate had been placed in liquidation;
6. claims which are specifically exempted from the effects of a compulsory arrangement according its provisions by being paid in full, cf. the second paragraph of Art. 36 of the BA.

The third paragraph of Art. 28 of the BA then provides for composition to result in the cancellation of debts which would have been ranked according to Art. 114 of the Act if the debtor’s estate had been placed in liquidation. These claims, which would be the lowest in priority if the debtor's estate were placed in liquidation, are therefore automatically cancelled in composition. As the above discussion indicates, generally speaking but with some exceptions, however, composition includes only those claims which would have had priority as referred to in Art. 113 of the BA in the event of liquidation.

III.
Implementation of composition following winding-up proceedings

As previously mentioned, Act No. 161/2002, on Financial Undertakings, refers almost entirely to Act No. 21/1991, on Bankruptcy etc. with regard to the implementation of composition following winding-up proceedings. A Winding-Up Board intending to conclude winding-up proceedings through composition must first prepare and present a

compulsory arrangement. According to Art. 36 of the BA, the compulsory arrangement must provide for the following:

1. how much the debtor is offering to pay on contractual claims and by what means;
2. when payment will be made;
3. whether interest, and if so, what interest, will be paid on contractual claims from the date the compulsory arrangement is effected until the due date for payment, if a time limit is proposed for payment;
4. whether, and if so what, security will be provided for fulfilment of the composition.

In the compulsory arrangement, therefore, the debtor is making an offer to its creditors concerning the terms of payment of their contractual claims, which they will vote upon at a later stage. The contents of the compulsory arrangement will therefore become the composition contract between the debtor and its creditors. For this reason it is extremely important that the contents of the compulsory arrangement are clear, so as not to create doubts subsequently as to what the composition provides for.

Once the compulsory arrangement is prepared, the Winding-Up Board shall call a meeting of creditors to vote on the proposal. According to the first paragraph of Art. 151 of the BA, this shall be done with a notice published by the Winding-Up Board in the *Legal Gazette at* least two weeks prior to the meeting (although in winding-up proceedings it is probably necessary to inform creditors by more dependable means and farther in advance of the creditors' meeting). According to the above provision, the compulsory arrangement must be available at the offices of the Winding-Up Board during the two weeks immediately prior to the meeting, so creditors can acquaint themselves with its contents. The Winding-Up Board must also prepare a list of voting rights on the arrangement, cf. the second paragraph of Art. 151 of the BA. The list shall only include those claims which have been recognised in the winding up and which convey voting rights, in the estimation of the Winding-Up Board; the votes attached to each claim shall be listed, both by number of creditors and by the amounts of claims. The Winding-Up Board need not notify creditors as to whether and how their claims are recorded on the list, except in cases where it is of the opinion that a recognised contractual claim does not confer voting rights.

At the creditors' meeting convened to vote on the compulsory arrangement, the Winding-Up Board shall invite comments on the determination of voting rights on the list, including whether any creditor deems itself to have voting rights which are not included on the list, cf. the first paragraph of Art. 152 of the BA. Objections cannot be raised concerning aspects of the Winding-Up Board's list, which have already been resolved during winding-up proceedings, cf. the third paragraph of Art. 120 of the BA. Nor can new claims be advanced except those which can concurrently be pursued in the winding-up proceedings, as provided for in Art. 118 of the BA. Regarding the voting itself, reference is made in other respects to the discussion below.

IV.

Voting on a compulsory arrangement

In winding-up a financial undertaking, the number of votes required for acceptance of the compulsory arrangement and the voting procedure are provided for in Art. 49-52 of the BA, unless the outcome of voting can be determined by contested votes in which case the Winding-Up Board is to have the disagreement resolved as provided for in the second paragraph of Art. 120 of the BA, cf. the second paragraph of Art. 152 of the BA. In such case the outcome of the voting is postponed until a resolution of the disagreement is obtained.

A compulsory arrangement is deemed to be approved if supported by the same proportion of votes as the proposed proportion of the reduction in contractual claims according to the arrangement, however, with a minimum of 60% of these votes, and 60% of the number of voting creditors as well, cf. Art. 49 of the BA. As this indicates, assessment of votes on a compulsory arrangement is always done in two ways: on the one hand by the number of voters and on the other hand by the amount of their claims. The required majority must be obtained on both accounts for composition to be effected. Each voter therefore has a double vote. These two different types of voting are examined in more detail.

Voter numbers

According to the third paragraph of Art. 33 of the BA, the main principle is that each voting creditor has one vote when voting by number, based on its contractual claim. This assumes that all claims due to one and the same creditor shall be aggregated to comprise one contractual claim represented by one voter, who shall therefore exercise only one vote when voting by number if included in voting creditors, cf. the fourth paragraph of Art. 30 of the BA. The fourth paragraph of Art. 30 of the BA states that if a creditor who had more than one claim against the debtor has transferred any of them three months prior to the reference date or later, then these claims shall also be aggregated as one contractual claim, while in such case the transferee is deemed to hold its share of the contractual claim in proportion to the amount of each claim held. The same applies to other changes in the ownership of claims. Thus if two or more voters hold a contractual claim jointly, they shall exercise one vote jointly but each of them shall have an independent right to vote on his/her proportion of the claim, cf. the third paragraph of Art. 33 of the BA.

Votes representing claims amounts

The fourth paragraph of Art. 33 of the BA provides for determining the amount of the claims represented by each voter. This is done by adding together the amounts of all the voter's claims and then calculating each of their claims as a percentage of the total. Each of their votes then represents its percentage of the total.

With regard to Art. 49, it should in addition be pointed out that the percentages listed there are calculated not only of the votes cast, but of the total number of possible votes

according to the list of voters' claims. The requirement that the prescribed percentage of votes is needed for the approval of a compulsory arrangement also means that regard is had, not only for those votes which directly support or oppose the proposal, but also to abstentions or absentee voters. Voting rights, which are not exercised, therefore serve as a vote against the compulsory arrangement in the end.

Instructions as to how the actual voting on the arrangement takes place are provided in Art. 50 of the BA. Although it is not specifically stated in this provision, the basic assumption is that the voter or proxy is present and votes orally. A voter may, in addition, vote in writing if he/she does not attend the meeting or send a proxy, cf. the first paragraph of Art. 50 of the BA. According to the fourth paragraph of Art. 50, entries shall be made specifically in the minutes of whether a voting creditor has cast a vote, how this was done, and how he/she voted. It should be stated specifically if the claim or the votes it confers are disputed and clearly indicated that this is a contested vote.

There is a special rule in the third paragraph of Art. 50 of the BA as to how votes can be cast for a claim which is contested, or when the voting right itself is contested. In such case the vote shall be accepted but it must be specifically stated in the minutes that this comprises a so-called contested vote. Where composition is sought following winding-up proceedings, however, the above-mentioned vote must be examined having regard for the second paragraph of Art. 152 of the BA. Based on the latter provision, aspects of the Winding-Up Board's list concerning matters which have already been resolved in the winding-up proceedings, cannot be objected to, cf. the third paragraph of Art. 120 of the BA, nor can new claims be advanced except those which can concurrently be pursued in the winding-up proceedings, as provided for in Art. 118 of the BA. The reason for this is that when composition is sought under Chapter XXI of the BA rather than Part 3 of the same Act, an invitation to lodge claims has already been issued for the winding-up proceedings and lodged claims handled more or less according to the rules of Articles 119 and 120 of the BA. The probability of disputes arising concerning voting rights in these two instances is very different. On the other hand, it should be pointed out that if disputes do occur concerning voting rights when composition is sought pursuant to Chapter XXI of the BA, which could be the result in particular of a dispute over voting rights for a claim, the recognition of which had not yet been resolved in the winding-up proceedings, and the contested votes could determine the outcome regarding the approval of the compulsory arrangement, then the special rule of the fourth paragraph of Art. 52 of the BA would not apply to the tallying of votes. This provision comprises in fact a solution of last resort in tallying votes, under which the contested votes in support of the compulsory arrangement are to be counted while all other contested votes are to be disregarded. In seeking composition with creditors under Chapter XXI, however, the second paragraph of Art. 152 provides for the disagreement to be resolved in accordance with the general rules on handling claims in liquidation before a final outcome is obtained concerning approval of the bill.

Once the voting is finally concluded, the outcome shall be announced before the creditors' meeting is adjourned, cf. the first paragraph of Art. 52 of the BA. When the votes are counted, regard shall first be had for whether votes other than contested votes, as referred to in the third paragraph of Art. 50 of the BA, are sufficient on their own to determine the outcome, even if all disputed votes were included, cf. the second paragraph of Art. 52 of the BA. If this is the case, the outcome of the voting has been decided without further actions. If it turns out that the contested votes could determine the outcome as to whether the compulsory arrangement is approved, the Winding-Up Board shall make every effort to resolve the disputes concerning them at the meeting, cf. the third paragraph of Art. 52 of the BA. If the dispute can be resolved, in part or in full, the votes shall be recounted as provided for in the second paragraph of Art. 52 of the BA. If the second count does not result in the approval of the compulsory arrangement, the special rules of the fourth paragraph of Art. 52 of the BA do not apply under these circumstances; instead the disagreement must be resolved according to the provisions of the second paragraph of Art. 120 of the BA, as described above, cf. the second paragraph of Art. 152 of the BA.

Finally, in connection with the vote counting it should be mentioned that insufficient participation at a creditors' meeting could result in a compulsory arrangement being neither approved nor directly rejected. This could happen, for example, if votes have been cast on the an arrangement requiring 70% of the votes to approve it, and 64% percent of the votes were in favour and 24% against. As a result, the first paragraph of Art. 51 of the BA states that under these circumstances a follow-up meeting can be called to continue the voting. Such a decision must be taken before the meeting is adjourned. Such a follow-up meeting must be held within two weeks of the original meeting. If a voter does not attend the follow-up meeting provided for in the first paragraph of Art. 51 of the BA or does not vote at that meeting, his/her previous vote stands unchanged, unless the compulsory arrangement has been amended after it was cast, cf. the second paragraph of Art. 52 of the BA .

V.
Ratification of composition and the conclusion of winding-up

If a compulsory arrangement is approved, the Winding-Up Board shall request its ratification as provided for in Chapter IX of the BA, as appropriate, cf. the third paragraph of Article 103 a of the AFU and the second paragraph of Art. 153 of the BA. Special attention is drawn to the fact that ratification by a District Court is subject to the important condition that claims with reference to Articles 109-112 have previously been paid, that satisfactory security is provided for their payment or that the creditors concerned agree in writing that the compulsory arrangement can be ratified without this.

The Winding-Up Board must submit a written request for the ratification of the compulsory arrangement to a District Court judge within one week after its approval is announced at a creditors' meeting, cf. the first paragraph of Art. 54 of the BA. Art. 57 of

the BA provides for circumstances which result in a judge rejecting a request for ratification of a compulsory arrangement. This could, for instance, include whether the invitation or notifications to creditors, the handling of their claims, meetings on the compulsory arrangement or voting, had been so flawed that it could have made a difference in the outcome of the voting.

If a compulsory arrangement is ratified the Winding-Up Board shall, as necessary, fulfil any obligations to creditors it includes and conclude the winding-up proceedings as provided for in the first and second paragraphs of Art. 103 of the AFU, cf. the third paragraph of the same Art. This means the Winding-Up Board is either to conclude winding-up proceedings by:

1. returning the bank once more to control of its shareholders, if a meeting called by the Winding-Up Board has approved, with the votes of persons controlling at least 2/3 of its share capital, having the company recommence its activities and a new Board of Directors has been elected to take over from the Winding-Up Board,
provided that the Financial Supervisory Authority has given its consent thereto and that the undertaking fulfils other legal requirements to recommence its activities; or

2. paying to the shareholders their portion of the remaining value of assets, in accordance with a scheme for distribution which shall comply with the provisions of Chapter XXII and Part 5 of the BA.

According to the second paragraph of Article 103 of the AFU, winding-up proceedings may be concluded as referred to in Point 1 of the first paragraph of Article 103 a of the AFU, even though payment of all recognised claims has not been completed if creditors who have not yet received satisfaction agree to this.

VI.
Main obstacles and points of contention concerning composition following winding-up proceedings

It is evident that various difficulties are involved in seeking composition with creditors in the case of a financial undertaking in winding-up proceedings, in particular in the immediate future. Some of the issues involved in this connection will now be discussed.

Large number of matters of dispute

The collapse of the financial system in Iceland has resulted in an enormous increase in the number of court cases in Iceland. A large number of cases have already been referred to the courts in connection with the winding-up of financial undertakings and insolvent corporate estates, and this number can be expected to increase yet further in coming quarters. These involve in particular disputes on claims lodged and voiding issues, as well as various other matters concerning settlement in connection with

winding-up and liquidation. A number of criminal cases in connection with the economic collapse can be expected in the near future. Many cases of this type are extremely broad in scope and will require expertise in various complex financial instruments and related aspects, knowledge of which can be said to be in many respects limited within the Icelandic judicial system. The courts can be expected to require considerably more time to deal with cases than they have in the past. It is not incautious to estimate that it may take at least 3-5 years to resolve the vast majority of cases connected to winding-up of financial undertakings in Iceland.

As pointed out above, in winding-up a financial undertaking, the number of votes required for acceptance of the compulsory arrangement and the voting procedure are provided for in Art. 49-52 of the BA, unless the outcome of voting can be determined by contested votes in which case the Winding-Up Board is to have the disagreement resolved as provided for in the second paragraph of Art. 120 of the BA, cf. the second paragraph of Art. 152 of the BA. In such case the outcome of voting is postponed until a resolution of the dispute is obtained. The above-mentioned legal provisions and the large number of disputed issues currently before the courts advise against seeking composition with creditors as provided for in Chapter XXI until some time has passed, i.e. until the greatest share of the disputed issues concerning claims lodged has been resolved. This needs to be assessed at different points in time, however, having regard for the disputes unresolved.

Special requirements for the ratification of a compulsory arrangement upon the winding-up of a financial undertaking

The second paragraph of Art. 153 of the BA refers mainly to the general rules of Chapter IX on how ratification of a compulsory arrangement is to be carried out upon the winding-up of a financial undertaking; this provision furthermore provides for the special requirement for ratification that claims as referred to in Articles 109 and 112 have previously been paid, that satisfactory security is provided for their payment or that the creditors concerned expressly agree to the ratification of the compulsory arrangement without payment or security. Obviously, the above provision results in considerably restricting when composition can be sought, since at that point in time it must be established that the above requirement of the Act can be satisfied.

Time limit for bringing suit in voiding cases

The provision of the fourth paragraph of Article 103 a of the AFU states that if it is not evident that the assets of a financial undertaking in winding-up proceedings will be sufficient to fulfil its obligations in full, reversal of its dispositions may be demanded according to the same rules as apply to reversal of dispositions by an insolvent company under liquidation, however with the time limit for bringing suit, as referred to in the first paragraph of Art. 148 of the BA, 24 months instead of 6 months, cf. the amendments made by Act No. 125/2009 to the AFU. Changes were also recently made to the BA according to which, in the case of voidable measures involving close relatives, as referred to in Articles 131-134, 137 and 138 of the BA, the time limit for bringing suit

shall be extended from 24 to 48 months in cases which will be filed prior to the end of 2012, cf. Act No. 31/2010, amending the BA. For this reason, it is pointed out especially that, according to the first paragraph of Art. 32 of the BA, the rules of Chapter XX of the Act, on voiding of measures upon liquidation, can be applied if a compulsory arrangement is achieved, with the exception that the debtor must bring a suit for voiding within three months of the date the arrangement takes effect. According to this, the time limit for bringing suit will be shortened considerably if composition is sought in the near future and results in the ratification of a compulsory arrangement.

Difficulties in achieving a compulsory arrangement

A compulsory arrangement is deemed to be approved if supported by the same proportion of votes as the proportion of the proposed reduction in contractual claims according to the arrangement, however, with a minimum of 60 per cent of these votes, and 60% of the number of voting creditors as well, cf. Art. 49 of the BA. It is therefore evident that it requires a considerably high participation on the part of creditors in the voting on the compulsory arrangement if it is to be approved. In the case of a large financial undertaking in winding-up proceedings, where creditors number in the thousands and claims lodged amount to several thousand billion ISK, the probability is relatively high that a compulsory arrangement will not receive the necessary approval, simply due to insufficient participation in the voting. In this connection it must be borne in mind that the percentages specified in Art. 49 of the BA are calculated not only of votes cast but of the total number of votes which could have been cast according to the list of voters' claims. The requirement that the specified percentage of votes is needed to approve the compulsory arrangement furthermore makes it clear that regard is had not only for votes which directly support or oppose the arrangement, but that abstentions and absentees also have an impact. A vote which is not utilised is therefore in actuality regarded as a vote against the compulsory arrangement in the end.

In addition to the above, it is clear that the provisions of the BA concerning the achieving of composition, in particular how a creditors' meeting is to be held and votes cast on the compulsory arrangement, are not entirely suitable for the winding-up of the largest financial undertakings in Iceland. They are primarily conceived with the traditional Icelandic undertaking in mind, whereas no examples exist of seeking composition for undertakings of a size equal to that of the collapsed banks in Icelandic judicial practice. Despite recent amendments made to the BA, in part with the intention of making the procedure simpler and more effective, to facilitate achieving composition, further statutory amendments are not unlikely to be required for it to be feasible to seek composition with creditors in the case of winding-up of large financial undertakings. This question, however, needs further examination.

A compulsory arrangement is not approved or its ratification is refused

If a compulsory arrangement has not been approved or a request for its ratification has been refused, the Winding-Up Board must demand that a District Court place the undertaking's estate in liquidation, cf. the fourth paragraph of Article 103 a of the AFU. A

creditor may do the same if its claim has been recognised in winding-up proceedings and attempts by the Winding-Up Board to seek composition with creditors have either been unsuccessful or the creditor demonstrates that the legal conditions for seeking composition with creditors do not exist, or such a large number of creditors are opposed to composition that there is no possibility of achieving composition based on available information on the undertaking's financial situation.

When a financial undertaking is placed in liquidation under these circumstances, the procedure changes from a winding-up as provided for in the AFU, where efforts are made to have regard for the special circumstances which apply when a financial undertaking is wound up, to a traditional liquidation under insolvency law, governed by the general rules of the BA. Among those special rules of the AFU which may be of significance in this context are, for example, the increased flexibility allowed to Winding-Up Boards in connection with distributions, which enable regard to be had for creditors' different situations, cf. the sixth paragraph of Article 102 of the AFU. Another example is the more extensive authorisations to the Winding-Up Board for disposal of the interests of the financial undertaking, cf. the second paragraph of Article 103 of the AFU. The latter provision specifically provides for winding-up to take longer than a traditional liquidation, as it enshrines in law that the objective of the Winding-Up Board shall be to maximise the assets of a financial undertaking, for instance, by waiting as necessary for outstanding claims to mature rather than realising them at an earlier date.

Bearing all of the above in mind, it can be argued that the interests of creditors may be best served if the special rules of the AFU apply in these circumstances. As a result, there may be a certain risk involved in seeking composition at this stage, since it is anything but certain that a compulsory arrangement would be approved or the arrangement ratified. If it were not, then liquidation would be the result with the consequences previously mentioned.

Claims not lodged under winding-up proceedings could be revived

As previously related, Art. 152 of the BA provides for voting on a compulsory arrangement in liquidation and who has voting rights. It states that no new claims can be advanced except those which could be pursued under Art. 118 of the BA. It also states that aspects cannot be objected to which have already been finally resolved in the winding-up proceedings. Attention is drawn to the fact that Art. 152 of the BA concerns only voting on the compulsory arrangement. There is no specific mention of how claims which are not properly lodged shall be treated once insolvency proceedings have concluded with the ratification of a compulsory arrangement, as provided for in Chapter XXI of the Act, i.e. whether they are deemed to be cancelled, as provided for in Art. 118 of the BA, or whether they could be pursued and be included in the composition after insolvency proceedings concluded. Here it must be borne in mind that the third paragraph of Art. 45 of the BA states directly that a debtor's claim is not cancelled upon composition even though it is not lodged within the time limit for lodging claims in composition. From the above discussion it can be concluded that the BA is not

completely clear in this respect, although it can be considered probable that claims would not be revived if composition was ratified under these circumstances and that the provisions of Art. 118 of the BA simply prevent other contractual claims than those which have been lodged in the winding-up proceedings from being pursued.