Permanent Committee on Procedural Law

Reykjavík, 10 September 2009

Ministry of Justice and Ecclesiastical Affairs
Skuggasund
150 Reykjavík [Iceland]

The Permanent Committee on Procedural Law refers to a letter from the Ministry of Justice and Ecclesiastical Affairs dated 20 July 2009, informing the Committee that various matter relating to the Act on bankruptcy etc. No. 21/1991 are currently under review in connection with the support being granted by the International Monetary Fund to Iceland. For this purpose, a Letter of Intent was drafted, which was attached to the Ministry's letter, stating the issues that need to be considered in assessing whether any amendments are needed to the Bankruptcy Act.

The attachment to the Ministry's letter refers to the rules of the Act concerning both private persons and legal persons. As regards legal persons, the issues are the following, as quoted:

1. Incorporating a liquidity test for initiation of insolvency proceedings.
2. Expediting court approval of restructuring plans concluded between viable firms and a requisite majority of creditors.
3. Including secured creditors in agreed restructuring plans.
4. Facilitating new financing during a firm's rehabilitation by clarifying the priority ranking of such financing.
5. Introducing the subordination of related-party claims in insolvency proceedings, where warranted.
6. Strengthening procedures for the efficient liquidation of non-viable firms.
7. Adressing coordination between Icelandic and foreign courts on cross-border insolvencies.

As regards the rules of the Act concerning natural persons, the review focuses on determining whether there is reason to enact rules on counsel for natural persons in financial difficulties, and whether claims secured by a debtor's assets should fall within the scope of temporary mitigation of payments.

The letter from the Ministry requests that the Permanent Committee on Procedural Law return an opinion on the above issues and specifically address the question of whether they warrant amendment of current legislation. Having regard to the above issues, and taking into account the background and occasion for the request for this opinion, the Committee believes it is appropriate to provide a general account of the recourses available under Icelandic judicial procedure in cases of insolvency, whether to natural persons or legal persons. This discussion, in Chapter I below, will primarily focus on Act No. 21/1991 on bankruptcy etc. and the background of that Act. This will be followed by specific discussion of the above issues, first in Chapter II, as regards legal persons, and subsequently in Chapter III, as regards issues relevant to natural persons. Finally, Chapter IV comprises a summary together with proposals for legislative amendments.

It should be noted that in preparing this report, the Committee held consultation meetings with a number of legal experts with extensive experience in the field of insolvency law.

I

General points concerning insolvency law in Iceland

1.

The first comprehensive legislative act in the field of probate law enacted in Iceland was the Act on the division of estates etc. No. 3/1878. This act was modelled on a Danish act of law on the same subject passed on 30 November 1874; at that time Iceland formed a part of the State of Denmark. This legislation laid down the basic principles in this field of law, and it remained in force for over a century, i.e. until 1 July 1992, when the entire body of Icelandic law on judicial procedure was co-ordinated and reviewed in conjunction with the reform of the first-instance court system.

Even though Act No. 3/1878 did not, in substance, apply to bankruptcy, it was applied *de facto* in cases of bankruptcy up to the time that a special Bankruptcy Act, no. 7/1894, was passed. That Act was then subjected to slight revision and eventually replaced by Act No. 25/1929 on bankruptcy. This legislation remained in force for almost fifty years, until the passing of the Bankruptcy Act No. 6/1978. Among the new features of this Act was the adoption of moratorium rules, as until that time legislation on bankruptcy proceedings had only contained rules on that sole recourse. This last act of law was subsequently replaced by the current Act on bankruptcy etc. No. 21/1991.

Rules on composition were first enacted with Act No. 19/1924 on composition with creditors. There were also instances of rules on insolvency agreements within individual industries, as in the case of Act No. 99/1935 on a Boat Owners' Insolvency Fund. In practice, Act No. 19/1924 was not tested to any significant degree. With Act No. 21/1991 the policy was adopted of combining into a single act of law the rules on bankruptcy proceedings and the recourses designed to resolve debtors' insolvency. The rules on composition were therefore transposed from a separate act of law on that specific legal recourse into Act No.21/1991. Ever since this last Act entered into force in 1992, all the rules on moratorium, composition and bankruptcy have been contained in a single codex.

With Act No. 21/1991 on bankruptcy etc. various changes were effected from the rules of previous laws, as this report will outline in greater detail in the discussion of the legal recourses laid down in the Act. In drafting the legislation, close consultations were held with the Icelandic Bar Association, and special efforts were made to obtain the views of professionals in the field concerning possible improvements. Also, the drafting of the legislative bill took account of existing legislation elsewhere in the Nordic countries, particularly in Denmark.

No significant changes have been made to Act No. 21/1991 since it entered into force, with the exception that under Act No. 24/2009 new special rules were established for composition with creditors in the case of natural persons who are not involved in business operations, with the new form of composition known as "temporary mitigation" (*greiðsluaðlögun*). The reason for this introduction was the experience that the recourses offered by existing legislation for the resolution of insolvency, i.e. moratorium and composition, had primarily benefitted persons engaging in business operations. Even though these recourses applied to natural persons as well, who were not involved in business operations, there were few instances of these recourses being applied for their benefit. Following the collapse of the banks in the autumn of 2008 and the severe economic downturn that ensued, it was regarded as necessary to rectify this situation in order to address the acute problems resulting from the vastly increased indebtedness of Icelandic households. It was for this purpose that the new legal recourse was enacted. Since the temporary mitigation measure under Act No. 21/1991 does not extend to claims secured by a mortgage on the debtor's assets, rules were also enacted on the mitigation of debts secured by a mortgage on debtors' residential property in Act no. 50/2009 on temporary mitigation of residential mortgage payments.

Following this account of the background of Act No. 21/1991 on bankruptcy etc. this report will now discuss in further detail the recourses provided for in the Act.

2.

As discussed earlier, the recourse of moratorium was first provided for by law in the Bankruptcy Act No. 6/1978. Act No. 21/1991 on bankruptcy etc. entailed various changes in the rules on this recourse, all contained in Chapter II of the Act. Specifically, far more detailed rules were established on the conditions that a debtor needs to meet in order to qualify for a moratorium on debts, and in addition much more specific rules were established concerning the legal effects of a moratorium relating to the scope available to a debtor to dispose of property during the effective period of the moratorium. Among other things, the purpose of these rules was to respond to situations where the recourse of moratorium had frequently been resorted to for the sole purpose of protecting a debtor from enforcement measures without any effort being made to achieve a permanent resolution of the debtor's financial problems. Also, the rules of the earlier legislation were in may ways imperfect and unclear and the new rules were designed to improve that situation.

A moratorium in the understanding of Chapter II of Act No. 21/1991 refers to a legally determined and temporary situation entailing an exception from the general rules of the freedom of action of a debtor and the permission of creditors to take action against a debtor for the purpose of rectifying an impending or existing financial difficulty with the help of an assistant.

Chapter III of Act No. 21/1991 lays down the conditions that a debtor needs to meet in order to be granted permission for a moratorium on his debts. These conditions are primarily that the debtor must be experiencing financial difficulties and some plan must be available which is capable of providing a permanent solution to the difficulties. The restriction is imposed that the situation of the debtor must not be such that the debtor is clearly under obligation to petition for bankruptcy as required of persons who are obliged by law to keep accounts, as provided in the second paragraph of Article 64 of the Act. Article 1 of the Accounts Act No. 145/145 lists the persons who are required to keep accounts; with some simplification, this lists includes companies, organisations and natural persons who are engaged in business operations.

A moratorium is a legally determined situation in the sense that authorisation must be obtained from a court of law pursuant to the rules of Chapter II of the Act. The authorisation is temporary, with maximum time limits of six months and three weeks. Before a debtor can be granted permission for a moratorium on debts, the debtor must have appointed an assistant who is either a legal professional or a chartered accountant. The role of the assistant is, among other things, to supervise or monitor to the extent possible the debtor's finances in order to prevent any measures from being taken which would be in violation of the provisions of the Act. Furthermore, the assistant is required to consult with the debtor’s creditors by summoning them to meetings to discuss the debtor’s affairs.

Chapter IV of Act No. 21/1991 provides for the legal effects of a moratorium, which on the one hand entail curtailment of the freedom of action of the debtor and, on the other hand, restrictions on the permission of creditors to take enforcement measures against the debtor. It is appropriate to give a further account of these rules on the legal effects of a moratorium.

As regards the freedom of action of a debtor, the rule applies that the debtor is not permitted, while a moratorium is in effect, to dispose of his property and rights except with the previous consent of the assistant, and, furthermore, any such disposal must be permitted by law pursuant to Articles 20 and 21 of the Act. Those provisions describe in further detail under what conditions a debtor is permitted to dispose of assets and financial interests. Thus, a debtor is not permitted to sell his assets unless such sale constitutes a necessary part of day-to-day operations or is necessary for the success of the attempt to reorganise his finances. It is

also a condition that a fair price must be obtained in return for assets and the proceeds preserved so as to remain undiminished at the end of the moratorium. In addition, there are extensive restrictions on a debtor's disposition of liquid assets during the course of a moratorium, and furthermore the debtor is not permitted to pay any debts unless the claim would be paid in the event of a bankruptcy of the estate or the payment is necessary to forestall damage. Finally, debtor is prohibited from assuming any liabilities except for the purpose of securing daily necessities or to the extent necessary to continue business operations or forestall significant damage. However, it is a condition that this measure would benefit his creditor in the event of a declaration of bankruptcy following the moratorium.

If debtor has assumed a debt during the period of a moratorium with the consent of the assistant, and provided that such measure is permitted by law, the claim will constitute an estate claim pursuant to Article 110 of the Act if the estate of the debtor is subsequently subjected to bankruptcy proceedings. These claims are among the highest ranking claims on division of the estate and are normally paid. In the existing case law it has on occasion been put to the test whether these conditions for undertaking obligations during a moratorium have been met in order for claim to be accepted as an estate claim.

Once a debtor has been granted permission for a moratorium on debts, the rights of creditors to enforce claims against him are restricted, as provided in Article 22 of the Act. Thus, no rights to default remedies are established, with the exception that a claim against a debtor will carry default interest. Also, enforcement measures cannot be taken against the debtor, and government authorities are prevented from taking coercive measures against the debtor for defaults on debts to the State or local governments.

Chapter V provides for the end of the moratorium, which lapses if its time limits expire without extension of the permission. Also, a moratorium can be terminated at the request of the assistant or a creditor if the conditions for the moratorium are no longer met.

In order for a debtor to obtain and retain permission for a moratorium, a court of law needs to agree that the debtor has a realistic plan to find a permanent solution to the financial difficulties he is facing. What this plan is depends on the prevailing circumstances, but for the sake of example a moratorium may be requested for the purpose of gaining time to sell assets in the market instead of by enforced auction. This would make it more likely that a higher price could be obtained for the assets, and the proceeds would then be used for the payment of debts. It is also common for a debtor to receive permission for a moratorium for the purpose of preparing for composition with creditors, which will be discussed in the following chapter. In such an event, the plan of the debtor consists in obtaining relief from debt to the extent where he can manage to settle. Act No. 21/1991 specifically provides for this connection between the recourse of moratorium and seeking composition with creditors. Thus, the permission for a moratorium is cancelled when a debtor is granted permission to seek composition with creditors, cf. Point 2 of the second paragraph of Article 23 of the Act. Also, the legal effects of such permission are largely the same as those which result from Chapter IV of the Act, and therefore the debtor will continue to enjoy protection from the enforcement measures of creditors, in addition to the fact that the freedom of action of the debtor is curtailed, as provided in the first and second paragraphs of Article 40 of the Act.

3.

As recounted earlier petitions for composition with creditors under Act No. 19/1924 were relatively rare. These rules were subsequently replaced by Chapter II of Act No. 21/1991 on bankruptcy etc. The explanatory notes attached to the legislative bill for that Act state that an attempt was being made to make the rules on composition with creditors more accessible and simpler and modelled to this end on Danish rules. The notes also express the hope that this could lead to the increased use of this recourse, both for companies and self-employed persons, as well as for persons experiencing financial difficulties for other reasons. However,

this hardly transpired, as this report will discuss further below, following a description of the principal rules of the act of law.

According to Article 27 of the Act, composition with creditors refers to the conclusion of an agreement on payment of debts, and relief from debt, which is reached between the debtor and a required majority of his creditors, and which is subsequently confirmed before a court of law. Such an agreement is binding for all creditors, regardless of their views of the agreement, to the extent that their claims are not exempted from its effects, whether this means they will be paid in full or rendered void.

The claims covered by a composition agreement are known as contractual claims, and these include all claims against the debtor except for those provided for in Article 28 of the Act. The Article specifies those claims which are not affected by the composition agreement and must therefore be paid in full. Among these claims are the highest-ranking claims in bankruptcy proceedings and claims secured by a pledge of the debtor's property, or by other means, to the extent that proceeds from the property are sufficient to honour the claims, and the right of security remains in effect notwithstanding the composition agreement. Furthermore, contractual claims do not include claims which are cancelled on the conclusion of a composition agreement, i.e. the lowest-ranking claims in bankruptcy proceedings. Apart from these claims, which fall outside the scope of composition agreements, the agreement will cover all other claims, whether they are known or subject to some unmaterialised future condition. It makes no difference whether the validity of a claim is disputed, and the claim will constitute a contractual claim as it is finally resolved, as provided in Article 31 of the Act.

A composition agreement can provide for full relief from contractual claims, partial reduction of the claims, deferred payment, changed form of payment or all the three last arrangements, as provided in the second paragraph of Article 29 of the Act. The third paragraph of the same Article provides for a general principle of non-discrimination among holders of contractual claims. However, with the consent of the creditors in question it is permitted to decide on greater concessions on the part of some creditors than others, and it is also permitted to provide for payment of small contractual claims by a specified amount, even if this has the effect that such creditors concede less of their claims than the others. As regards deferral and form of payment, there are also rules in effect which are designed to ensure non-discrimination among creditors, unless they themselves agree to further concessions for the benefit of the debtor, as permitted in the fourth and fifth paragraphs of Article 29 of the Act.

A debtor seeking composition needs to obtain permission from a court of law in accordance with the rules of Chapter VII of the Act. A petition from a debtor for permission to seek composition with creditors must be accompanied by draft composition agreement, which should include a communication to creditors concerning payment and payment terms. The creditors will subsequently vote on the draft proposal at a later stage of the proceedings, as further outlined below. The petition must also be accompanied by a written declaration from at least one fourth of the holders of contractual claims qualified to vote on the debtor's proposal, as determined from the enumeration of liabilities in the petition. The number of holders qualified to vote should be based on both number of creditors and amounts of claims. If the information supplied by the debtor and documents attached to the petition are satisfactory, and if the debtor has not in the preceding three years been granted permission for a moratorium on his debts or for composition which was then withdrawn as a result of his conduct, or if a composition agreement has been reached or rejected in the same period, the petition is granted by a court order. Subsequently, the judge shall appoint an agent for the debtor to supervise the conduct of the composition negotiations; the agent shall be a practising legal professional. As mentioned earlier, the legal effects of a court order permitting a debtor to seek composition with creditors are in principal respects the same as when a debtor is granted permission for a moratorium; these legal effects were discussed earlier.

Composition negotiations of debtors are discussed in Chapter VIII of the Act; these are conducted with the intermediation of a composition agent and consist primarily in putting the debtor's draft proposal to the vote among creditors. In addition to verifying and supervising the debtor's finances, the agent shall post a notice to creditors and have it published twice in the Legal Notice Journal. Among other things, the notice shall call on creditors who believe themselves to possess a contractual claim to declare such claim within four weeks. Holders of contractual claims who do not declare their claims within the deadline set for such declaration are not entitled to vote on the debtor's composition proposal, as provided in the fourth paragraph of Article 45 of the Act. Also excluded from voting are holders of contractual claims who are closely related to the debtor in the understanding of Article 3of the Act and creditors possessing conditional claims, as long as the condition has not been fulfilled, as provided in the first paragraph of Article 33. Creditors entitled to vote on a composition proposal are referred to as voting creditors, as provided in the second paragraph of the same article.

Within two weeks from the expiry of the period granted for stating claims the agent shall call a meeting for voting on a debtor's composition proposal. At the meeting, the agent shall, among other things, provide an account of the debtor's proposal, his inspection of the debtor's finances and whether the proposal is fair in the light of the inspection. Furthermore, the agent shall present the list he has prepared of submitted claims and voting rights and put the question whether anyone protests the claims stated and whether anyone who is not included in the list claims a right to vote. After the agent has given those present an opportunity to express their views concerning the debtor's proposal the proposal shall be put to the vote as provided in Article 48 of the Act.

According to Article 49 of the Act, a composition proposal shall be deemed approved if supported by the same proportion of votes as the proportion of contractual claims to be conceded according to the proposal, as calculated both by a head count of voting creditors and by the amount of their claims. In any case, the proposal must be supported by a minimum of 60% of the votes, both by number of voting creditors and by amount. In counting votes it should first be ascertained whether undisputed votes alone are sufficient to decide the issue. If a decision cannot be reached in this manner, account shall be taken of disputed votes, where either a claim has been protested or a creditor who is not included in the claims list claims the right to vote. This is done by making every attempt to settle any dispute, and if the dispute can be resolved fully or to some extent, the votes are counted anew. If a resolution cannot be achieved in this manner, the last resort is to count the votes so that disputed votes supporting the agreement are included, while other disputed votes are ignored, as provided in Article 52 of the Act.

If the debtor's proposal is defeated by the above procedure, the composition negotiations shall be automatically terminated. However, if the debtor's proposal is accepted, the debtor must submit to the district court, within one week, a request for confirmation of the composition agreement under the rules of Chapter IX of the Act. On receipt of such a claim, the district court judge shall, by means of a notice in the Law and Ministerial Gazette, announce a session of the court to address the request. If any defects are found in the composition process, as listed in Article 57, the judge shall deny the request for confirmation of the agreement. Also, the district judge may, at the request of any legitimately interested party protesting the request for confirmation of a composition agreement, deny the request if the concession to be granted is unfair in the light of the debtor's financial situation, if the debtor has damaged his financial situation intentionally or by negligence, if significant probability is established that attempts have been made to influence voting creditors' position through concessions, if the poll on the composition proposal was decided by a disputed vote where significant probability can be established that it should not have been counted, or where

significant probability is demonstrated that the debtor will not perform even if the composition agreement is confirmed, as provided in Article 58 of the Act.

When a debtor's petition for confirmation of a composition agreement has been granted by a final court resolution, the agreement is regarded as concluded, as provided in the first paragraph of Article 60 of the Act. The legal effect of this granting is that the agreement becomes binding for creditors and their assigns as regards their contractual claims. The settlement of claim in accordance with the provisions of a composition agreement has the same effect as the specific performance of the original obligation, according to the second paragraph of the same Article.

If a composition agreement is established for a debtor, the rules on Chapter XX on the rescission of measures taken in the course of bankruptcy proceedings are enforced, with certain deviations, for the purpose of rescinding any measures taken by the debtor and other actions, as further described in this Chapter of the Act; these rules will be discussed further below. This represents an attempt to ensure non-discrimination among creditors, and in addition the permission to enforce these rules can prevent a creditor from forcing bankruptcy proceedings for the sole purpose of gaining access to rescission recourses. The fact that this recourse is available if a composition agreement can be reached makes it more likely for creditors to be amenable to lending their support to composition negotiations.

According to Article 62 of the Act a composition agreement which has not been performed in full may be voided by judgment in a legal action brought by a party possessing a contractual claim if any fraudulent or criminal conduct by the debtor is established, if the debtor has paid or promised any concessions to any creditor, or if the debtor is significantly in default of his obligations under the composition agreement.

As mentioned earlier in the discussion of composition agreements, it was hoped that with the enactment of Act No. 21/1991 this recourse would used to a greater extent than before. In order to ascertain whether this was the case, the Permanent Committee on Procedural Law has procured data on the number of cases from the District Court of Reykjavik; since approximately half of the Icelandic population lives in Reykjavík, and since Reykjavík has the greatest number of business undertakings in the country, these data are believed to provide a sufficiently clear picture and therefore no need was seen to obtain similar data from other courts around the country. During the period from 1 July 1992 to the end of 2008, petitions for permission to seek composition were 81, which corresponds to an average of five petitions per year. Of this figure, composition agreements were confirmed in 61 cases, or just short of four each year.

4.

As recounted earlier, the recourse of temporary mitigation passed into law with Act No. 24/2009, where Chapter X(a) was inserted into Part 3 of Act No. 21/1991 on bankruptcy etc. According to these rules, a person can seek composition for temporary mitigation if he can show that he is currently, and will in the foreseeable future, be unable to meet his obligations. However, self-employed persons are excluded from this recourse.

Temporary mitigation is subject to the rules governing composition with creditors, which are described above, with the deviations provided for in Chapter X(a) of the Act. These deviations have the principal purpose of making it easier for individuals to have a realistic recourse for resolving their payment difficulties by adapting the burden of their debt to their ability to pay. The following is a description of the special rules applicable to this recourse and the differences between these rules and the rules generally applicable to composition with creditors.

Temporary mitigation can provide for complete concession of contractual claims, their proportional reduction, deferred payment or altered form of payment, as provided in Article 63(b) of the Act. A debtor needs to submit to a court of law a petition to seek temporary

mitigation, and the petition must be accompanied by further specified documents, including a payment plan. The petition by a debtor for permission to seek temporary mitigation can be rejected if the petition is defective, if the debtor has conducted his financial affairs in a significantly improper manner or taken financial risks which were inconsistent with his financial situation, or undertaken debts when he was clearly unable to meet his obligations. A petition can also be rejected if a debtor has incurred an obligation of significance through conduct which is subject to criminal sanctions or liability for damages, if the debtor has not paid his debts even when he was able to do so, or conducted his affairs with the deliberate intention of seeking temporary mitigation. If a petition by a debtor for permission to seek temporary mitigation is satisfactory it may be accepted by a ruling of a court of law, after which the judge will appoint a debt mitigation supervisor. The debt mitigation supervisor is subject to the same rules as composition agents, with the exception that his commission shall be paid out of the State Treasury.

After a notice to creditors has been issued and the deadline for declaring claims has passed, the supervisor shall call a meeting with the creditors possessing a contractual claim on the debtor in order to discuss his payment plan. Subsequently, the supervisor shall, within one week, adopt a reasoned position as to whether he will recommend temporary mitigation for the debtor. In his assessment, the supervisor shall consider, among other things, whether any facts have emerged which should from the outset have precluded debt mitigation, whether the debtor is seeking unreasonable concessions and whether the debtor has conducted himself in an honest manner. In this respect the rules on temporary mitigation are different from the rules on composition, as a conclusion is not reached by a poll of the creditors. However, the supervisor shall also in his assessment consider the viewpoints of the creditors who have expressed their views in the course of the negotiations.

If the supervisor advises against temporary mitigation, the negotiations are closed. If, on the other hand, the supervisor recommends temporary mitigation this corresponds to a proposal for composition being approved by creditors. The supervisor shall than deliver to the debtor all necessary documents, including an approved proposal for debt mitigation which specifies the amount to be paid by the debtor and other payment terms, as provided in Article 63(g).

Following a recommendation by a supervisor of temporary mitigation, the debtor must, within one week, submit a written petition to a district court for confirmation of composition with creditors. Subsequently, a ruling is issued on the petition pursuant to the rules of Chapter IX of the Act, as described earlier.

Temporary mitigation pursuant to Act No. 21/1991 applies only to contractual claims, and for this reason claims secured by a mortgage fall outside the scope of mitigation to the extent that the mortgaged property covers their payment. In order to further meet the needs of heavily indebted individuals, rules were also enacted on temporary mitigation of claims secured by a mortgage on residential property by Act No. 50/2009 on residential mortgage payments Through this form of mitigation the debts of the debtor are altered so that only the payments which he is regarded as capable of paying fall due, while the due dates of the remainder of the debts are postponed for as long as the temporary mitigation is in effect. Temporary mitigation of mortgage claims may remain in effect for up to five years; after that period, however, a debtor has the option of having removed from the property any debts in excess of its market value plus ten percentage points if he is incapable of effecting payment of the incumbent debts and other available debtor assistance recourses are inadequate, as provided in Article 12 of Act No. 50/2009.

If this applies, it is provided in Act No. 50/2009 that temporary mitigation in respect of mortgage claims should be requested concurrently with temporary mitigation under Act No. 21/1991. In such cases the same supervisor should normally be appointed for the debtor to

supervise both cases. The consideration to the supervisor in respect of temporary mitigation of mortgage debts is paid by the State Treasury.

5.

Part IV of Act No. 21/1991 on bankruptcy etc. contains rules on bankruptcy; provisions of this last recourse constitute the principal substance of the Act, as its name implies. Bankruptcy refers to a joint enforcement procedure on the part of the creditors of a bankrupt which takes place for the benefit of all of them and is designed to dispose of the debtor's assets and rights for the discharge of his debts.

The bankruptcy process is commenced with a ruling of a court of law for the process to take place pursuant to the rules of Chapter XI of the Act; both the debtor himself and each respective creditor can submit a petition for the process to take place subject to certain conditions. The principal condition for the acceptance of a petition for bankruptcy is that the debtor must be insolvent. When it is the debtor who is the petitioner, he must be in a financial situation where he cannot fully discharge his debts to creditors on the due date of their claims and where it is not considered likely that his financial difficulties will be resolved in the near term. If this is the situation for a debtor who is required by law to keep accounts, the debtor is under obligation to surrender his estate for bankruptcy proceedings, as provided in Article 64 of the Act. Whether a debtor is so required or permitted depends on whether he is required to keep accounts, as provided in Article 1 of the Accounts Act No. 145/1994. However, if the petitioner is a creditor, the creditor must prove the insolvency of the debtor by means of certain documents which are listed in Article 65 of the Act; normally, however, bankruptcy proceedings will arise from a recent unsuccessful attachment procedure.

On the pronouncement of a ruling for commencement of bankruptcy proceedings a separate legal person is formed, i.e. the bankruptcy estate of the debtor, which bears the name of the debtor and takes over all his financial rights and obligations, except as otherwise provided by law. To carry out the liquidation of the estate, the judge will appoint a trustee in bankruptcy, who shall be a practising legal professional.

Generally speaking, the bankruptcy process consists in the trustee collecting the assets and rights of the estate and liquidating them in accordance with the further rules of the Act. As applicable, the trustee can continue the business operations of the bankrupt in order to recover the maximum value of his assets. At the same time, the trustee shall issue a notice to creditors, to be published in the Law and Ministerial Gazetted, inviting creditors to declare their claims within a specified time limit, normally two months. Following the expiry of this time limit, the trustee will take a position regarding the claims stated. All of these actions take place concurrently, and on their conclusion the liquidation is concluded in accordance with certain rules as described below.

The trustee has the duty of thoroughly examining all the financial affairs of the debtor. The primary purpose of this examination is to ensure that all the bankrupt's assets are subjected to the liquidation process and, in addition, to obtain information as to whether any measures were taken prior to the liquidation which may be rescinded pursuant to the rules of Chapter XX of the Act. Rescission under these rules permits the recovery of assets when an attempt has been made to avoid their liquidation, e.g. by means of deeds of donation or other similar measures, as provided, e.g., in Article 134 of the Act. Also, rescission may be used to rectify any discrimination among creditors, where the debtor has paid one creditor in excess of others. This is consistent with the general principle of the Act of ensuring non-discrimination among creditors. The provisions of the Act concerning rescission of a bankrupt's measures are detailed, and in most respects identical to Danish rules on the same subject. It is safe to say that in practice the enforcement of these rules has been expedient and the case law in this field is extensive.

According to Article 99 of the Act, all claims fall due when a ruling is pronounced on the bankruptcy of an estate, regardless of any previous agreement or decision. Also, a cash value shall be established for any claims other than claims for cash where specific performance is not possible. Finally, claims in foreign currency shall be translated into Icelandic krónur based on the posted selling rate at the time that the estate was declared bankrupt. However, this does not apply to the highest-ranking claims at the time of liquidation, i.e. claims pursuant to Articles 109-111 of the Act.

In order to maintain a claim in the course of bankruptcy proceedings, a creditor must declare the claim to the trustee in bankruptcy within the time limit set for declaring claims, and normally a creditor will not have recourse to any other manner of enforcement of his claim. If the claim is not declared, the general principle under Article 118 will apply and the claim will be cancelled with respect to the estate. Following the expiry of the deadline for declaring claims the trustee in bankruptcy will produce a list of declared claims stating his position as regards their admissibility and ranking. In the event of any dispute at a meeting of creditors as regards the position taken by the trustee on declared claims, the trustee is required to attempt to resolve the dispute, but if this proves unsuccessful the issue shall be referred to a court of law for resolution, as provided in Articles 119 and 120 of the Act.

Chapter XVII of Act No. 21/1991 lays down the rules on the ranking of claims by priority in bankruptcy proceedings. The general principle applies that creditors should enjoy parity when it comes to the payment of claim, except as otherwise dictated by the applicable rules, which variously provide that certain claims rank higher or lower in priority than other claims. The highest ranking claims in bankruptcy are the third party claims provided for in Article 109, which are claims based on property rights. Thus, a party owning property in the possession of the estate may call for the surrender of such property, or its value if the property has been disposed of. These are followed in rank by estate claims pursuant to Article 110 of the Act, which include costs arising from the division of the estate and costs incurred by the bankruptcy estate. They also include costs which were properly incurred in the period leading up to the bankruptcy proceedings if the debtor had been granted a moratorium or permission for composition with creditors, as discussed earlier. Next, the proceeds from sales and income from assets should accrue to those who have a mortgage or other security in the assets in question, to the extent that such proceeds and income will cover such claims. Next in order of rank are so-called priority claims pursuant to Article 112, which for the most part consist of wages and other remuneration for work performed in the service of the bankrupt. This is followed by all other claims, referred to as general claims, pursuant to Article 113, with the exception of residual claims, which rank lowest in priority on the division of the estate, as provided in Article 114 of the Act. The claims falling into this category include interest and cost accruing to higher-ranking claims after the estate went into bankruptcy, deeds of donation and subordinate loans.

The conclusion of the bankruptcy process differs depending on the financial situation of the estate and circumstances in individual cases. If a bankrupt achieves composition with creditors in the course of the division of the estate pursuant to the rules laid down in Chapter XXI of the Act, the bankruptcy proceedings shall be brought to an end. The same applies if the bankrupt is granted temporary mitigation, as provided for in Article 63(i) of the Act. Bankruptcy proceedings shall also cease if the bankrupt submits, after the deadline for declaring claims expires, declarations from all parties who have submitted claims to the effect that they will withdraw their claims, or if the bankrupt shows that the claims have been cancelled, as provided in Article 154 of the Act. If the estate has no assets, or if its assets will only cover third-party claims and the cost of the bankruptcy proceedings, the bankruptcy proceedings shall cease following payment of those claims, as provided in Article 155 of the

Act. However, if the estate owns further assets, the bankruptcy proceedings will conclude with allocations to creditors pursuant to the further rules of Articles 158-160 of the Act.

6.

As shown in the outline above, the entire procedure under the Act on bankruptcy etc. No. 21/1991 is characterised by the fact that it is carried out under the auspices of courts of law. Thus, a court order is needed to launch the process provided for by the Act and, furthermore, all legal disputes in the course of proceedings can be expeditiously referred to a court of law for resolution, both as regards form and substance. Also, the procedure is transparent and it is understood that creditors are in most respects permitted to intervene as their interests may dictate. Also, the principle applies under the law that non-discrimination should prevail among creditors, with due regard for the debtor's interests. Finally, there are numerous provisions in the Act to the effect that the process should be expedited to the extent possible, and in all cases the procedure is brought to a formal conclusion.

II

Legal Persons

As mentioned earlier, the Ministry has requested that the Permanent Committee on Procedural Law should address the issues laid down in the "Letter of Intent" which was compiled in the context of the International Monetary Fund assistance to Iceland. The seven items in the letter refer to legal persons or business undertakings in financial straits, as specified in letter from the Ministry. The following is a discussion of these items in the order that they are listed in the Letter of Intent. The numbers of the sections below correspond to the listing of the items on the first page of this report.

1.

This issue relates to the conditions for bankruptcy proceedings, as follows: *Incorporating a liquidity test for initiation of insolvency proceedings*.

As referred to earlier, insolvency is a condition for debtor's estate to be subjected to bankruptcy proceedings. Insolvency can mean both that a debtor's assets fall short of his debts [balance sheet insolvency], or that a debtor is unable to pay his debts when they fall due; this latter situation is referred to as cash flow insolvency. In either case, the debtor qualifies as insolvent. However, cash flow insolvency is an absolute condition for bankruptcy, while the asset to liability ratio has less weight, as further discussed below.

According to Act No 145/1994 on financial accounts, all legal persons are required to keep accounts. According to the second paragraph of Article 64 of Act No. 21/1991 on bankruptcy etc. a person who is required to keep accounts is under obligation to surrender his estate to bankruptcy if he is unable to pay his creditors when their claims fall due and when it is not regarded as probable that the payment difficulties will be resolved in the near term. In this situation, the fact alone that a debtor cannot pay his due debts is sufficient so that he must, on his own initiative, take measures for his estate to be declared bankrupt; it is irrelevant in such circumstances whether his assets are sufficient to cover his debts. However, there is a proviso that the cash flow insolvency should not be temporary, and for this reason seasonal fluctuations in individual sectors cannot be decisive in this context.

Neither Act No. 21/1991 nor any other provisions of Icelandic law provide for any sanctions for non-observance of the obligation to surrender an estate for bankruptcy proceedings. However, certain actions taken after this obligation becomes effective may be subject to criminal sanctions. Thus, an agent who place a legal person under an obligation, knowing that the obligation will not be honoured, may be found guilty of fraud, as provided in Article 248 of the Penal Code No. 19/1940. Also, individual measures may constitute fraudulent settlement under Article 250 of the Code. Finally, the agent of a legal person who does not observe the obligation to surrender an estate for bankruptcy proceedings may incur personal liability in tort to a counterparty who suffers damage after the legal person is

required to declare bankruptcy. This obligation which rests on the agents of a legal person has undoubtedly had the effect that most large estates are subjected to bankruptcy proceedings on the initiative of the debtor himself.

If a legal person does not fulfil the obligation to declare bankruptcy pursuant to Article 64 of Act No. 21/1991, a creditor can respond by submitting a request to such effect. The conditions for bankruptcy at the request of a creditor are discussed in Article 65 of the Act. According to paragraph 2 of that Act, cash flow insolvency is a necessary condition for bankruptcy, which means that a debtor can always defend himself against a request for bankruptcy if he can demonstrate that he is capable of fully meeting his financial obligation when they fall due, or that he will be within a short time.

Points 1-4 of the second paragraph of Article 65 of Act No. 21/1991 recount the means by which a creditor can prove the insolvency of a debtor in order to obtain a granting of his request for the debtor's estate to be declared bankrupt. The four points describe certain circumstances which are regarded as showing probability of insolvency. According to *Point 1*, a debtor's insolvency is regarded as manifest if unsuccessful distraint, impoundment or attachment proceedings have been carried out against the debtor within certain specified time limits. In these circumstances, insolvency is demonstrated by showing that the debtor does not possess sufficient assets to secure his debts, at the same time that sufficient probability has been shown that he is incapable of paying his debts. In *Points 2 and 3* insolvency is regarded as manifest where, within a month before the petition for bankruptcy proceedings was received by a district court, the debtor's moratorium expired or the debtor's permission to seek composition lapsed. In such circumstances the insolvency rests on the contention that the debtor has himself, by resorting to these recourses, admitted his financial difficulties. If the debtor has been unsuccessful in resolving this problem by the means proposed during the time granted for the moratorium, it is unlikely that he will be able to prevent the granting of a creditor's petition for bankruptcy. However if the actions taken have returned lasting results, a debtor can defend himself against such a petition on the grounds that he is solvent, as provided the second paragraph of Article 65 of the Act. The same applies if a debtor has held permission to seek composition with creditors. If a composition agreement has not been reached, it is unlikely that the debtor will be able to defend himself against a petition for bankruptcy. Finally, a creditor can, under *Point 4*, prove insolvency be means of a debtor's declaration of insolvency.

According to the above, insolvency is an unavoidable condition for bankruptcy, whether the petitioner is the debtor himself or a creditor. To the extent that the insolvency needs to be demonstrated, the burden of proof rests on the debtor, whether he is petitioning for bankruptcy or defending against such a petition from a creditor. The reason for this is that is most expedient for the debtor himself to provide information on his own financial situation. Thus, it should be a simple matter for a debtor to explain that his cash and income, in the light of experience and other available information, is sufficient to cover his debts as they fall due.

Looking at the case law in Iceland, it has generally not been difficult for creditors to gain acceptance of a petition for a debtor's bankruptcy. It should be noted that the legislation in Iceland in this regard is no different from legislation elsewhere in the Nordic countries, with the exception that in Denmark there is greater scope for declaring an estate bankrupt when a debtor has in fact stopped payments to creditors. However, a creditor possessing a claim which has not fallen due who sees need to defend his interests by having a debtor's estate subjected to bankruptcy proceedings may find it difficult to submit a petition to such effect if enforcement proceedings against the debtor at the request of another creditor possessing a due claim have not been concluded without success. However, a creditor possessing a claim which has not fallen due does have the recourse of requesting attachment of a debtor's assets, as provided in Article 5 of Act No. 31/1990 on seizure, injunction etc.,

but the conditions set for such measures are rather strict. Other enforcement measures are unavailable if a claim is not yet due. Also, it can take considerable time for a creditor possessing a due claim which is not enforceable to obtain permission for attachment proceedings against the debtor. In order to strengthen the position of creditors in this regard, it could be an option to amend the legislation so that a creditor is enabled to petition for bankruptcy proceedings on the grounds that a debtor has not responded to a formal request for written confirmation that the debtor is solvent. This way the obligation of debtors to take the initiative in petitioning for bankruptcy would be made clearer, and in addition debtors would not be able to delay bankruptcy proceedings simply by refraining from taking any action. Concurrently, it might be an option to make appropriate amendments to Act No. 90/1989 on enforcement procedure to facilitate the completion of unsuccessful attachment measures even if the respondent does not present himself when the attachment takes place. At the same time, it would need to be ensured that action of this kind would constitute adequate grounds for subjecting the debtor's estate to bankruptcy.

2.

This issue is phrased as follows: *Expediting court approval of restructuring plans concluded between viable firms and a requisite majority of creditors*. This needs to be assessed both on the basis of the rules applicable to voluntary arrangements (2.a) and rules on composition with creditors in Part 3 of Act No. 21/1991 on bankruptcy etc. (2.b.).

2.a

In Iceland, there is a long tradition of debtors resolving their financial difficulties through out-of-court settlements, or so-called voluntary arrangements. Although no statistical information is available on the frequency of such agreements, it may be assumed that they are comparatively frequent in light of the fact that composition with creditors under Act No. 21/1991 and earlier legislation on the same has have been rare, as recounted earlier.

Voluntary arrangements are established by the debtor negotiating relief from debt or deferment of payments with each creditor separately. Such agreements are based on the general principles of commercial law on the freedom of parties to enter into contracts, and they are subject to general rules applicable to contracts, e.g. Act No. 7/1936 on contracts, agency and void legal instruments. In other respects, there are no statutory rules that can be applied to agreements of this kind.

It may be assumed that normally the creditors of a debtor will enter into negotiations on voluntary arrangements on the assumption that all creditors will offer comparable concessions. In the event of any significant deviation in this regard, a creditor will not be bound by any promise of relief or other concessions. However, it is possible for creditors to agree specifically that certain claims should fall outside an agreement on debt settlements; this would most likely come into consideration in the case of taxes which, if unpaid, would give rise to criminal sanctions.

When a debtor seeks voluntary arrangements, each creditor will not be bound except to the except that he grants his consent. In these circumstances it makes no difference whether all other creditors are prepared to accept an offer for settlement and whether it can be asserted that further enforcement will not be achieved through enforcement measures under general rules. However, in such circumstances it would be likely for a creditor to agree to a voluntary arrangement, as he can otherwise expect the debtor to seek composition with creditors under the rules of Part 3 of Act No. 21/1991, whereby confirmation may be obtained for an agreement by which creditors are then bound whether the agreement is to their satisfaction or not. It should also be noted that through voluntary arrangements further performance may be achieved through the debtor's future income instead of resorting to full enforcement with the result that his business operations are stopped, with the risk of loss of other value inherent in

the operation. For example, this could include goodwill, business contacts and staff expertise. These are no doubt the reasons for the favourable experience of voluntary arrangements in Iceland. It addition, it may be pointed out that the number of disputes arising in respect of arrangements of this kind that have needed resolution before a court of law has been insignificant.

In light of the long experience of these arrangements, there would not appear to be any reason to enact rules on voluntary arrangements, with or without the intervention of courts of law. There is no evidence either that such suggestions have ever been raised by any parties involved in such arrangements. The absence of rules on arrangements of this kind is not unique to Iceland, as the legal environment in Denmark and Sweden is comparable in this respect. Finally, it should be noted that a debtor has full control over whether he will seek composition with creditors pursuant to the rules of Part 3 of Act No. 21/1991, while a creditor can encourage this course of events by rejecting voluntary arrangements. This ensures that negotiations are conducted in accordance with statutory rules, where rights are protected by enabling the parties to obtain a resolution of any disputes which are significant for the negotiations.

2. b

For the purposes of the issue under discussion here, the Permanent Committee on Procedural Law has carefully scrutinised the rules on composition with creditor in Part 3 of Act No. 21/1991 on bankruptcy etc. in order to assess whether any changes could be effected with a view to making the process more efficient and encouraging the achievement of composition for viable businesses. The discussion below and the proposals submitted take account, *inter alia*, of the results of the meetings of the committee with legal professionals referred to above.

Articles 34-36 of Act No. 21/1991 lay down instructions on the manner in which creditors are required to prepare their petitions for permission to seek composition with creditors and what documents need to be attached to the petition. According to Point 2 of the first paragraph of Article 35 the petition should be accompanied by a written declaration from at least one fourth of the voting creditors according to the list of debts in the debtor's petition, both based on number of creditors and the amount of their claims, that they recommend composition on the basis of the debtor's proposal. In the case of large enterprises, where there may be numerous claims and a large part of them may not be significant in amount, it may require considerable effort to obtain the support of a quarter of the creditors based on a head count. For this reason it is proposed that this condition should be abolished, and it could even prove feasible to abolish entirely the condition that a creditor must obtain support from creditors in order to be allowed to petition for permission to seek composition with creditors. For comparison it is worth noting that a debtor petitioning for a moratorium does not need to take any measures to obtain the support of creditors to submit such a petition.

Article 45 of Act No. 21/1991 contains rules on declarations of claims by creditors in composition negotiations. For the purpose of simplification, it is proposed that a creditor should have the option of submitting in the declaration of claims itself a vote on the proposal of the debtor as presented. This would remove the need for a creditor to attend a meeting where votes are taken or to obtain his vote in writing in accordance with the first paragraph of Article 50 of the Act.

According to Article 47 of Act No. 21/1991, a debtor is not permitted to make any changes in his proposal for composition when he has received permission to seek composition until voting on the proposal has been brought to a conclusion. This takes account of the fact that a clearer view is obtained of the debtor's financial position as the composition negotiations proceeds, when declarations of claims have been received and the composition agent has scrutinised his affairs. It may then ensue that the debtor is capable of paying more

or less than it appeared at the outset. Article 47, *in fine*, lays down the condition for an amended proposal to be put to the vote that a debtor must obtain the support of creditors if the change is in the debtor's favour. Having considered the matter, the Permanent Committee on Procedural Law sees no reason why a debtor should be required to obtain support for the sole purpose of submitting an amended proposal. The obvious course would be for creditors to express their opinion with their vote, and the debtor can anticipate that creditors will vote against a changed proposal if it provides for greater concessions to the debtor than warranted.

Article 49 of Act No. 21/1991 provides for the support needed for a composition proposal to be approved. According to the provision, a proposal is approved if it receives the same proportion of votes as the proposed concessions from the contractual claims, both by the number of all voting creditors and the amounts of their claims, but never less than 60% counted both ways. For further clarification a proposal assuming payment of 30% of claims, for example, would require a 70% vote, both by number of creditors and amount of claims. However, if a debtor offers 50% payment, the minimum of 60% support for the proposal, counted both ways, would apply. In order to make it easier for a debtor to have a composition proposal approved, it is suggested that this rule should be changed so that it would suffice for 60% of the creditors, by head count, to vote in favour of the debtor's proposal, regardless of its substance. However, the rule should remain unchanged as regards the support required for a proposal based on the amount of the claims. In light of the interests at stake, it is not considered likely that this change would prejudice excessively the interests of creditors.

In addition to the changes mentioned above, Section 3 below will discuss the position of secured claims in composition negotiations. The section will also address possible legal reforms for the purpose of rendering composition a more realistic recourse in resolving a debtor's financial problems.

In addition, the Permanent Committee on Procedural Law has studied whether there might be grounds for taking a larger step from the current rules by enacting permission for a debtor to appear before a court of law with a composition proposal which already has sufficient support from creditors based on the information submitted by the creditor regarding his debts. In order to ensure the correctness of this information to the extent possible, it could be stipulated that the information must be confirmed by an auditor who has examined the debtor's books. It is then possible that the procedure could be completed without the appointment of an agent, issue of a notice to creditors or a poll. The Committee believes that it would be premature at this stage to propose such radical changes, as their enactment would require extensive preparations and more extensive consultation discussions than those already held with the professionals working in this field. However, the Committee is prepared to study the matter further, *inter alia* in light of the trends in neighbouring countries.

3.

Here, the issue is as follows: *Including secured creditors in agreed restructuring plans.*

When the Act on bankruptcy etc. No. 21/1991 was passed, the rules permitting natural and legal persons to mortgage their property or rights were contained in the Act on mortgages No. 18/1887. This act of law was replaced by the current Act on contractual liens No. 75/1997, which significantly widened the scope of permitted mortgages, including the mortgage of portfolios of properties and assets. For this reason the weight of mortgage claims has increased greatly in actions in the field of insolvency law, while the proportion of unsecured claims has fallen correspondingly. From the viewpoint of debtors there is greater need now than before the entry into force of Act No. 75/1997 for financial reorganisation to extend to secured debts as well. However, there is no avoiding the fact that security rights, such as mortgages or other similar rights to a debtor's assets, constitute indirect property rights. This means that a creditor holding rights of this kind has acquired a share in the debtor's title to the property in question, and the right of title of the debtor is curtailed

correspondingly. Property rights are inviolate under Article 72 of the Constitution, that this protection extends to indirect property rights as well. This constitutional right therefore significantly reduces the scope for prejudicing security rights of this kind to the extent where a claim can be enforced on the value of the property covered by the right. Thus, it is not an option to amend the law so that that composition would have the effect that the mortgage rights would lapse and the claim would fall within the scope of the debtor's composition. However, it should be noted that a creditor can, on his own volition, waive his mortgage rights and thereby obtain a contractual claim on the debtor, as provided in the second paragraph of Article 28 of Act No. 21/1991.

Even though mortgages and other security rights are protected by the Constitution, this does not mean that composition or other recourses to resolve a debtor's financial problems could not have some effect as regards creditors holding such rights. However, the scope is limited in this regard owing to the need to avoid encroachment on the inviolability of property rights. However, it is worth mentioning that it would hardly encroach on the Constitution if it were permitted by composition with creditors to provide for a reasonable moratorium on secured debts. Another option could be that in the course of composition with creditors the value of a property secured by a mortgage or other security could be assessed in order to ascertain to what extent the asset in fact secures the debt. The part of the claim which is unsecured would then fall within the scope of the composition. Rules of this kind are to some extent paralleled in Act No. 50/2009 on temporary mitigation of residential mortgage payments.

In addition to the outline above there would be reason to specify explicitly in the provisions of Chapter IX of Act No. 21/1991 that a debtor must, when seeking confirmation of a composition agreement, provide a satisfactory account of how he intends to meet secured debts and other debts which are not affected by the composition.

4.

This issue is delimited as follows: *Facilitating new financing during a firm's rehabilitation by clarifying the priority ranking of such financing*.

As recounted earlier, among the highest ranking claims in bankruptcy proceedings are claims pursuant to point 4 of Article 110 of Act No. 21/1991, which are established with the approval of an assistant during a moratorium or a composition agent, provided that such measures were permitted pursuant to Articles 19-21 of the Act. This applies, *inter alia*, to loans to the debtor during a moratorium or composition negotiations.

At a meeting of the Permanent Committee on Procedural Law with legal professionals, which was referred to earlier, the unanimous opinion emerged that there were no grounds for changing these rules so that rights of priority could be extended to loans to a debtor before the time that he has obtained permission for a moratorium or composition. Specific reference was made to the risk of abuse of this permission, e.g. by using new loans to pay of older, unsecured debts. The consequence would be that claim would remain at the first rank of priority, replacing older claims which would have held the rank of general claims. In addition, it is noted that there is a long tradition in practice that financial contributions to companies in financial difficulties have had the form of new share capital, often concurrently with the dilution of existing share capital. For these reasons, the Permanent Committee on Procedural Law does not see reason to amend the above rules.

5.

Here, the issue is the following: *Introducing the subordination of related-party claims in insolvency proceedings, where warranted*.

In bankruptcy proceedings, the general principle applies that non-discrimination should prevail among shareholders. This principle emerges in various places in Act No. 21/1991, and among other things it shows in the fact that all claims rank equally in the class of the so-

called general claims, as provided in Article 113 of the Act. However, there are deviations from this principle in that some claims rank higher than general claims, as provided in Articles 109-113 of the Act, and other claims rank lower, i.e. the so called residual claims pursuant to Article 114 of the Act. In the case of the claims that are further described in these provisions the legislature has deemed it appropriate to deviate from the general principle of non-discrimination among creditors, so that some claims are ranked higher or lower in priority than general claims. In the case law the practice has been that deviations of this sort have been given a strict interpretation and they have not been applied by analogy. Thus, with the exception of these statutory deviations, the general principle of non-discrimination among creditors applies.

Article 3 of Act No. 21/1991 specifies the persons who are deemed to be related to a bankrupt; these include persons owning a significant share in a company undergoing bankruptcy proceedings. They also include persons who are related in a specified manner to a person holding a significant share in a company. The Act does not describe in further detail what constitutes a "significant share" in a company, so that this is subject to case-by-case assessment. In this assessment the most important factor is whether the share confers influence on management and decision-making within the company. If a person is deemed to be closely related to a bankrupt, the legal effect is that there is greater scope to rescind any measures taken by the bankrupt in respect of such person pursuant to Chapter XX of the Act. Finally, persons who are related to a bankrupt do not enjoy priority as regards their wage claims in the course of the bankruptcy proceedings pursuant to the third paragraph of Article 112 of the Act.

Act No. 21/1991 does not provide for the claims of related persons to constitute residual claims, and in the opinion of the Permanent Committee on Procedural Law there are no objective grounds for any general provision on such deviation from the principle of non-discrimination among creditors. Claims of related persons therefore enjoy a normal position in priority as general claims. However, it is safe to say that such claims are normally carefully scrutinised by the trustee of a bankruptcy estate in adopting a position on their recognition in order to prevent pro forma transactions or other misconduct.

After consulting with legal professionals working in this field it is the assessment of the Permanent Committee on Procedural Law that there are no grounds for changing the rules so that claims posted by related persons should, regardless of substance, be counted among residual claims in bankruptcy proceedings. This takes account of the fact that such a change would have the effect that undertakings would have more restricted access to loan capital if such lending by owners could only take the form of subordinated loans.

6.

This issue is described as follows: *Strengthening procedures for the efficient liquidation of non-viable firms*.

Since the entry into force of Act No. 21/1991 on 1 July 1992, there have been no known suggestions to the effect that its provisions on the liquidation process are inadequate. Also, all the evidence points to the process during the time that the current legislation has been in force being generally efficient; this was the unanimous opinion of the legal professionals consulted by the Permanent Committee on Procedural Law. No reason is therefore seen to revise the legislation in this regard.

7.

This issue concerns international relations, as follows: *Adressing coordination between Icelandic and foreign courts on cross-border insolvencies*.

According to the first paragraph of Article 6 of Act No. 21/1991 the Icelandic State is permitted to conclude agreements with other states providing that a licence for financial reorganisation or for composition with creditors granted in one contracting state shall be

automatically valid in another contracting state, with the legal effects applicable in either state. Similarly, the State may conclude agreements with other states providing that a bankruptcy declaration in one contracting state shall have effect with respect to the assets and interests of a bankrupt in another contracting state, and such agreements may provide that bankruptcy proceedings should in part or in whole take place independently in each contracting state in accordance with the law of the respective state or some other specified state. The second paragraph of Article 6 of the Act states that permission for financial reorganisation or for composition with creditors granted in another state, or a bankruptcy declared in another state, shall not have effect in Iceland in the absence of arrangements provided for in an agreement concluded in accordance with the first paragraph of the same Article. There are further provisions relating to branches of foreign companies in Iceland stating that the Act is applicable if the company which is liable for the obligations of the branch has received the same permission, or fully comparable permission, in its home state.

This option in Article 6 of Act No. 21/1991 of entering into international agreements has not been exercised, and Iceland is currently a party to only one such agreement, which was concluded among the Nordic countries long before the entry into force of the Act, as evidenced by Act No. 21/1934.

In order to facilitate foreign legal assistance in this field it is important that it should be possible to respond to requests for such assistance from other states. This would fulfil what is often a condition in international relations, that the assistance should be mutual. The Permanent Committee on Procedural Law therefore believes it is proper to propose that permission should be enacted to respond to requests from other states for legal assistance without the need for such assistance to be provided for in an international agreement. Thus, it could be made permissible to invoke certain provisions of the Act to ensure that bankruptcy proceedings outside Iceland would extend to assets in Iceland. Another possible option is that various other rules of the Act should apply to corresponding legal recourses in other countries, specifically the rules of the Act concerning the legal effect of a moratorium and permission to seek composition with creditors.

In the preparation of this opinion, the Permanent Committee on Procedural Law has looked at responses to Iceland's requests for legal assistance in this field of law in other countries. According to this informal survey, such requests have normally been responded to without problems, both in Europe and North America. No doubt the reason or this is that Icelandic legislation in this field has not been called into question, as in fact it is similar to rules on the same matter in the countries with which Iceland has its principal relations. Bearing this in mind, it has been regarded as important when legislating in the field of insolvency law to take into account the trends in legislation in the other Nordic countries. It is safe to assert that such harmonisation has the effect of facilitating relations with the countries which are most important to Iceland. For this reason the Committee is of the opinion that legislation in Iceland should not be modelled on legislation in other more distant countries where legal tradition is different from that of the Nordic tradition, of which Iceland is a part.

III

Natural persons

As regards natural persons, the Ministry of Justice has under consideration whether rules on counselling for those who are unable to pay their debts should be enacted. The recently passed Act No. 23/2009 amended Act No. 21/1991 on bankruptcy etc. with the effect that at the first hearing of a petition for a debtor's estate to be subjected to bankruptcy proceedings the judge is required to advise the debtor on the recourses available under Part III of the Act. This applies both to temporary mitigation and composition pursuant to general rules. In the opinion of the Permanent Committee on Procedural Law, there is no need to provide for counselling for natural persons in insolvency legislation. It is also worth noting

that the Ministry of Social Affairs set up a Domestic Debt Advisory Service (www.rad.is) in 1996 in co-operation with various entities, and its services have been widely advertised in the media.

Finally, it is revealed in the letter from the Ministry that the Ministry has under consideration whether claims secured by a debtor's property should fall within the scope of temporary mitigation. As recounted earlier, legislation has already been enacted on temporary mitigation with regard to claims which are secured by a mortgage on a debtor's residential property– see Act No. 50/2009 – and this legislation has in all likelihood covered the most important aspects. This legislation, which was enacted for the purpose of responding to a serious social problem, has not been tested to any extent as yet, but there is no evidence that it is in any way defective. It is admittedly common for natural persons to grant rights of security in property other than residential property, e.g. by posting a vehicle as security for a part of the purchasing price. When it is borne in mind that the constitutional protection of property rights significantly restricts the scope available to disrupt by law the rights of security of creditors it is the assessment of the Permanent Committee on Procedural Law that it would be imprudent to go to further lengths in this regard than already has been done.

IV.

Summary of proposals

Based on its examination of various aspects of insolvency law described above, the Permanent Committee on Procedural Law recommends the following amendments to the legislation.

1. In order to prevent debtors from being able to delay bankruptcy proceedings simply by refraining from taking any action, it is proposed that creditors should be enabled to petition for bankruptcy proceedings on the grounds that a debtor has not responded to a formal request for written confirmation of his solvency. Concurrently, it is proposed that appropriate amendments should be made to Act No. 90/1989 on enforcement procedure to facilitate the completion of unsuccessful attachment measures even when the respondent is not present at the time that the action is taken, and to provide that such unsuccessful attachment can constitute grounds for subjecting the debtor's estate to bankruptcy.
2. In order to make it easier for a debtor to petition for permission to seek composition with creditors it is proposed that the condition that a debtor needs to obtain declarations of consent from a quarter of the number of voting creditors should be removed. Removing the condition that a debtor needs to obtain the consent of a quarter of the voting creditors calculated from the aggregate amount of claims is also an option.
3. For the purpose of simplification, it is proposed that a creditor should be able to submit in the declaration of claims itself a vote on the composition proposal of the debtor as presented.
4. It is proposed that a debtor should not be required to obtain the support of creditors to be permitted to make alterations to a composition proposal which are unfavourable for the creditors.
5. In order to make it easier for a debtor to have a composition proposal approved, it is proposed that it should be sufficient for 60% of the creditors, by head count, to vote in favour of a debtor's proposal, instead of the number being calculated on the basis of concessions under the proposal.
6. The proposal is submitted that it should be considered whether it would be feasible to make a change in the rules on composition so that it would be possible in such agreements to provide for a reasonable moratorium on secured debts. At the same time, it should be considered whether it might be permitted to assess the value of a

property secured by a mortgage or other security in the course of composition negotiations so that the unsecured part of the mortgage claim could fall within the scope of the composition.

7. It is proposed that a rule should be enacted in Chapter IX of Act No. 21/1991 to the effect that a debtor should be required to provide a satisfactory account of how he intends to meet his secured debts, in seeking confirmation of a composition agreement, in addition to other debts not affected by the composition.
8. In order to facilitate foreign legal assistance for action taken in Iceland in the field of insolvency law it is proposed that a general authorisation should be legislated for the Icelandic courts of law to respond to requests from other states for such assistance, even in the absence of an international agreement to such effect.

In accordance with the letter from the Ministry dated 20 July 2009, the Permanent Committee on Procedural Law is prepared to draft a legislative bill to bring about the reforms referred to above.

Respectfully,
on behalf of the Permanent Committee on Procedural Law

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Markús Sigurbjörnsson