LEGAL OPINION

on the draft agreements on the so-called Icesave accounts in the branches of Landsbanki Íslands hf. in the UK and the Netherlands.

Requested by the Budget Committee of Althingi on 22 December 2010.
Legal opinion by Stefán Már Stefánsson, professor, Benedikt Bogason, district court judge and associate professor, Dóra Guðmundsdóttir, adjunct, and Stefán Geir Þórisson, Supreme Court attorney.

Legal opinion - 7 January 2011.
INTRODUCTION

The Budget Committee of Althingi entrusted the undersigned in an e-mail dated 22 December 2010 with submitting a legal opinion on the draft agreements on the so-called Icesave accounts in the branches of Landsbanki Ísland hf. in the UK and the Netherlands. The Budget Committee is currently working on a bill that grants authorisation to the Minister of Finance to confirm agreements on the guarantee of reimbursement to the United Kingdom and the Netherlands arising from the Icesave accounts (parliamentary document no. 546 - parliamentary item no. 388).

The background and substance of the draft agreements addressed here is covered in detail in the abovementioned bill and in the accompanying annex III to the bill, which is entitled "Explanatory notes to the agreements between the Depositors' and Investors' Guarantee Fund and the Icelandic State on the one hand and the UK and the Netherlands on the other". The Budget Committee requested that we address certain issues which are set out in Points A-H. Our discussion of these issues follows.

A. What happens if the Icesave agreements are not confirmed?

If the dispute arising from the Icesave accounts in the branches of Landsbanki Íslands hf. is not concluded with an agreement the following reactions are foreseeable:

1. The UK and the Netherlands may initiate legal proceedings and maintain *inter alia* that the government or ministers made binding statements regarding the payment of amounts that were reimbursed. This litigation would most likely also be based on the assumption that the Icelandic State is liable because of statements made by ministers and because the Icelandic authorities did not fulfil their obligations with regard to directive 94/19/EC on deposit-guarantee schemes and discriminated against depositors of Landsbanki Íslands in the UK and the Netherlands. This case would presumably be filed in Iceland but it cannot be ruled out that it would be filed in a foreign court. A case of this kind might test EEA rules and therefore it is possible that the court in question would request an advisory opinion from the EFTA Court (or, as the case may be, a preliminary ruling from the Court of Justice of the European Union). The UK and the Netherlands would most likely base their demands on the entire amounts reimbursed and not just the approximately EUR 20,000 paid to each depositor.
2. ESA will most likely proceed with its infringement proceedings against Iceland as a result of the Icesave dispute. The Authority has already expressed its opinion in a letter of formal notice dated 26 May 2010 and is likely to submit a reasoned opinion shortly. If Iceland does not respond to that opinion, it can be assumed that ESA will refer the infringement case to the EFTA Court. However, it is possible that ESA will will stay its proceedings if the UK and/or the Netherlands bring civil proceedings against Iceland for the same reasons before ESA has referred the case to court.

3. The UK and the Netherlands (and conceivably other nations) will presumably, at least to a similar extent as before, act in opposition to Iceland and Icelandic interests if an agreement is not confirmed. This has been demonstrated by their opposition to granting loans and other facilities, e.g. within the IMF, the European Investment Bank and other institutions. It is unclear how extensive such actions could become and how long they could last. This could prove damaging to Iceland, but an estimate of the nature or scope of such damages will not be attempted here.

Although it does not constitute an answer to the question posed above, it merits mention that there are currently cases before the Icelandic courts that relate to the constitutional validity of Act no. 125/2008, the Emergency Act, which will in addition test its compatibility with the EEA Agreement. These cases will proceed regardless of whether the current draft agreements will conclude the Icesave dispute. Where applicable, an advisory opinion from the EFTA Court will be called for during these proceedings. It cannot be ruled out that the creditors of the fallen banks will attempt to establish jurisdiction abroad, e.g. through freezing orders, or that the Emergency Act will be tested in foreign courts though other means, e.g. in a case involving the set off of claims pursuant to an agreement that stipulates the jurisdiction of a particular state. With regard to the provisions of Act no. 161/2002 on financial undertakings, with subsequent amendments (in particular amendments by Act no. 130/2010 and Act no. 132/2010 which entered into force on 16 November 2010), we are of the opinion that there is little chance of such attempts succeeding. Chapter XII of Act no. 161/2002 *inter alia* provides for the winding up of financial institutions and implements directive 2001/24/EC on the reorganisation and winding up of credit institutions, which stipulates that home states have jurisdiction and that the winding up of credit institutions is primarily carried out in accordance with the laws of the home state, cf. in particular Articles 9 and 10 of the directive. Although Articles 20-27 of the directive provide for exceptions from the principle that the laws of the home state shall apply, cf. the comparable provisions in Article 99 of Act no. 161/2002, we are of the opinion that the laws and jurisdiction of another state primarily apply to the settling of judicial disputes on the substance of the rights in questions (e.g. regarding certain ownership rights) but that disputes on distributions from the estate of a financial institution are still subject to Icelandic jurisdiction. We also find it unlikely that the Emergency Act will be repealed, cf. further discussion under Point E. This opinion is *inter alia* based on the conclusions of the Law Institute of the University of Iceland from 14 November 2008, and takes into account the identical conclusion reached by ESA on 15 December 2010 with regard to changes in the priority of claims so that deposits are treated as priority claims according to bankruptcy law in the winding up of financial institutions.[1] It must be noted however that ESA did not believe it possessed sufficient information to make a decision regarding every aspect of the complaints it received following the collapse of the banks and the adoption of the Emergency Act. The issue of whether the Icelandic authorities fulfilled their obligations pursuant to the abovementioned directive on the winding up of credit institutions as regards the failed banks is thus the subject of a decision by ESA in a separate case. In our opinion, this point does not carry significant influence here.

[1] Cf. points 11 and 12 in the 15 December 2010 decision by ESA.

In its decision of 15 December 2010, ESA found that depositors on the one hand, and general unsecured creditors on the other, are not in an equivalent position and therefore the measures taken by the Icelandic authorities, *inter alia* guaranteeing priority ranking of deposits in the winding up of credit institutions over general claims, did not constitute a discriminatory restriction of Article 40 of the EEA Agreement (free movement of capital) or Article 16 of directive 2001/24/EC on the reorganisation and winding up of credit institutions.[2] ESA did not express any view on whether discrimination took place between domestic and foreign depositors, but in its conclusion of 26 May 2010, ESA found that the Icelandic authorities were in breach of their obligations pursuant to directive 94/19/EC on deposit-guarantee schemes, in particular Articles 3, 4, 7 and 10 and/or Article 4 of the EEA Agreement (principle of non-discrimination) as regards the minimum deposit guarantee of approximately EUR 20,000.

B. What are the advantages and disadvantages of taking the matter to court?

This answer is based on the assumption that the question refers to the advantages and disadvantages of foregoing an agreement with the UK and the Netherlands and relying instead on Iceland not being held liable based on the appropriate laws and that a court of law will confirm this.

Taking the matter to court ensures a legally correct outcome. It should not be of importance in this regard whether the court in question in Icelandic or foreign (e.g. the EFTA Court). It must be assumed that Iceland could lose cases such as those described in Point A. The undersigned are not unanimous in their view of what a likely outcome of taking the matter to court would be. In comparison to the current draft agreements the following scenarios can be envisioned:

All claims by the UK and the Netherlands are fully accepted. If the claims by the UK and the Netherlands for reimbursement of all claims by depositors are accepted along with accrued interest and interest on reimbursement claims (from October 2008) up to the payment date, then the draft agreements are much more favourable to Iceland, since they are based on the payment of approximately EUR 20,000 to each depositor with interest until 22 April 2009, instead of the total deposits of each depositor. In addition, interest is added to the reimbursement amount pursuant to the draft agreements. It must be considered unlikely that a court decision obliging Iceland to guarantee the deposits of foreign depositors in full will be obtained, despite arguments of some weight in support of the view that declaring full guarantee of deposits of domestic depositors constitutes discrimination on grounds of nationality.

1. It must be assumed based on the available sources, in particular ESA's letter of formal notice from 26 May 2010, and the sources of European law referred to there, that the legal definition of the issue is based first and foremost on the obligations

[2] Cf. points 65, 69 and 108 in the 15 December 2010 decision by ESA.

which can be derived from directive 94/19/EC on deposit-guarantee schemes, i.e. the payment of approximately EUR 20,000. It must be considered a difficult task to achieve a judgement on Iceland's liability for deposits beyond that amount as regards foreign depositors on the basis of the general provision of Article 4 of the EEA Agreement which prohibits discrimination. On the other hand, it must be noted that ESA has not ruled on the issue, neither in the letter of formal notice nor in the decision of 15 December 2010 (see above).We are of the opinion, however, that a judgement awarding full reimbursement to the UK and the Netherlands cannot be completely ruled out.

2. *The claims by the UK and the Netherlands are accepted as regards the minimum deposit guarantee for each depositor*, approximately EUR 20,000 plus interest. This outcome is similar to the premises of the draft agreements. The arguments that support this outcome are those that ESA has based its letter of formal notice to the Icelandic authorities on, and the European Commission has seconded.[3] This outcome is possible. When directive 94/19/EC was amended by directive 2009/14/EC, rules on deposit guarantees were tightened, time limits curtailed, wording on Member State liability made more explicit, and the minimum deposit guarantee raised to EUR 50,000 as of 30 June 2009. Further amendments recently proposed provide for further raising the minimum guarantee to EUR 100,000. These amendments, and the deliberations on the matter, suggest that the Member States are in agreement on the necessity of the minimum deposit guarantee. It is likely that the governments of the EU Member States would support ESA and the European Commission's case before the EFTA Court.
3. *All claims by the UK and the Netherlands are rejected.* Such an outcome would be based on the argument that directive 94/19/EC does not obligate states to assume liability for minimum deposit guarantees and that Iceland thus has no liability in the matter. No court ruling has been issued on this aspect by domestic courts, the EFTA Court or the European Court of Justice. This outcome is also deemed possible.

Potential action for breach of EEA law against Iceland is discussed in Point C.

It follows from the abovementioned that the advantages of pursuing the court option are primarily that it ends with a legal outcome which potentially absolves Iceland from payment. The disadvantages are, however, that the case may be lost which would most likely put Iceland in a worse negotiating position than it holds at present and could lead to a less favourable outcome. It must also be kept in mind that legal proceedings can be lengthy which can lead to uncertainty and loss for every party involved. They can furthermore impact friendly relations with the nations involved.

[3] Cf. *inter alia* the letter from Michel Barnier, member of the European Commission, to the Minister of Finance on 17 August 2010.

C. If an agreement is not reached, and assuming that ESA will pursue an infringement case and refer it to the EFTA Court, what would the likely conclusion of the EFTA Court be? Assuming a judgement goes against Iceland, what would the likely legal and political effects be?

ESA reached the preliminary conclusion in the abovementioned letter of formal notice from 26 May 2010 that Iceland is obligated to pay approximately EUR 20,000 to each depositor. This seems to originate in both the wording of directive 94/19/EC on deposit-guarantee schemes and the assumption that Iceland unlawfully discriminated against the depositors in foreign and domestic branches as regards this amount when the banks were taken over upon the adoption of the Emergency Act. The Icelandic authorities have yet to respond to ESA's preliminiary conclusion, but this will most likely happen if the matter in dispute is not concluded with an agreement. It should be noted that the Icelandic authorities have advanced the arguments mentioned in Point B 3 and ESA has adopted a negative opinion with regard to those arguments.

We have reviewed the documentation in the matter in so far as it is available, but we differ in our view of what the likely court judgement would be in such a case. Some of us believe that there is considerable chance of winning such a case, but others are of the opinion that the chances are correspondently bad. However, we all believe that the possibility cannot be ruled out that Iceland would lose such a case.

A negative outcome of such a case involves a recognition of Iceland having infringed on its obligations pursuant to the EEA Agreement. Such a judgement cannot be appealed and is binding for Iceland in accordance with international law. On the other hand, such a judgement is not enforceable, neither in substance nor in accordance with international law. Everything indicates that such a judgement, in so far as it is binding, will form the basis of other cases which might be tried in Iceland, as further discussed in Point D.

We believe that the political effects of such a negative outcome could be unfavourable to Iceland. This assumption is based on previous experience of attempts to pressure Iceland into paying the Icesave claims. However, we do not feel that we can confidently predict what form these effects could take in detail or how long they might last, e.g. as regards access to markets or the reactions of the political institutions of the European Economic Area.

D. EFTA Court decisions are not enforceable. If the government does not react to the court's decisions it must be assumed that the UK and the Netherlands may submit their claims in Icelandic courts. How would the UK and the Netherlands take court action in Iceland and what would be considered a likely outcome of such a case? What is the probable legal and political impact of a negative judgment in such a case?

If the EFTA Court finds against Iceland in an infringement case, the court will probably recognise that Iceland was in breach of its obligations by failing to guarantee compensation of

the minimum guarantee of approximately 20,000 EUR to each depositor, and for failing to effectively implement the aforementioned deposit-guarantee scheme. It must be considered unlikely that the court will lay down measures that Iceland should take in order to meet its obligations, but that may depend on claims made by the claimant. As stated before an enforceable decision will not be delivered as there is no authorization for that. According to Article 33 of the ESA/Court Agreement the EFTA States shall make the necessary arrangements to enforce the decisions of the Court. There is, on the other hand, no judicial remedy under national law to enforce that obligation and the EFTA Court does not have the power to impose fines for breach of the EEA Agreement.

According to this, following a negative judgement for breach of the Agreement, Iceland would have to define its own obligations, which are not obvious in all respects, such as regarding interest rates, costs and other terms of payment. It is however evident that the main obligation would be the payment of approximately 20,000 EUR to each depositor, either immediately or within a short period of time. In this case, it would be necessary to re-initiate settlement negotiations with the British and the Dutch. Should an agreement not be reached, these States would have to bring their claims to an Icelandic court, in order to define the duties once and for all, and provide an enforceable court order against the Icelandic State. In such a case, the Icelandic courts would probably use the decision of the EFTA Court in the matter of the breach of agreement, as far as that is relevant. Otherwise, the courts of this country would have to reach a final decision, including the sum to be repaid and the terms of such a restitution. The courts might seek the advisory opinion of the EFTA Court regarding issues related to EEA-law that could arise in the course of such proceedings.

The conclusion of such proceedings, should they be initiated, is impossible to predict. As always, the results would chiefly depend on the procedures conducted by each of the parties. As said before, the Icelandic courts would in such a case probably use the decision of the EFTA Court in the matter of breach of agreement, as far as that is relevant.

The plausible impact of such an unfavourable judgement to Iceland would be that it would be binding for the parties and enforceable by law. The judgement might be subject to an appeal, in accordance with applicable law. In our opinion, we are unable to predict the political effect of a judgement not in favour of Iceland in such a case, as the effect may depend on the claim and the outcome of the case in respect of the claim. In addition, a long time will pass until a final judgement in a case of this kind will be passed; therefore there is uncertainty about the future political situation.

It is not possible to rule out the possibility that the states in question choose to apply other measures towards Iceland than start legal proceedings in Iceland or in another state based on their claims. It is to be expected that other states would be ready to support the states in question, at least to some extent. It is also conceivable that divergence as to the enforcement on behalf of Iceland should Iceland be found in breach of agreement could lead to the termination of the EEA agreement or some part of it towards Iceland. Another possible

scenario is that these measures would be applied to all the EFTA states in order to create even more pressure.

E. Risk associated with the emergency legislation and the significance of the recent ESA decision regarding those measures

It is a fundamental point of the Icesave agreement that the provisions of the emergency legislation comply with all legal obligations, including the priority given to depositors over other unsecured creditors as set out in the emergency measures. The EFTA Surveillance Authority (ESA) has reached the conclusion that the measures taken by the Icelandic authorities comply with the EEA Agreement. As said before, it is unlikely in our opinion that the emergency legislation will be overruled, in this respect. The opinion is, as said earlier, based on the conclusion reached by the Law Institute of the University of Iceland on 18 November 2008, also taking into account a similar finding by ESA on December 15 2010. See point A for further information.

Norway and Liechtenstein are competent to initiate proceedings against this decision, but it must be considered highly unlikely. Other parties to the EEA Agreement, for example the UK or the Netherlands cannot take proceedings of this kind. In our opinion, it is more likely than not that proceedings for breach of the Agreement will not be initiated on the basis of the foregoing.

The ESA decision is not binding, however, for natural persons or business enterprises which may be affected by the provisions of the emergency legislation. As known, numerous proceedings have already been initiated in Iceland seeking a ruling on whether the aforementioned provision of the emergency legislation regarding priority given to depositors over other unsecured creditors is constitutional and whether it complies with the EEA Agreement. This issue of contention will therefore be evaluated and ruled on by Icelandic courts. Icelandic courts may, as the case may be, seek an advisory opinion from the EFTA Court on whether the provisions of the law are in this respect pursuant to the EEA Agreement. According to information obtained from the winding-up boards of Kaupthing, Landsbanki and Glitnir, no party has requested that an advisory opinion be sought from the EFTA Court regarding ongoing court proceedings against the winding-up boards in Icelandic courts. Irrespective of whether such an opinion will be sought a reasoned opinion by ESA will no doubt be submitted before the court in question, as well as other observations and documents of importance. No conclusion can be drawn, however, as to whether the ESA ruling will be of particular importance. That will depend on the legal arguments presented and built on during the proceedings. As previously mentioned, the Law Institute of the University of Iceland has reviewed this issue and reached the conclusion that the aforementioned provision of the emergency legislation is constitutional.

It is also possible that a case of this kind will not be referred to the EFTA Court in order to obtain an advisory opinion. Whether such an opinion is sought is within the discretion of the Icelandic courts and depends on their evaluation of the necessity of such an opinion.

Having studied the opinions in question and the legal arguments presented therein it is our opinion that the risk of the emergency legislation being overruled is not very high, but present nonetheless. Such a risk can thus not be ruled out or disregarded.

F. Article 40 of the Constitution and the scope of competence to negotiate the current agreement.

H. State guarantee and payment obligation. Taking into account the report by the Special Investigation Commission a review is requested of the legal powers of parliament Althingi according to Article 40 of the constitution to grant state guarantee on obligations and payments set forth in the draft agreement.

The following is a compilation of questions raised in points f. and h. The questions seek an answer to whether it is constitutional to commit the State Treasury in the way provided in the draft agreement with the UK and the Netherlands.

Article 40 of the Constitution provides i.a. that the authority to commit the State can only be granted by *statutory provisions*. There is no doubt that this provision extends to the state guarantee intended here. The intent is to guarantee Althingi's authority, and thus the nation's authority by implication, over obligations the Icelandic state is allowed to accept.

What then is the meaning of statutory provisions in this context? There seems to be consensus on one of the main requirements for a rule to qualify as a legal provision, which is that it must be clear and decisive enough to cover the aim to pursue it. Often there may be doubt as to whether such a requirement is met. That should, however, be the legislator's aim, superseded by the courts if a legal provision does not extend to an issue in this way. If liabilities are unclear and contingent, i.a. on account of various future events which are in no way remote possibilities and may result in obligations that are much heavier than expected or even entirely unsurmountable, it may rightly be argued that this issue might be put to the test. The same applies to the budgetary authority. According to Article 41 of the constitution no disbursement may be made without authorisation by the budget or the supplementary budget.

We have looked into the main risks to the State Treasury inherent in the new draft agreement and they are:

- Whether the emergency legislation will be overruled.
- Exchange rates development.
- The asset recovery rate for the Landsbanki estate.

As said earlier, it is a fundamental precondition of an Icesave agreement that the provisions of the emergency legislation will prevail, including the priority given to depositors over other creditors. The consequences of the emergency legislation being overruled in this respect would be very serious, as the assets of old Landsbanki would be disbursed to pay all creditor claims against the bank.

As argued in point E, we believe that in the light of recent developments it is rather unlikely that the emergency legislation will be repealed by a court ruling, although it is not impossible. This applies both to national and foreign courts. While assessing the constitutional significance of the act in question, we also believe that the inefficiency and damage which may arise should no agreement be reached should be taken into account, as well as the risk involved if Iceland were to lose an infringement case involving Icesave. Last, we believe that the legislator has scope to assess how guarantee obligations should be assumed in detail, with regard to the significance of the issue at hand.

The same applies with reference to foreign-exchange risk. The bill is based on certain assumptions considered likely regarding exhange rates development. The consequences of possible variations are generally speaking not as grave as would be the case if the emergency legislation were overruled, in addition measures can be taken to reduce that risk.

While assessing the draft agreement on Icesave it is also noted that it is assumed that a ruling will be sought on the priority of TIF claims against the Landsbanki estate over claims by the British and the Dutch State originating from compensation disbursed to Icesave-depositors in excess of the minimum guarantee of approximately 20,000 EUR which they have redeemed. This dispute will presumably be settled by Icelandic courts subject to the advisory opinion of the EFTA Court. Moreover, without going into detailed elaboration, the majority of the undersigned believes that there is considerable likelyhood that TIF claims arising from the minimum guarantee of approximately 20.000 EUR will have priority over other claims when disbursement is made to creditors from Landsbanki's estate, which means that claims against TIF have priority over claims by the British and the Dutch. In this case the bank's assets would be sufficient to cover the outstanding principal in full in a shorter time, which would lower interest payments accordingly. If this would be the case, the foreign-exchange risk would be negligible.

Assets in the old Landsbanki estate may also be of less value and thus present a risk. Similarly priority claims to the Landsbanki estate may prove to be somewhat higher than expected. Both these instances can result in less available funds being available than presently estimated from the Landsbanki estate for repayment due to the Icesave accounts

When assessing the aforementioned risk factors one should bear in mind the economic reservations provided by the draft agreement in case of the worst possible development. These reservations on the one hand stipulate 5% of state total revenue and on the other hand 1,3% of gross national product, of which the higher amount prevails. The maximum repayment period is 30 years from 2016 onwards. These reservations are useful to gain a better understanding of the commitments planned for Iceland. The same applies to the revised default measures from the previous agreements, which are covered in section G. There is, however, not much legal hold in the revision provisions of the draft agreement.

After our risk evaluation of the agreement we concluded that it is unlikely that Icelandic state assets will be foreclosed upon for satisfaction of payments according to the agreement, in

concurrence with issues which fall under Article 40 of the constitution. One must also look to the fact that the Icelandic position that certain property and control of natural resources can never be foreclosed upon has been agreed to in the draft agreement.

We have assessed all these issues and come to the conclusion that the current agreement is not in breach with Article 40 of the Constitution, nor with other provisions therein, in case the bill is enacted into law. However, the aforementioned constitutional rule provides for passing a law on the proposed state guarantee as planned.

G. Non-compliance and default measures in the Icesave agreement draft

We have compared provisions for non-compliance in the draft agreement on Icesave with comparable provisions in previous agreements on the same issue. The provisions in the previous agreements contained clear indications of being drafted unilaterally in favour of British and Dutch interests. These provisions were very onerous with regard to Icelandic interests. For instance a negligible delay of payment could result in severe financial obligations being defaulted on Iceland. Provisions in the current draft are by far more reasonable and proper and take better note of the interests of both parties. This is covered in depth in the memorandum accompanying the bill and is referred to without being described in detail here.

We have no reservations to these provisions in the draft agreement.

CONCLUSION

It is our opinion that the advantages and disadvantages of entering into an agreement on the basis of the aforementioned draft agreement have to be evaluated on the one hand in light of the provisions and the risk exposure therein, and on the other hand with regard to the risk exposure and disadvantages which would be the result of not entering into an agreement.

The current draft agreement contains a considerable improvement from previous draft agreements with regard both to the financial data which fall due as well as to various other terms. There is no reason to elaborate further on these issues in this document. The aforementioned risk exposure and disadvantages of, on the one hand pursuing court options, and on the other hand of entering into an agreement have been defined above as well as possible. Regard to fairness and moral obligations in the interaction between civilised countries may also play a role with regard to the final stance taken on the current draft agreement. As previously mentioned we are of the opinion that the provisions of the Constitution do not pose an obstacle to entering into an agreement on the basis of the draft agreement. It should be noted that the worst possible outcome of the agreement is that it could lead to severe financial obligations for Iceland for many years to come. It has previously been mentioned that this outcome is unlikely. The best possible outcome is that Iceland would only be obliged to pay negligible amounts or nothing at all.

Reykjavík, 7 January 2011

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