MEMORANDUM

Overview of legislative framework in respect of restructuring of the Icelandic banking system

I. INTRODUCTION

On 6 October 2008 an Act on Authority for Treasury Disbursements Due to Unusual Financial Market Circumstances etc. No. 125/2008 (the "**Emergency Act**"), was passed by the Icelandic Parliament. The Act entered into force immediately. An official translation of the Act is available at the webpage of the Ministry of Business Affairs in Iceland. See: http://eng.vidskiptaraduneyti.is/Publications/nr/2797.

The Act grants extensive powers to the Financial Supervisory Authority in Iceland (the Fjármálaeftirlitið "**FME**") to intervene into the financial sector in Iceland. Among the powers granted is the authority to assume the power of the shareholders meeting, dismissing the board of directors and taking over the operations of the financial undertakings in whole or in part.

On 14 November 2008 a new legislation, Act No. 129/2008, which amends the Act on Financial Undertakings No. 161/2002 (the "**Act on Financial Undertakings**"), was passed. The new legislation has immediate force. A translation of the Act is in Appendix II to this memorandum.

The purpose of this memorandum is to provide a general overview of the Act, the amendments to the Act on Financial Undertakings, and the recent decisions of the FME in respect to Glitnir Bank hf. ("**Glitnir**"), Landsbanki Islands hf. ("**Landsbanki**") and Kaupthing Bank hf. ("**Kaupthing**") (together the "**Old Banks**").

II. OVERVIEW OF THE EMERGENCY ACT

Article 1 of the Emergency Act authorizes the Minister of Finance on behalf of the State, when special and highly unusual circumstances arise on the financial markets, to establish and/or to take over a financial undertaking or its bankruptcy estate wholly or partly and allocate funds on behalf of the state treasury for this purpose.

To constitute "special and highly unusual circumstances", if any of the following have occurred or are likely to occur in respect of a financial entity (a bank):

- it is likely to be unable to honour its obligations towards creditors or customers. This would include seeking or having entered into moratorium or reorganisation, or if a petition for bankruptcy proceedings has been filed or granted;
- the FME finds it likely that the conditions for a revocation of an operational license of the bank have arisen; or
- it is probable that the financial undertaking does not fulfil equity requirements required by laws and the measures that the FME is able to take are not likely to limit losses on the financial markets or limit the risk of such losses.

Article 5 sets out the power that the FME has been given:

- It can convene a Meeting of the Shareholders or Capital Owners of a financial undertaking without being bound by the time limit or means of convening prescribed by the Article of Association of the financial undertaking or by law.
- If the circumstances are pressing the FME may remove the Members of the Board of Directors wholly or partly, limit or cancel the power of the Board of Directors, or assume the assets rights or obligation of the financial undertaking, wholly or partly.
- The FME may, in parallel, take a decision to remove the Board of Directors and appoint in their place a special committee which has all the authority that a Board of Directors can enjoy according to legislation on limited companies. The committee shall operate the bank and handle all the affairs of the bank. During the appointment of the committee the bank is exempted from being subject to bankruptcy proceedings or any form of enforcement.
- The FME may, if it considers it necessary, limit or prohibit the disposition of funds and assets of a financial undertaking.
- The FME may assume the assets of a financial undertaking, evaluate them, and dispose of them to honour due debts of the financial undertaking.
- The FME may set aside transactions for the sale of assets for the past 30 days prior to a decision was taken by the FME for special measures according to Article 5 of the Emergency Act.
- The FME may demand that a financial undertaking will seek a moratorium or reorganisation in accordance with the Act on Bankruptcy et al. No. 21/1991 (the "**Bankruptcy Act**"), and to file for bankruptcy proceedings.
- The executives and employees of the FME are not liable because of decisions and actions according to this Article.

Furthermore, the provisions of the Emergency Act stipulate that:

- The procedural provisions of the Administration Act No. 37/1993 do not apply to proceedings and decision of the FME according to Article 5 of the Act.
- The Housing Finance Fund can buy bonds secured on mortgages in residential property without the approval of the debtor.

III. APPOINTMENT OF COMMITTEES

Pursuant to the Act, resolution committees consisting of five members each were appointed on 7 October 2008 with respect to each of Landsbanki and Glitnir and on 9 October 2008 in respect of Kaupthing.

The Committees acts as a Board of Directors in accordance with the Act on Public Limited Companies No. 2/1995.

IV. PRIORITY RANKING OF DEPOSITS

Article 6 of the Emergency Act makes an amendment to Article 103 of the Act on Financial Undertakings, to the effect that claims, pursuant to the Act on Deposit Guarantees and Investor Compensation Scheme No. 98/1999, shall take priority over all general and unprioritised claims against the financial undertaking, which rank according to Article 112 of the Bankruptcy Act, i.e. deposits rank as e.g. wages behind claims of property, cost of the estate and secured claims and before all general claims.

Furthermore Article 8 of the Emergency Act implements into the Act new provisions which include:

- that the Depositors' and Investors' Guarantee Fund is authorized to reimburse the value of deposits from its Deposit Division and to remit such payments in accordance with the terms applying to the deposit or securities; for example, as regards tied periods, termination, and the like.
- that it shall always be permissible to reimburse the value of deposits, securities or cash in ISK, even though the original transactions may have been in another currency.
- that the Depositors' and Investors' Guarantee Fund is authorized to set-off the financial undertaking's claims against a customer's claim of disbursement.
- that in case of insolvency the claim of the Fund shall have priority over all general and unprioritised claims against the financial undertaking, which rank according to Article 112 of the Bankruptcy Act; otherwise, it is enforceable by execution without prior adjudication or settlement.

V. DECISIONS OF THE FME IN RESPECT OF THE "OLD BANKS" AND NEW "NEW BANKS"

The provisions of the new law (law No. 125/2008) were quickly put to use. The Ministry of Finance established in October three new banks, wholly owned by the Treasury. After the Boards of the three main banks, Landsbanki, Glitnir bank and Kaupthing bank, had decided that they were not able to continue in business and had requested the FME to intervene on the basis af Act no. 125/2008, the FME decided to do so in order to secure the continuation of vitally important domestic banking services and to safeguard the public´s bank deposits. It was also seen as important to down-size the banking sector to a level more in line with the size of the economy.

Each of the three banks was split into a "new bank" and an "old bank". The new banks consist of the domestic operations funded by local deposits. The three new banks as corporations owned by the Treasury referred to above. The old banks consist of what was left in the previously privately owned banking companies after the new banks had been split from them. They consequently comprise the activities, assets and liabilities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. All derivatives were left in the old banks.

The FME has commissioned an independent valuation of the new banks, to be completed by the end of January 2009. It will be undertaken by Oliver Wyman, an internationally recognised financial consultancy firm. Oliver Wyman will in this process co-operate with the three international accounting firms, Deloitte, KPMG and PwC. The methodology that will be used will reflect the long term economic value inherent in the new bank assets. The creditors of the banks will be given an opportunity to get an insight into and comment on the valuation methodology while it is still in a formative stage. The methodology will be finalised in the beginning of December 2008. Any currently released information on balance sheet numbers from old and new bank should be regarded as preliminary and will change based on this process.

Information regarding the new bank's equity and the size of the balance sheets can be found on the FME's webpage, http://www.fme.is/lisalib

FME's Decisions based on Act no. 125/2008, can be found on the following website: http://www.fme.is/?PageID=867.

Evaluation of assets

The Decisions state that the FME shall appoint recognised appraisers to evaluate the true worth of assets and liabilities allocated to the New Banks according to the Decisions. Following this valuation, a settlement shall be made, whereby the New Banks shall pay to each of the Old Banks (respectively) the difference between the worth of assets and liabilities, with reference to their value at:

- 9 a.m. on 9 October 2008 with regards to the Landsbanki Decision;
- 9 a.m. on 22 October 2008 with regards to the Kaupthing Decision; and
- 9 a.m. on 15 October 2008 with regards to the Glitnir Decision.

Moreover, it is stated that the valuation of the appraisers shall have been performed within 90 days from the date of each of the Decisions. Please note that the original Landsbanki Decision referred to a time period of 30 days but this was subsequently extended to 90 days.

Furthermore, it is stated that the payment from the New Banks to each of the Old Banks shall be in the form of a bond issued by each of the New Banks to each of the Old Banks. The detailed terms of such bond are not set out in the Decisions but it shall be available within 10 days of the announcement of the conclusion of the appraiser. The value shall be verified by an internationally recognized valuation company to be appointed by the FME.

The provisional opening balance sheets of the New Banks

On 14 November 2008 the FME published the opening balance sheets for the New Banks. These contain provisional figures which are subject to a revaluation which has already commenced. The outcome of the revaluation should be available within 90 days of the decision of the FME on the division of the Old Bands. The opening balance sheets of the banks can be accessed at: http://www.fme.is/lisalib/getfile.aspx?itemid=5765.

VI. LEGAL STATUS OF THE NEW BANKS

a. NBI hf. (formerly the New Landsbanki Islands hf.)

NBI hf. ID No. 471008-0280, whose registered address is at Austurstraeti 11, 155 Reykjavik, Iceland, is a company duly incorporated and validly existing under the laws of Iceland as a public limited liability company.

b. New Glitnir Bank hf. (in Icelandic: Nýi Glitnir banki hf.)

New Glitnir Bank hf. ID No. 491008-0160, whose registered address is at Kirkjusandi 2, 155 Reykjavik, Iceland, is a company duly incorporated and validly existing under the laws of Iceland as a public limited liability company.

c. New Kaupthing Bank hf. (In Icelandic: Nýi Kaupþing banki hf.)

New Kaupthing Bank hf. ID No. 581008-0150, whose registered address is at Lindargotu 1-3, 101 Reykjavik, Iceland, is a company duly incorporated and validly existing under the laws of Iceland as a public limited liability company.

VII. BANKRUPTCY PROCESS AND MORATORIUM

Financial undertakings registered in Iceland are subject to bankruptcy, rehabilitation and moratorium proceedings under the Bankruptcy Act and the provisions of Chapter XII (*Financial Reorganisation, Winding up and Merger of Financial Undertakings*) of the Act on Financial Undertakings.

Icelandic courts will not exercise insolvency jurisdiction over financial undertakings on the sole basis that assets of the financial undertakings, whether substantial or not, are located in the country. Furthermore, Icelandic courts do not have any jurisdiction over independent foreign subsidiaries of Icelandic entities.

According to Article 5 of the Emergency Act the FME has the power to demand that any of the three financial undertakings enter a moratorium process or a composition with creditors in accordance with the Bankruptcy Act if it considers such a process or composition necessary in order to resolve the undertaking's financial or operational difficulties. The FME may also demand that a financial undertaking be subjected to insolvency proceedings in accordance with the Act on Financial Undertakings No. 121/2002 and the Bankruptcy Act.

Moratorium

The Act No. 129/2008 that amended the Bankruptcy Act brings about three main changes with regards to moratorium:

- According to the Act No. 129/2008 financial undertakings may now enter into a moratorium procedure under the Bankruptcy Act for a period of up to 24 months (as opposed to the current existing maximum period of 6 months and three weeks).

- If financial undertakings enter into moratorium proceedings and subsequently bankruptcy proceedings, then the "suspect period" within which certain may be challenged will run from a number of new applicable dates, including the date of the appointment of a Committee. With regards to the Old Banks that were already

under the regime of a committee when the Act No. 129/2008 was passed the suspect period will run from 14 November 2008.

- Judicial proceedings will not filed against a financial undertaking while it is in moratorium unless such proceedings are specifically authorised by law or if it is a criminal procedure and sanctions which can be levied on a financial undertaking are petitioned. This amends current legislation where judicial proceedings were applicable.

Kaupthing and Glitnir have been placed into moratorium proceedings as of 24 November 2008. Mr. Olafur Gardarson, Supreme Court Attorney, has been appointed assistant to Kaupthing during its moratorium and Ms. Steinunn Gudbjartsdottir, Supreme Court Attorney, has been appointed assistant to Glitnir. The moratoriums are valid until 13 February 2009 and can according to the newly amended Article 98 of the Act on Financial Undertakings be extended for up to 24 months from the initial authorization being granted.

Please see Appendix I to this memorandum for an overview of the moratorium (including coverage on the new legislation) and bankruptcy process in Iceland.

APPENDIX I

Overview of the Icelandic bankruptcy process

1. MORATORIUM

(i) Request for moratorium

According to Article 100a of the Act on Financial Undertakings as amended on 14 November 2008, the Financial Supervisory Authority (the "**FME**") can request that a district court authorizes a financial undertaking to enter into moratorium in order to reorganize its financial affairs.
A District Court Judge shall deny a request for moratorium if one of the following applies:

a) If a bankruptcy petition has been submitted, and has not been either withdrawn or denied by a court decision, before the financial undertaking's petition for moratorium is received for a decision;
b) if the financial undertaking had previously been authorized moratorium, which expired within three years before the Reference Date[1];
c) if the financial undertaking has obtained composition with its creditors within three years before the Reference Date;
d) if the financial undertaking is not in such financial difficulties as being deemed significant, or if the information submitted is inadequate to assess this;
e) if there is reason to suspect that the information submitted by the financial undertaking is wilfully false or misleading; and
f) if the financial undertaking's petition or its attachments are deficient in other respects, or if the person engaged to assist the financial undertaking is not deemed to fulfil the competency requirements necessary to discharge that function, and the financial undertaking has failed to take into account any observations of the district court judge.

Should a district court grant a financial undertaking authorization to enter into moratorium the authorization shall be granted to a certain date and time within twelve weeks from the ruling.

The financial undertaking's court appointed assistant shall call its creditors to a meeting no later than three days before that certain date. An invitation to the meeting is deemed to

1 The term "Reference Date" shall mean the earliest date of the following; the date which the FME has set as deadline for the undertaking in question to increase its own funds to the minimum provided for in law; the FME appointed a Receivership Committee on the basis of Article 100a of the Act on Financial Undertakings; authorization for moratorium was granted on the basis of paragraph 3 of Article 98 of the Act on Financial Undertakings; or it was authorized to seek rehabilitation in accordance with Article 27 of the Bankruptcy Act. If none of the above is the precursor of bankruptcy proceedings the date used shall be the date when a district court judge receives a request from the FME according to paragraph 1 or 2 of Article 102 of the Act on Financial Undertakings. For financial undertakings, over which the FME has appointed a Receivership Committee on the basis of Article 100a of the Act on Financial Undertakings, the suspect period shall count from the date when Act no. 129/2008 on the change to the Act on Financial Undertakings was adopted, that is the 14th of November 2008. Effectively this means that the earlier of the above is the trigger for the "suspect period".

be satisfactory if it is published in at least two newspapers in Iceland and in each of the countries where branches of the financial undertaking have been operated.

At a meeting of the creditors the financial undertaking's assistant shall exhibit a list of the financial undertaking's assets and liabilities, estimating the value of each asset and stating the calculated amount of each liability at the Reference Date. The assistant shall, at the meeting, describe in what manner he deems possible to reorganize the financial undertaking's finances, what measures have already been taken, and whether the financial undertaking will seek an extension of the moratorium. The assistant shall furthermore, during the meeting, seek the opinions of the creditors relating to his plans, and their proposals as regards the measures to be taken.

(ii) Extension of moratorium

A financial undertaking which desires continued moratorium shall submit a written petition to that effect to the court. Creditors shall be entitled to attend the court session and protest against the petition being granted.
The Judge shall deny a petition for an extension of moratorium if one of the following applies:

a) In a situation such as referred to in item d-f above;
b) if the financial undertaking's assistant is deemed to have neglected his duties, and this cannot be amended by engaging a new assistant;
c) if the financial undertaking has, with or without its assistant's approval, taken any measures contrary to the provisions of Articles 19-21 of the Bankruptcy Act;
d) if it is deemed, considering the facts then known and in the light of the general situation, that the attempts to reorganize the financial undertaking's finances during the moratorium have not been soundly conceived; or
e) if continued moratorium is deemed not to serve a purpose.

Should the District Court Judge agree to extend the moratorium he shall extend the moratorium to a specified date. Then a court session shall be held in order to bring up the matter again within nine months from when the petition was brought up in court. If moratorium has been extended without the additional period having sufficed for reorganizing the financial undertaking's finances, the financial undertaking may submit a petition for yet another extension if the granting of its petition is deemed significantly likely to lead to success. The district court can under no circumstance authorize a moratorium for a longer period than a total of 24 months from the initial authorization for moratorium being granted.

(iii) Permitted action during moratorium

During moratorium the financial undertaking is not authorized to make dispositions concerning its property or to assume financial obligations without the prior approval of its assistant and provided the measure in question is allowed by Articles 20 or 21 of the Bankruptcy Act. The assistant may authorize the financial undertaking to use funds within specified limits for regular and necessary outlays on which its continued business operation depends. The financial undertaking shall regularly report any measures taken

on the basis of such approval to its assistant, who may withdraw the approval without notice.

According to Article 20 and 21 of the Bankruptcy Act any disposition concerning the assets or financial rights of the financial undertaking during moratorium is only allowed to the extent such a measure is deemed necessary for the day to day continuation of the financial undertaking's business or necessary in order to achieve a reorganization of its finances, and provided a fair price is paid in return which is safeguarded in a manner ensuring that the valuables in question remain available and undiminished at the end of the moratorium. The financial undertaking is, however, entitled to make dispositions concerning any assets that would be exempted from bankruptcy proceedings if it had been declared bankrupt.

Furthermore, during moratorium any use of the financial undertaking's liquid assets, monies obtained by sale of assets, or any use of rents, dividends, or revenues of the financial undertaking derived from its business operation, is prohibited for purposes other than the following:

(a) making the payments necessary for continuing the financial undertaking's business operation;
(b) paying debts to the extent this is allowed by the provisions of Article 21 of the Bankruptcy Act;
(c) paying the unavoidable costs arising from the attempts to reorganize the financial undertaking's finances, and
(d) defraying the costs of measures deemed necessary in order to forestall significant damage.

For the financial undertaking, any payment of liabilities or performance of any other obligations is prohibited during moratorium except to the extent it may be certain that the obligation would be fulfilled or the debt paid, considering its rank in the order of preference, in the event of a bankruptcy declaration following the moratorium. However, the payment of a debt or the performance of an obligation is allowed if this is necessary in order to forestall significant damage.

During the moratorium the financial undertaking may not assume any liabilities or obligations, or encumber its assets unless it is necessary in order to continue its business operation or in order to forestall significant damage, and provided it is deemed certain that the measure would benefit its creditors in the event of a bankruptcy declaration following moratorium.

(iv) Legal effects of moratorium

Creditors cannot enforce their security against a financial undertaking while a moratorium is ongoing. Creditors can claim default interest, penalties and other related remedies which will however only be enforceable when the moratorium period has lapsed. The Bankruptcy Act also states that while the moratorium is ongoing the financial undertaking will not be subject to bankruptcy proceedings, it will not be subject to attachment for debt and its assets will not be subject to forced sale.

Furthermore, judicial proceedings will not filed against a financial undertaking while it is in moratorium unless such proceedings are specifically authorized by law or if it is a criminal procedure and sanctions which can be levied on a financial undertaking are petitioned.

If judicial proceedings have been filed against a financial undertaking which is later authorized to go into moratorium such proceedings will not proceed during the moratorium unless it is specifically authorized by law or if it is a criminal procedure and sanctions which can be levied on a financial undertaking are petitioned.

Should an Icelandic court decide to authorize a financial undertaking, which is established and licensed to operate in Iceland, to go into moratorium the authorization shall automatically apply to any branches operated by the undertaking in other states of the European Economic Area (the "**EEA**"). The legal effect, procedure and implementation of the decision shall be governed by Iceland law, with those exceptions listed in the second paragraph of Article 99 of the Act on Financial Undertakings.

2. REHABILITATION (OR COMPOSITION WITH CREDITORS)

A court can also grant a debtor the permission to seek rehabilitation. The term rehabilitation effectively means that the debtor seeks to enter into an arrangement with its creditors in relation to their claims against the debtor. Generally, the debtor seeks the approval of the creditors to have their claims reduced proportionally.

If the debtor's creditors agree to the rehabilitation, contractual claims are reduced on a pro rata basis. Article 49 of the Bankruptcy Act provides that rehabilitation is considered to have been accepted by the creditors if agreed upon by the same ratio of creditors as the reduction of the claims. However, there is a requirement that, regardless of the reduction, at least 60% of the debtor's creditors, both in respect to amount and number of creditors, must agree to the rehabilitation. The rehabilitation has to be confirmed by a decision of a district court.

3. BANKRUPTCY

3.1 The commencement of bankruptcy proceedings

According to the Bankruptcy Act individuals and legal entities are obliged to file for bankruptcy if they are not able to meet their obligations when they fall due and it is likely that the difficulties are not of a temporary nature.

Moreover, any creditor can file for a bankruptcy of a debtor if:

(i) the respective creditor can demonstrate that unsuccessful enforcement proceedings (including detention and attachment) have taken place against the debtor within three months before filing for a bankruptcy before a district court;

(ii) the moratorium period of a debtor (that has been granted a moratorium from a district court) has expired provided that the creditor files for bankruptcy within a month from the expiration;

(iii) the rehabilitation period of a debtor (that has been granted a permission to seek rehabilitation from a district court) has expired provided that the creditor files for bankruptcy within a month from the expiration; or

(iv) the debtor has declared that he is not able to meet his obligations when they fall due and it is likely that the difficulties are not of a temporary nature.

Furthermore, it should be noted that in the events described above, the debtor has the opportunity to display that he is able to pay the respective claims.

3.2 Ruling of bankruptcy

When the district court has ruled that the estate of a debtor shall be subject to bankruptcy, all claims against it will fall due. There are a few exceptions to this rule, mainly in relation to financial collateral arrangements, cf. the Act on Financial Collateral Arrangements No. 46/2005 that implemented Directive 2002/47/EC and in respect of the bankruptcy of financial undertakings, cf. the recent Act on Allocation from the State Treasury Due to Special Circumstances in the Financial Markets et al. No. 125/2008 that entered into force on 6 October 2008 (hereinafter continued to be referred to as the "Act"), cf. our discussion in Chapter 3.7 below.

At the time of ruling of bankruptcy, the district court appoints an administrator or administrators who shall administrate the bankruptcy estate.

The administrator's main occupation is to work primarily for the creditors. The administrator commences the proceedings by publishing an advertisement in which it is announced that the debtor has been declared bankrupt and all creditors should send the administrator their statement of claims within a period of two months. The statement of claims must give full information of the amounts and the origin of the respective claims. The period of two months must pass before the liquidation of estate's properties can begin.

However, this does not apply to a creditor which can prove that certain property is not in the ownership of the bankruptcy estate, but in the ownership of the creditor. If the administrator accepts the arguments, which are set forth in this respect, he is obliged to deliver the assets to the creditor in question.

3.3 Necessary actions to protect interests

If a debtor is declared bankrupt it is necessary for the creditors, especially those with major claims and collateral for their claims, to establish a good cooperation with the administrator right from the beginning of the proceedings or right after he has been appointed by the district court. This will also be necessary for the administrator due to the fact that creditors, especially major creditors, have some influence over the bankruptcy proceedings.

The administrator has the authority to make decisions and to liquidate assets of the estate without getting permission or acceptance from the creditors. The administrator is obliged to hold meetings where he must inform the creditors of his decisions. The creditors cannot change the decisions that the administrator has already made but a creditor meeting can decide what the administrator should do in matters that the administrator has not decided himself.

In practice this means that the administrator will call upon a creditor meeting to take all major decisions regarding the estate. If the creditors are of the opinion that the administrator's decisions are damaging the estate and their interests they can file a case for the district court against the administrator. In such cases both the administrator's

decision can be questioned and subsequently changed and his appointment as administrator revoked. In such cases a new administrator can be appointed. This is however highly unusual.

The administrator's authority as described above has one major perception regarding the rights of the creditors which have secured their claims against the debtor by acquiring collateral in the property of debtor.

The creditors that have secured their claims as described above, can be categorised into two groups according to their status with regards to the bankruptcy estate, i.e. (i) creditors which will receive money according to their status in the secured property and (ii) those creditors which will not receive anything. The reason which distinguishes the one group from the other is what amount the administrator for the bankruptcy estate is able to get for the property when it is sold to a third party.

After having received a payment for the property he will distribute it in accordance with the status of the creditors. The status is decided differently subject to the property involved. If the property is for example a real estate, then the status is decided in accordance with the registration of mortgage at respective magistrate's office depending on where a property is located.

The administrator for the bankruptcy estate is obliged to hold special meeting with the creditors, which have secured their claim by acquiring collateral in the property, especially when it is foreseen that some creditors will lose their guarantee in the property when it is sold to a third party. In these meetings the creditors, who will lose their rights because the market value of the property is not enough to pay up the claims of all the creditors who have obtained a mortgage in the property, will be informed of their status.

In such meetings the administrator will consult with the creditors in relation to the sale of the property and will hold a special vote in which it is decided whether the property will be sold and at what price. After having liquidated the property the administrator will distribute the purchasing price as described before. Only the creditors, which have direct interest in the sale of the property, will have voting rights in a meeting with the administrator.

If a meeting convened by the administrator approves the sale of a property the property is subsequently sold. The group of creditors, which will not receive anything, when the purchasing price is distributed among the creditors, will then lose their privilege. Their claims will be considered claims not secured in any property owned by the estate, i.e. the claims will be classified as general claims, cf. below.

The group of creditors who will not receive anything from the estate can before the property is sold take two courses of action. Firstly, they can themselves protect their interest by making a bid for the property which is the same as the bid which the administrator has received or higher. Secondly, they can protest to this arrangement.

The administrator will, after having received their arguments, convene a meeting in which the dispute is settled. If there is no basis for a settlement the administrator will direct the dispute to the district court, in which the case will be tried. After having received the ruling of the district court, the group of creditors or the administrator for the bankruptcy estate can appeal the ruling to the Supreme Court of Iceland.

We would like to stress that the above mentioned principles mainly apply to the property of the estate, which can be sold to a third party. One course of action is of course applicable, especially if the certain creditors have obtained a mortgage in the property of

the debtor, and that is that the property is handed over to the creditors involved. This would be the case if the property has been mortgaged and the claims of the creditors together equal the market value of the particular property. The easiest way out for both the creditor and the administrator is to hand over the property for the sole discretion of the creditors involved.

3.4 Set off rights

Conditions for a set off are to a certain degree lenient in the Bankruptcy Act. For example, the claims between the creditor and the insolvent are not subject to the condition of being comparable (which is usually a condition for a set off). However, the Bankruptcy Act also contains other strict conditions for a set off which do not apply to set off under other circumstances. For a set off to apply in a bankruptcy the following conditions must be met:

I. There must have been mutual dealings between the insolvent and the creditor where the creditor's claim must have been established at least three months prior to the submission of a request for bankruptcy or bankruptcy filing, the filing of a petition for composition or the commencement of a moratorium, cf. Article 2 of the Bankruptcy Act. For the purposes of bankruptcy proceedings on the estate of a financial undertaking, the period ends on the date which the Icelandic Financial Supervisory Authority (the "**FME**") has set as deadline for the undertaking in question to increase its own funds to the minimum provided for in law or if such a deadline does not precede bankruptcy, the date used shall be the date upon which the request of the FME is received by a District Court judge. cf. Paragraph 2 of Article 103 of the Act on Financial Institutions No. 161/2002, as amended (the "**Act on Financial Undertakings**"). Effectively this means that the earlier of the above is the trigger for the "suspect period" of three months.

II. The creditor must not have known or have had reason to know that the debtor was insolvent at the time of the transfer.

III. The creditor may not come into possession of the relevant claim only for the purpose of a set-off against the insolvent.

Claims referred to in Article 114 of the Bankruptcy Act can not be used for the purpose of set off unless the assets of the insolvent estate can pay for them when other claims have been dealt with. Those claims are:

I. claims for interest, inflation interest, exchange difference and the cost of enforcing claims that have accrued after a court ruling was made that the insolvent party would be subject to bankruptcy proceedings;

II. claims for penalties;

III. claims for gifts;

IV. claims that have been negotiated to be subordinate to other claims;

V. and claims for interest, inflation interest, exchange difference and cost of enforcing a claim under item (II) to (IV) that have accrued after a court ruling

was made that the insolvent party would be subject to bankruptcy proceedings.

It must be stated that Article 136 of the Bankruptcy Act stipulates that the provisions on retroactive termination ("claw back") apply to set off if the set off was not authorised according to Article 100 of the Bankruptcy Act..

3.5 Chapter XV of the Bankruptcy Act – reciprocal agreements

Termination of mutual agreements upon the insolvency of one party is subject to chapter XV of the Bankruptcy Act.[2] According to Article 91 of the Bankruptcy Act, the administrator has the authority to uphold any mutual agreement by choice, i.e. "cherry picking". This is the right of the estate, but not a duty. If the administrator exercises its right according to Article 91, the administrator has to honour the agreement in every respect, inter alia, make all payments due. This right of the administrator is considered by scholars to supersede or revoke provisions in agreements which state that the agreement terminates upon bankruptcy. It must be stated that we have no case law on this as far as we are aware of. Counterparty to a mutual agreement with an insolvent party can request that the administrator answers within a reasonable time whether the administrator will authorise this authority.

If the insolvent estate does not exercise the authority to uphold the relevant agreement or fails to provide sufficient guarantees within a reasonable time limit, the contracting party may terminate the agreement. Under these circumstances the contracting party may claim damages incurred upon the termination of the agreement.

The administrator may terminate rental contracts and other binding legal relationships in the usual manner or within reasonable time limits even though the contract calls for a longer term of notice or may not be terminated at all, unless the contract has been notarised or entered into official registers in similar fashion. Under unusual circumstances, the administrator may be required to provide compensation for damages caused by the termination under these circumstances.

If the contracting party's payment is due and payable and the administrator has used its authority to uphold the agreement, the administrator has to make payment in accordance with the contracting party's claim or, if the due date has not yet been reached, provide guarantee for the payment.

If a bankrupt party has concluded reciprocal agreements prior to its estate entering into bankruptcy proceedings but yet not remitted payment, the contracting party may retain their own payment, or, if the bankrupt party has concluded its payment, prevent these funds from falling to the insolvent estate until having received adequate insurance for timely payment by the insolvent estate.

The Icelandic Parliament responded to a certain legal uncertainty relating to an administrator's ability to engage in "cherry picking" with regards to derivatives, by amending the Icelandic securities legislation. Chapter V of the Act on Securities Transactions No. 108/2007 (the "**Securities Act**") concerns contractual settlement of

[2] A mutual agreement is an agreement whereby both parties have rights and obligations. Also referred to as reciprocal agreements.

derivatives. The provisions of the chapter apply to netting and guarantee rights in connection with derivatives. Article 40 of the Securities Act states that one or more written agreements between two parties providing for their obligations under a derivative contract to be offset through netting upon renewal or default, a moratorium being obtained, composition with creditors or bankruptcy shall remain fully valid, notwithstanding the provisions of Articles 91 and 100 of the Bankruptcy Act. Article 41 of the Securities Act states that collateral pledged to secure derivative transactions are not cancellable notwithstanding provision 137 of the Bankruptcy Act.

3.6 Bankruptcy "claw back" – recovering of assets

The period of which an insolvency administrator is authorized to retroactively terminate certain arrangements made by an insolvent party is generally referred to as the "suspect period". The "suspect period" is up to six months for deals with unrelated parties and up to two years for related parties. The time limit commences on the day when the petition for bankruptcy proceedings is filed in the relevant district court (or the date on which the petition for moratorium or composition was filed if followed by the petition for bankruptcy within one month from that date). The suspect period runs backwards from such date.

According to Article 131 of the Bankruptcy Act an administrator may request a retroactive termination of a transaction at undervalue. Three conditions have to be met for the administrator to be able to succeed in his request. Firstly the assets of the insolvent party have to be reduced by the transaction; secondly the counterparty's assets have to have increased and thirdly the insolvent party has to have the intention to sell at an undervalue (give). The assessment of the two first conditions is objective but the third one subjective.

According to Article 134 of the Bankruptcy Act, an administrator may request a retroactive termination of a payment of debt, which can refer to claims for money or claims for commitment or delivery by the insolvent entity that has been made during the suspect period if the payment is (i) unusual, e.g. if the debt was paid in other than cash, (ii) made sooner than could be expected, e.g. before the due date without any reasonable explanation or (iii) the amount of the payment resulted in the insolvent party not being able to pay his debts at a due date, unless the payment would be deemed normal under the circumstances.

Under Article 136 of the Bankruptcy Act, the provisions on retroactive termination also apply to set off if it was not authorized according to Article 100 of the Bankruptcy Act. The rules for set off, in relation to an insolvent party, are more stringent than the general set off rules.

Article 137 of the Bankruptcy Act states that any mortgage, liens or other security arrangements that creditors have acquired during the six months "suspect period" preceding bankruptcy and were not created at the same time as the debt which they are related to, can be retroactively terminated. The same applies if such rights are either not registered at the relevant magistrates office or secured in another manner against enforcement within reasonable delay after the creation of the debt and not until the commencement of the suspect period.

Article 141 of the Bankruptcy Act contains a general right of the administrator to retroactively terminate arrangements that discriminate against creditors, lead to the fact that the assets of the insolvent party are not available for the enforcement of creditors or increase the liabilities of the insolvent party to the damage of other creditors, if (i) the

insolvent party is not able to pay his debts at a due date or became so due to the arrangement and (ii) the party that had benefit of the arrangement knew or had reason to know that the insolvent party was insolvent at the time of the arrangement and the circumstances that lead to the fact that the arrangement was improper. This provision constitutes a general claw back provision and is not subjected to any suspect period.

It must be stated that Article 6 of the Act on Financial Collateral Arrangements No. 46/2005 stipulates that a financial collateral arrangement, as well as the provision of financial collateral under such arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided at the day of the commencement of winding-up proceedings or reorganisation measures, but prior to the order or decree making that commencement, or in a prescribed period prior to the commencement of such proceedings or measures to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures.

3.7 Insolvency of financial undertakings

Article 5 of the Act stipulates that Articles 64 and 65 of the Bankruptcy Act do not apply during the Resolution Committees tenure (with the effect that debtors and creditors cannot apply to have any bank which is under the control of a Resolution Committee entered into a bankruptcy procedure). At the same time, the Act provides that the financial undertaking shall not be subject to enforcement pursuant to Act on Legal Execution or preliminary seizure pursuant to Act on Preliminary Seizure, Injunction etc. Under Article 5 of the Act the FME may demand that a financial undertaking applies for a moratorium on payments or request composition of creditors, in accordance with the Bankruptcy Act, if this is considered necessary in order to resolve the undertaking's financial or operational difficulties. The FME may also demand that a financial undertaking is subjected to insolvency proceedings under the Bankruptcy Act.

Please note that, under Icelandic law, there is a separate insolvency process which applies to financial undertakings. Although the Act states that financial undertakings under the control of the Resolution Committees will use the processes set out under the Bankruptcy Act, any other financial undertaking which finds it necessary to enter into insolvency proceedings will do so under the provisions of the Act of Financial Undertakings, as set out below.

Article 101 of the Act on Financial Undertakings provides that the estate of a financial undertaking may not be subjected to bankruptcy proceedings in accordance with general rules. Furthermore, it states that a financial undertaking must be wound up in the following instances:

I. if the FME revokes the financial undertaking's operating license, as referred to in Article 9 of the Act on Financial Undertakings, refuses to extend a time limit for the financial undertaking in question to increase its own funds to the minimum provided for in law, or the time limit in accordance with this provision has expired without the undertaking having increased its own funds above the minimum provided for in Article 84 of the Act on Financial Undertakings;
II. if the financial undertaking must be wound up in accordance with the Articles of Association of the undertaking in question;

III. if a shareholders' meeting or meeting of guarantee capital owners has decided to wind up the financial undertaking.

In such instances as are referred to in Points 2 and 3 above, the FME must obtain a financial statement from the board of the financial undertaking concerned in the same manner as provided for in the second paragraph of Article 86 of the Act on Financial Undertakings.

A decision as provided for in Point 3 above shall only be valid if it is approved by the FME and receives the approval of at least two-thirds of the votes cast, and furthermore the approval of shareholders or guarantee capital owners controlling at least two-thirds of the share capital or guarantee capital represented at a meeting of guarantee capital owners.

Article 102 of the Act on Financial Undertakings concerns ruling by a District Court on winding up of a financial undertaking. There it is stated that when a financial undertaking must be wound up as provided for in Point 1 referred to above, or if the FME is of the opinion, in instances covered by Points 2 or 3 referred to above, that it is not certain that the undertaking's assets will be sufficient to cover its liabilities, the FME shall send to a District Court judge in the legal venue of the undertaking concerned a request that its estate be subject to bankruptcy proceedings.

When a financial undertaking must be wound up as provided for in Point 2 or 3 referred to above, and the FME deems it evident that the undertaking's assets will be sufficient to cover its liabilities, the FME shall send to a District Court judge in the legal venue of the undertaking a request that its estate undergo bankruptcy procedures to wind up the financial undertaking.

Once a District Court Judge has examined whether the provisions of Article 101 concerning the demand are satisfied, he/she shall issue a ruling as to whether such request shall be granted.

Article 103 of the Act on Financial Undertakings concerns bankruptcy proceedings of a financial undertaking. There it is stated that unless otherwise prescribed by the provisions of the Act on Financial Undertakings, the general rules of the Bankruptcy Act shall apply as appropriate to bankruptcy proceedings on the estate of a financial undertaking, with the exception that their provisions on clawback of measures shall not apply to bankruptcy resulting when a financial undertaking must be wound up as provided for in Point 2 or 3 referred to above and the FME deems it evident that the undertaking's assets will be sufficient to cover its liabilities.

Moreover, where the provisions of the Bankruptcy Act base legal effect on the day of deferral, for the purposes of bankruptcy proceedings on the estate of a financial undertaking, it shall be the date which the FME has set as deadline for the undertaking in question to increase its own funds to the minimum provided for in law or if such a deadline does not precede bankruptcy, the date used shall be the date upon which the request of the FME is received by a District Court judge has set as deadline, in accordance with the fourth paragraph of Article 86 of the Act on Financial Undertakings.

Once all the debts of a savings bank have been paid, the guarantee capital owners shall be paid their shares out of the bank's remaining assets. Any remaining assets shall be allocated in accordance with the provisions of the savings bank's Articles of Association. The remaining assets may not, however, be disposed of to guarantee capital owners, cf. the fourth paragraph of Article 63 of the Act on Financial Undertakings.

Should an Icelandic court decide on the winding up of a credit institution which is established and licensed to operate in Iceland, this authorisation shall automatically apply to any branches operated by the credit institution in other states of the European Economic Area. The legal effect, procedure and implementation of the decision shall be governed by Iceland law, with those exceptions listed in the second paragraph of Article 99 of the Act on Financial Undertakings.

A draft translation of the Bankruptcy Act is available at http://eng.domsmalaraduneyti.is/laws-and-regulations/english/nr/6570.

APPENDIX II

This is an English translation. The original Icelandic text, as published in the Law Gazette (Stjórnartíðindi), is the authoritative text. Should there be discrepancy between this translation and the authoritative text, the latter prevails.

Act No. 129/2008 amending Act on Financial Undertakings, No. 161/2002, with subsequent amendments

Article 1

Article 9 shall be amended to include a new paragraph, Paragraph 3, which shall read as follows:

Notwithstanding the revocation of an operating licence pursuant to Paragraph 1, Subparagraph 6, those serving as trustees in the bankruptcy of a financial undertaking are authorised, with the approval of the Financial Supervisory Authority and under its supervision, to continue to engage in specified activities for which licensing is required, to the extent that such activities are necessary for the administration and disposal of the estate's interests.

Article 2

Article 98 shall be amended to include four new paragraphs, which shall read as follows:

If a district court judge grants a financial undertaking a licence for moratoriumof payments pursuant to Article 12 of the Act on Bankruptcy, etc., the licence shall be granted until a specified date and hour within twelve weeks of the date the ruling is rendered. Should a district court judge agree to extend a licence for moratorium of payments pursuant to Article 17 of the same Act, a court hearing shall be held anew within nine months of the date the petition for the extension was presented before the court. A district court judge may not authorise a moratorium of payments, however, for longer than a total of 24 months from the date of the court hearing wherein the licence was granted according to Item 1. A notification of a meeting according to Article 13, Paragraph 2 and a notification according to Article 17, Paragraph 5 of the Act on Bankruptcy, etc. shall be considered sufficient if such a notification is published in at least two newspapers in Iceland and in each of the countries where branches have been operated.

A lawyer or an authorised public auditor who has been engaged by a financial undertaking to act as an assistant in reorganising its financial affairs, cf. Article 10 of the Act on Bankruptcy, etc., no. 21/1991, shall not be liable for compensatory damages as a result of decisions or actions taken in his capacity as assistant, unless such decisions or actions represent violations committed by intent or gross negligence.

Legal proceedings shall not be initiated against a financial undertaking while a moratorium of payments is in effect unless explicitly authorised by law, or in the case of criminal proceedings in which criminal penalties applicable against a financial undertaking are demanded. In that instance, legal proceedings may be initiated in the jurisdiction of the district court that granted the licence for moratorium of payments.

If legal proceedings have been initiated against a financial undertaking that is subsequently granted a licence for moratorium of payments, the proceedings in that case shall not be continued while the moratorium of payments is in effect unless explicitly

authorised by law, or in the case of criminal proceedings in which criminal penalties applicable against a financial undertaking are demanded.

Article 3

Article 103, Paragraph 3 of the Act shall read as follows:

When legal effects are based on a reference date according to the provisions of the Act on Bankruptcy, etc., the reference date for the bankruptcy proceedings on the estate of a financial undertaking shall be based on the point in time when the Financial Supervisory Authority granted the undertaking a time limit as set forth in Article 86, Paragraph 4 or appointed a resolution committee on the basis of Article 100(a), or from the point in time when a licence for moratorium of payments was granted on the basis of Article 98, Paragraph 3, or permission was granted to seek composition with creditors, cf. Article 27 of the Act on Bankruptcy, etc., no. 21/1991. If none of these precedes the bankruptcy proceedings, the reference date shall be the date on which a district court judge receives a demand from the Financial Supervisory Authority pursuant to Article 102, Paragraph 1 or 2.

Article 4

A new temporary provision shall be added to the Act. It shall read as follows:

Should a financial undertaking petition for a licence for moratorium of payments or an extension of a moratorium of payments in accordance with a demand from the Financial Supervisory Authority on the basis of Article 100(a), such a licence shall be granted without consideration of the provisions of Article 12, Paragraph 2, Subparagraphs 4 and 6 of the Act on Bankruptcy, etc.

Article 5

This Act shall enter into force at once.

Temporary provisions

If a licence for moratorium of payments has been granted on the basis of Article 98, Paragraph 2 of the Act prior to the entry into force of this Act, but a meeting with creditors according to Article 13, Paragraph 1 of the Act on Bankruptcy, etc. has not yet taken place, a district court judge shall be authorised, upon receipt of a reasoned request from the debtor, to postpone the previously decided court hearing, but not for a longer time than is provided for in Article 98, Paragraph 3, Subparagraph 1 of the Act; cf. Article 2 of this Act. The district court judge shall grant a request for a postponement unless he considers the request manifestly unfounded. Should a district court judge grant the debtor's request, he shall extend the moratorium of payments with a ruling pursuant to Article 17, Paragraph 4 of the Act on Bankruptcy, etc.

For those financial undertakings for which the Financial Supervisory Authority has appointed a resolution committee on the basis of Article 100(a), the reference date shall be based on the date that this Act enters into force.

Adopted by the Althingi on 13 November 2008