

Iceland

Ólafur Arinbjörn Sigurðsson



LOGOS Legal Services

Ari Karlsson



1 Issues Arising When a Company is in Financial Difficulties

1.1 How does a creditor take security over assets in Iceland?

Under Icelandic law there exist four main types of security, depending on which assets security is intended to be created over. The main legislation for creating security is Act no. 75/1997 on contractual pledges (the “CP Act”):

- i) **Non-possessory Pledge** (Icelandic: “*Sjálfsvörsluveð*”). The non-possessory pledge does not transfer the ownership of the asset to the pledgee, nor does it require transfer of the possession of the pledged asset. The non-possessory pledge creates security interest over the asset for an amount specified in the pledge. The non-possessory pledge is commonly applied over real-estate, aircraft, registered vessels and vehicles. The perfection thereof usually requires public registration before a magistrate.
- ii) **Possessory Pledge** (Icelandic: “*Handveð*”). The possessory pledge does not transfer ownership of the asset, but the requirement for the creation thereof is that the pledgor’s control over the asset is effectively removed. The possessory pledge is commonly applied over various types of securities and negotiable bonds commonly traded on the financial market.
- iii) **Floating Charges.** Floating charges are charges over a specific category or group of assets all created pursuant to the provisions of the CP Act, such as over account receivables and inventories. Floating charges usually require registration in a book of chattels before a magistrate.
- iv) **Retention of Title.** A right similar to a security right can be created by retention of title. Such retention of title does not usually require any public registration, apart from retention of title in respect of motor vehicles. The retention of title created under Icelandic law is treated as a specific type of pledge pursuant to the CP Act. Restrictions apply on the type of assets title that may be retained in respect of.

1.2 In what circumstances might transactions entered into whilst the company is in financial difficulties be vulnerable to attack?

Transactions entered into when a company is in financial difficulty may be rescinded by a bankruptcy administrator during bankruptcy proceedings or the company, post successful composition, all pursuant to Act no. 21/1991 on bankruptcy proceedings etc. (the “**Bankruptcy Act**”), if they are entered into during the relevant suspect period pursuant to the Bankruptcy Act.

The suspect period runs from a reference date decided pursuant to

the Bankruptcy Act. For unrelated parties and companies the suspect period usually runs six months backwards from the reference date but for related parties this may run up to two years backwards from the suspect date.

The transactions vulnerable to such recession are chiefly the following:

- i) **Transaction at an undervalue:** the three main conditions that a transaction would have to fulfil to be considered at an undervalue are the following: (i) the assets of the insolvent party have to be reduced by the transaction; (ii) the counterparty’s assets have to have increased and (iii) the insolvent party has to have the intention to dispose for an undervalue.
- ii) **Payment of debt:** payment of debt by the insolvent entity may be rescinded if one of the following conditions is fulfilled, unless the payment would be deemed normal under the circumstances: (i) the payment is unusual, for example debt paid not by cash; (ii) made sooner than could be expected, such as before the due date without any reasonable explanation; or (iii) the amount of the payment resulted in the insolvent party becoming insolvent.
- iii) **Creation of security arrangements:** the creation of security arrangement such as pledge, lien or a charge may be rescinded if the creation thereof was not made simultaneously with the obligation they were intended to secure.
- iv) **Set-off not applicable in bankruptcy:** set-off applied may be rescinded if it is not permissible in bankruptcy proceedings.
- v) **Discrimination of creditors:** transactions discriminating creditors may be rescinded regardless of any suspect period, provided that insolvency of the company is proven at the time of the transaction, and the enrichment of a creditor or other party and his knowledge of the insolvency and the impropriety of the transaction is proven.

1.3 What are the liabilities of directors (in particular civil, criminal or disqualification) for continuing to trade whilst a company is in financial difficulties in Iceland?

Civil Liability

As a general rule of tort directors and officers will become liable towards a company and its stakeholders for loss they incur on the basis of intent or negligence provided that there is a causal link between such breaches incurred and the damage sustained. This rule is implemented by law in respect of limited companies.

Directors will generally not be made liable for debts of the company or business decisions made in the ordinary course of business that fall within the company’s purpose, unless the director knew or

should have known that the company could not fulfil the obligations it was undertaking at the time the transaction took place and that bankruptcy could not be avoided.

It should though particularly be noted in respect of a company trading in financial difficulties that the Bankruptcy Act compels a company to petition for bankruptcy proceedings if it is considered to be insolvent pursuant to the Bankruptcy Act (the term insolvency is further discussed in question 2.2 below). If officers and directors do not petition for bankruptcy they will become liable towards the creditors for the losses sustained as a consequence of their non-action, unless they can prove that their inaction was not caused by negligence or intent.

Criminal Liability

Directors and officers of a company continuing to trade when the company is in financial difficulty may also face criminal liability for their actions, mainly on the basis of the following provisions of Act no. 19/1940, the Penal Act (the “**Penal Act**”), the main ones being:

- i) **Creditors’ fraud:** The most common violation of the Penal Act is creditors’ fraud. Creditors’ fraud is the actions of the directors e.g. when they continue to trade, dispose of assets for an undervalue, give certain creditors preference over the company’s assets, pay debts that are not due or relatively high debts that are due, or create new debts, all to some detriment of the company’s assets and thwarting the possibilities of the creditors to receive satisfaction from the assets of the estate, and may be punishable with fines or up to six years’ imprisonment. A creditor given preferential treatment may also be prosecuted for creditor fraud.
- ii) **Breach of trust:** Directors or officers breaching their trust or acting outside their authority for the company and making it legally binding may face up to six years’ imprisonment.

Disqualification

The directors or the CEO of limited companies may not have been found guilty in connection with operation of a company or business, for violations of the Penal Code or other applicable legislation in respect of running the company.

2 Formal Procedures

2.1 What are the main types of formal procedures available for companies in financial difficulties in Iceland?

The main types of formal procedures for companies in financial difficulties in Iceland are the following, pursuant to the Bankruptcy Act:

- a) a cessation of payments (moratorium);
- b) a compulsory composition prior to bankruptcy proceedings with its creditors (composition); and
- c) bankruptcy proceedings (liquidation).

Besides the above, a company can also enter into a voluntary winding up, provided that the assets of the company are sufficient to pay off the obligations of all creditors, generally if the owners/shareholders approve such winding up.

It should be noted in respect of the winding up of financial undertakings incorporated in Iceland that specific procedures apply in respect of the commencement of any measure undertaken as the result of insufficient capital requirements or insolvency on the basis of Act no. 161/2002 on financial undertakings (the “**Financial Act**”). The procedure in respect of financial undertaking is not specifically addressed further in this review.

2.2 What are the tests for insolvency in Iceland?

Pursuant to the Bankruptcy Act a company is considered to be insolvent if (i) it cannot meet its obligations with its creditors once they fall due and (ii) it is not considered probable that its financial difficulties will disappear with the lapse of a short time.

The test of whether a company is considered insolvent is thus a “cash flow test” but not a test of whether the company has more assets than liabilities.

2.3 On what grounds can the company be placed into each procedure?

The main grounds for a company to be placed into each of the procedure are the following pursuant to the Bankruptcy Act:

Moratorium: pursuant to the Bankruptcy Act only the company may petition for a moratorium to the district court in its jurisdiction of incorporation. Attached to such petition the company will have to file a memorandum detailing its financial difficulties, the cause of the difficulties, measures to be undertaken by the company for reorganisation of its finances, and who the company has appointed to be the moratorium assistant. Pursuant to the Bankruptcy Act the conditions to be granted a moratorium are e.g. the following: (i) severe financial difficulties; (ii) that the company is not insolvent and obligated to file for bankruptcy proceedings already; and (iii) the measures proposed by the company are lawful, realistic and practicable for achieving the restructuring.

Composition: pursuant to the Bankruptcy Act only the company may petition for a authorisation to seek composition with its creditors to the district court in its jurisdiction of incorporation. The company will have to detail the reason for entering into composition, the reason for financial difficulties, the basis for the composition proposal and arguments supporting the company’s ability to honour its composition agreement if approved. Attached with the petition for a composition, the company shall submit e.g. (i) a proposal for the composition agreement (ii) a detailed list over the assets of the company, inclusive of the itemised estimated value of each asset and a list of all liabilities and (iii) written recommendation by at least 25% of the company’s creditors pursuant to the value of all claims to be affected by the composition agreement. The conditions for rejecting composition are basically the same as for a moratorium but in addition composition shall be rejected if there are reasons to severely doubt that the company’s proposal will be approved or the ability of the company to honour its composition agreement.

Bankruptcy Proceedings: if a company petitions for bankruptcy proceedings the formal requirements are (i) that the company places cash collateral for the cost of the bankruptcy administrator and (ii) the company’s inability to pay its debts when they fall due.

If a creditor petitions for bankruptcy proceedings of a company, besides putting up cash collateral for the proceeding costs, formal conditions will apply. The main conditions are unsuccessful attachment or seizing of property has been made, or the company has declared its inability to pay or not responded to a claim by a creditor to issue a statement of solvency.

2.4 Please describe briefly how the company is placed into each procedure.

Moratorium: pursuant to the Bankruptcy Act only the company can petition for a moratorium to a district court. If granted, the court appoints an assistant proposed by the company, provided that the assistant fulfils the specific statutory requirements of

impartiality. The assistant will usually be an attorney of law with knowledge and experience in insolvency proceedings. The moratorium imposes a general moratorium prohibiting the unsecured creditors from exercising default remedies, including levying execution against the assets of the company or selling them at a forced auction. The company retains all powers to manage its assets. Most decisions must, however, be approved by the assistant. The moratorium may initially be granted for a period of three weeks and following that an extension may be petitioned for by the company for the total period of six months. Stakeholders however, can attend court hearings and object any extension.

Composition: pursuant to the Bankruptcy Act, only the company can petition for a composition to the district court if the remedy is sought prior to the company entering into bankruptcy proceedings. A composition agent is then appointed, usually an attorney of law. The composition has the same legal effect as a moratorium has until the authorisation to seek composition is revoked, the composition proposal is rejected by the voting creditors or the composition is ratified and becomes a composition agreement. The company retains control to manage its assets although disposals and most decisions are subject to approval by the composition agent.

Bankruptcy Proceedings: pursuant to the Bankruptcy Act the company and/or creditors can apply for bankruptcy proceedings to the district court. If the petition is granted, a bankruptcy administrator is appointed, generally being an attorney of law. Once the company is placed in bankruptcy proceedings a new legal entity is created that assumes the liability and obligations of the company. The bankruptcy administrator controls the estate and its assets. The majority of creditors may take decision as to the matters of the estate, but the administrator is not necessarily bound by such decisions, for example if he considers them to violate the Bankruptcy Act or be discriminative in nature. The estate is fully protected from any civil suit, enforcement and attachments, as the court appointed administrator will take decision as to the disposal of assets, acknowledgment of claims etc. Any dispute over the decisions of the bankruptcy administrator in respect of acknowledgment of claims and other matters will be directed to the district court for final ruling.

2.5 What notifications, meetings and publications are required after the company has been placed into each procedure?

Moratorium: the moratorium assistant shall immediately convene a meeting of the creditors of the company and shall submit at the meeting an itemised and detailed list of the assets and liabilities of the company, including estimated value of all assets, what measures are possible for financial reorganisation, what measures have been undertaken and whether the company intends to petition for an extension of the moratorium. If the moratorium is extended the assistant shall notify this to the creditors. If a further extension is granted another meeting with the creditors shall be convened.

Composition: upon his appointment the composition agent shall notify unsecured creditors of the company to file a statement of their claim before him, within four weeks of the first publication in the Legal Gazette. The creditors that file their claim within the deadline (the “**Composition Claims**”) will be entitled to vote on the composition proposal of the company. The composition assistant shall compile a list over the Composition Claims and the creditors thereof. The notification shall specify the time and place of meeting of the creditors to vote on the composition proposal. The voting threshold for the composition proposal to be approved is at a minimum 60% of (i) the number of the creditors holding Composition Claims and (ii) the value of the Composition Claims, if the composition proposal contains a hair-cut of more than 60% of

the value of the Composition Claims, the same percentage of the creditors holding Composition Claims being equal to the percentage of the proposed hair-cut must approve the composition. The composition assistant will usually prepare a memorandum for the creditors on the company and whether he will recommend that the composition agreement will be ratified by the district court.

Bankruptcy Proceedings: the bankruptcy administrator shall, upon its appointment, issue a proclamation to the creditors to file their claim before a specific date before him, by an announcement in the Legal Gazette. Once the filing deadline has passed he will compile a list of claims with his decision on which claims are approved and/or rejected and convene a meeting with the creditors. Creditors that object his decision in respect of their claim must file their objections before or, at the latest, at the meeting of creditors. The bankruptcy administrator shall furthermore convene a meeting with secured creditors to discuss disposal of the assets of which they hold security over.

3 Creditors

3.1 Are unsecured creditors free to enforce their rights in each procedure?

No, in all procedures enforcement is usually prevented.

3.2 Can secured creditors enforce their security in each procedure?

No, enforcement of security must, as a general rule, await the sale of the secured asset.

3.3 Can creditors set off sums owed by them to the company against amounts owed by the company to them in each procedure?

According to the Bankruptcy Act, set-off may be applied in bankruptcy proceedings against a company if the entity claiming set-off (i) has acquired its claim at least three months prior to the reference date (ii) did not acquire its claim for the purpose of applying set-off and (iii) did not know or should not have known, at the time of acquiring the claim, that the company was insolvent. Additionally, general requirements for set-off under Icelandic law must be met.

To apply set-off when the estate is under bankruptcy proceedings, the claim and set-off notice have to be formally filed with the bankruptcy administrator. If set-off fulfils the above requirements, it may also be applied during a moratorium and composition.

4 Continuing the Business

4.1 Who controls the company in each procedure? In particular, please describe briefly the effect of the procedures on directors and shareholders.

In composition and moratorium the directors and officers retain the control of the company, although their actions are restricted pursuant to the Bankruptcy Act. The same applies for the shareholders. In bankruptcy proceedings the directors and shareholders are deprived of all control and relieved of their duties. These duties are assumed by the bankruptcy administrator.

4.2 How does the company finance these procedures?

Composition and moratorium are generally financed by the available funds of the company seeking such measures. The fees and costs of the composition agent and moratorium assistant are priority claims during bankruptcy proceedings. In bankruptcy proceedings the fees and costs of the administrator are also priority claims and the assets and the funds of the company are applied to fund these costs.

4.3 What is the effect of each procedure on employees?

Moratorium and composition have no formal effect on employees, although the part of reorganisation could be to terminate employee contracts. Bankruptcy proceedings do not have any formal impact on the employee contracts, but the administrator will, depending on whether he intends to sell the business or any part thereof, have to make a decision whether to terminate employee contracts or not.

4.4 What effect does the commencement of any procedure have on contracts with the company and can the company terminate contracts during each procedure?

Moratorium and composition do not authorise the company to terminate any contracts. However, in bankruptcy proceedings, as a general rule, the bankruptcy administrator may choose whether he terminates a contract or not depending on what is in the best interest of the estate. However, exceptions may apply in respect of the above in relation to specific contractual relationships.

5 Claims

5.1 Broadly, how do creditors claim amounts owed to them in each procedure?

Moratorium: during the moratorium, claiming of an amount will occur in respect of the terms and conditions applicable, although the company is prevented from making payments or any enforcement of payments as a general rule.

Composition: claims shall be filed before the composition assistant, as discussed above, for a creditor to be entitled to vote on the composition proposal. Once a composition agreement becomes effective, the company shall settle all claims affected by the composition as stipulated by the composition agreement, regardless of whether they were filed or not.

Bankruptcy Proceedings: claims must be filed before the bankruptcy administrator within the specific timeframe (usually two months) from the first publication of a proclamation in the legal gazette. If claims are not filed before the bankruptcy administrator before the deadline, a creditor will, with very few exceptions, forfeit any right and entitlement to receive any distribution from the disposals made from the estate.

5.2 What is the ranking of claims in each procedure? In particular, do any specific types of claim have preferential status?

Certain claims are given priority during bankruptcy proceedings. Priority claims may generally be paid during a composition and a moratorium if it is evident that the assets of the company are quite sufficient to pay all preference claim of the same ranking.

Composition generally only affects general, unsecured and

unsubordinated claims of the company, while other claims remain intact.

The order of priority is, very broadly, as follows:

- i) Assets belonging to third parties in the possession of the estate.
- ii) Costs of the bankruptcy administrator in bankruptcy proceedings.
- iii) Claims incurred after the reference date by contracts made by the administrator or damages inflicted by the estate on others.
- iv) Approved measures during a composition or a moratorium.
- v) Claims secured with the assets of the company.
- vi) Wages, pension contributions and all associated employee claims etc.
- vii) The fees of the appointed agent/assistant during a composition and moratorium.
- viii) Deposits held with financial undertakings pursuant to the Financial Act.
- ix) General claims.
- x) Interest and various costs incurred after the bankruptcy proceedings.

5.3 Are tax liabilities incurred during each procedure?

Yes, tax liabilities may be incurred during moratorium, composition and bankruptcy proceedings.

6 Ending the Formal Procedure

6.1 Is there a process for "cramming down" creditors who do not approve proposals put forward in these procedures?

The composition of a company will be binding on all creditors if the sufficient voting threshold is achieved. It should be noted that any preferential treatment of creditors of equal status is prohibited under the Bankruptcy Act and any composition violating this may run the risk of being set aside.

6.2 What happens at the end of each procedure?

Following a moratorium where the company has managed to reorganise its finances, e.g. by liquidating assets or renegotiating with its major creditors, the limitations of the company to partake in certain transactions is lifted. Following a successful composition the same applies, provided that the company honours the composition agreement. Unsuccessful compositions and moratoriums will generally compel the company to petition immediately for bankruptcy proceedings.

In bankruptcy proceedings, following the liquidation of assets and the distribution thereof, the corporate existence of the company ends, and the bankruptcy administrator is relieved from his duties.

7 Alternative Forms of Restructuring

7.1 Is it common to achieve a restructuring outside a formal procedure in Iceland? In what circumstances might this be possible?

Restructurings have occurred and are common in Iceland outside formal procedures. This is particularly common where a company

has a relatively small creditor base consisting of financial undertakings, pension funds etc. Such restructuring will only be possible if all creditors agree on the method, equal treatment of all creditors is ensured, and the company is a going concern post restructuring. However, limited space prevents us from giving further overview of these procedures.

7.2 Is it possible to reorganise a debtor rather than realise its assets and business?

The debtor may be reorganised instead of the realisation of assets and the business. This is for example achievable if the creditors wish to convert a part or all of their claims into equity of the company. In most major compositions pursuant to the Bankruptcy Act occurring in the past years, a debt for equity swap has formed a part of the composition agreement. However, limited space prevents us from giving further overview of these procedures.

7.3 Is it possible to achieve an expedited restructuring of the debtor by means of a pre-packaged sale? How is such a sale effected?

The term pre-pack is not defined in the Bankruptcy Act, and as such, is not common in Iceland. However, a restructuring via the sale of a business and its operations is known to have been negotiated fully with major creditors beforehand and implemented via a composition agreement. The limited space prevents any further analysis here.

8 International

8.1 What would be the approach in Iceland to recognising a procedure started in another jurisdiction?

Iceland has ratified the Nordic Convention on Insolvency. Under this convention, bankruptcies in Norway, Sweden, Finland and Denmark are recognised in Iceland.

Iceland has implemented the EU Directive no. 2001/24/EC on the reorganisation and winding-up of credit institutions.

Insolvency proceedings in other jurisdictions are not recognised in Iceland. Bankruptcy proceedings in another jurisdiction do not bar a creditor in Iceland from levying executions against assets situated in Iceland, belonging to the foreign bankrupt entity. In order to take possession of assets situated in Iceland, the foreign administrator must initiate bankruptcy proceedings in Iceland. If this is not possible, the foreign administrator must initiate proceedings before the ordinary courts.

Foreign creditors are dealt with in basically the same way as national creditors. Claims in foreign currency are converted into Icelandic kronor using the exchange rate on the date of the passing of the bankruptcy order.



Ólafur Arinbjörn Sigurðsson

LOGOS Legal Services
Efstaleiti 5
103 Reykjavík
Iceland

Tel: +354 540 0300
Fax: +354 540 0301
Email: olafurarinbjorn@logos.is
URL: www.logos.is

Ólafur Arinbjörn Sigurðsson is a partner at LOGOS, specialising in securities and banking law, restructuring, and the energy sector. He has advised clients in various major financial restructurings over the past years in Iceland, acting both for creditors and debtors. Before joining LOGOS in 2003, Ólafur was the head of Legal Affairs at the Icelandic Stock Exchange.



Ari Karlsson

LOGOS Legal Services
Efstaleiti 5
103 Reykjavík
Iceland

Tel: +354 540 0300
Fax: +354 540 0301
Email: ari@logos.is
URL: www.logos.is

Ari Karlsson is an associate at LOGOS, specialising in financing and banking law, structured finance and financial restructuring. He has advised a number of clients in financial restructurings in Iceland, acting mainly for debtors. Prior to joining LOGOS in 2007, he was manager of corporate banking at a local Icelandic bank.

LOGOS

REYKJAVIK LONDON COPENHAGEN

LOGOS Legal Services is a leading law firm in Iceland, providing companies and institutions with services based upon the firm's legacy of legal practice since 1907. LOGOS specialises primarily in corporate and commercial law, providing service for both the international business community and local Icelandic clients requiring legal assistance home and abroad. The firm's specific areas of practice include Aviation and Transport, Banking and Finance, Insolvency and Restructuring, Competition, Construction, Real Estate and Projects, Employment, EU/EEA, Intellectual Property, Information Technology, Insurance, Litigation and Arbitration, Media and Entertainment, Mergers and Acquisitions, Private Equity and Securities, and Telecoms. The firm is based in Reykjavík, London and Copenhagen and is committed to offering an excellent and efficient level of legal service to its clients in every practice area covered by the firm, using well defined internal procedures.