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16 December 2009

The Budget Committee
Althingi
150 Reykjavik
Iceland

Dear Sirs

Re: Icesave Loan Agreements – Confidential and Legally Privileged

1. **Introduction**: The purpose of this letter is to provide our opinion in relation to the questions identified in your letter of 11 December 2009. These questions relate to:

   (a) a £2,350,000,000 (maximum) loan agreement between (1) the Depositors' and Investors' Guarantee Fund of Iceland ("**TIF**"), (2) Iceland and (3) the Commissioners of Her Majesty's Treasury of the United Kingdom originally dated 5 June 2009 as amended by an acceptance and amendment agreement ("**AAA**") dated 19 October 2009;

   (b) a €1,329,242,850 loan agreement between (1) TIF, (2) Iceland and (3) the State of The Netherlands also originally dated 5 June 2009 and as amended by an acceptance and amendment agreement dated 19 October 2009 (together with the UK loan agreement the "**Icesave Loan Agreements**"); and

   (c) certain supplemental agreements entered into in connection with those loan agreements.

   We were not involved in the negotiation of the loan agreements as executed on 5 June 2009. However, we provided Althingi with a report dated 25 June 2009 on certain aspects of the original loan agreements. We subsequently assisted in the negotiation of the amendments to those loan agreements implemented by the AAAs from mid-September 2009 through to their signature on 19 October 2009.

2. **Question 1**: *An opinion on the wording and substance of the Icesave Loan Agreements, in particular in light of the interests of the various parties involved. In particular such opinion should extend to the content and terms of the Icesave Loan Agreements, whether they are considered customary in light of the terms of comparable agreements and whether the agreements reflect that the parties were on equal footing during the course of negotiation.*

   We have updated our June report on the Icesave Loan Agreements to reflect the modifications made by the AAAs. Our updated report (which summarises the essential terms of the modified loan agreements) is enclosed with this letter.

Notwithstanding the circumstances in which the Icesave Loans arose,[1] the main operative terms and structure of the Icesave Loan Agreements are customary and comparable to other international loan agreements. The requirements for conditions precedent, the interest and repayment provisions, the terms of the guarantee, the termination events and the "boilerplate" provisions dealing with payments, set-off, cross-indemnities, representations, notices, governing law and submission to jurisdiction are all consistent with what we would expect to see in an international loan agreement. The features which in our experience are not customary are those which are specific to the Icesave situation namely:

- the fact that Iceland's guarantee does not come into effect until 5 June 2016;
- in the UK loan, the right for FSCS to make drawdowns on behalf of TIF;[2]
- the cap on payments in each calendar year of 2% (Netherlands) and 4% (UK) of the cumulative growth in Icelandic GDP since 2008 (but with interest always being payable in full);
- the extension options whereby the repayment date for the loans may extend beyond 2024;
- the arrangements regarding the sharing of Landsbanki recoveries (either on a pari passu basis or, in certain circumstances, on a preferential basis);
- Iceland agreeing not to take any action which results in creditors of Landsbanki being treated in a manner contrary to generally accepted international or European principles of treatment of creditors in an international winding up;
- the obligation on the UK and Netherlands to meet with Iceland (on request) to consider how the Icesave Loan Agreements should be amended to reflect a change in circumstances if the IMF concludes there has been a significant deterioration in the sustainability of Iceland's debt relative to its assessment as at 19 November 2008.

Whilst these provisions are "non-customary" they reflect the agreements reached between Iceland, TIF, the UK and The Netherlands in relation to matters specific to the Icesave situation and are favourable to TIF and Iceland. We comment further on these aspects in our main paper.

Another "non-customary" provision appears at clause 2.1.3(b) of the Netherlands Icesave Loan Agreement. TIF and Iceland agree that they will not make any claim against the Netherlands or the Dutch Central Bank (DNB) in relation to DNB having paid compensation to an Amsterdam branch depositor or as a result of DNB refusing a claim of an Amsterdam branch depositor. The corresponding provision in the UK Icesave Loan Agreement records that neither the UK nor the FSCS will be responsible for any cost or liability suffered by TIF or Iceland in connection with the Icesave Loan Agreements "or otherwise in connection with the Landsbanki prior to the date of the [Icesave Loan Agreement]" . As a result TIF and Iceland both acknowledge that they may not bring claims against the UK, the Netherlands, FSCS or DNB as a result of actions taken in respect of the failure Landsbanki and the compensating of the London branch and Amsterdam branch depositors.

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1 As a result of the Financial Services Compensation Scheme in the UK and the Dutch Central Bank in The Netherlands making compensation payments to London and Amsterdam branch depositors when TIF was unable to do so following the collapse of Landsbanki.

2 Reflecting the fact that FSCS will handle the logistics of any further compensation payments to London branch depositors with Landsbanki.

We are asked to comment on whether the Icesave Loan Agreements "*reflect that the parties were on equal footing during the course of the negotiation*." All the contracting parties found themselves in unusual positions. The UK and The Netherlands were in an unusual position having already disbursed significant monies in compensating London and Amsterdam branch depositors on a "voluntary" basis on behalf of TIF. TIF and Iceland were in the unusual position of negotiating loans arising from such "voluntary" disbursement in order to fulfil their respective responsibilities in respect of directive 94/19/EC on deposit-guarantee schemes.[3] Given (i) that the monies had already been disbursed, (ii) the agreed Brussels guidelines announced on 17 November 2008[4] and (iii) the requirement for Iceland to conclude the Icesave Loan Agreements as a condition to the availability of loans and support from the IMF and others – it is difficult to say that the parties "*were on equal footing during the course of the negotiations*." Having said that, both the UK and Netherlands governments had a significant incentive to conclude the Icesave Loan Agreements to regularise the basis upon which they will be compensated for making the disbursements to London and Amsterdam branch depositors. Moreover, the willingness of The Netherlands and the UK to accommodate the main requirements stipulated in the Althingi Authorising Act of August 2009 is evidence that Iceland had sufficient bargaining power to modify the loan terms in its favour in the further round of negotiations in September and October leading to signature of the AAAs.

3. **Question 2**: *An opinion on the impact on the interests of the Icelandic State or Icelandic parties as a result of the position that any potential litigation in the future in the United Kingdom regarding a dispute under the Icesave Agreement is subject to English law and jurisdiction as opposed to Icelandic law and jurisdiction. In particular, such opinion should address whether contractual provisions, based on such grounds, would result in the legal position of the Icelandic State or Icelandic parties, such as Landsbanki Islands hf. and its subsidiaries, being weakened and whether the legal position of the British & Dutch State, or British & Dutch parties being strengthened.*

Both the UK Loan Agreement and The Netherlands Loan Agreement are governed by English law and the parties submit to the jurisdiction of the English courts.[5] As is well known, English law is one of the primary choices of law to govern international loan agreements. The English courts have a pre-eminent reputation for the quality of the judiciary and the pool of legal advisers available to parties when litigating international disputes. The choice of English law (and of the English courts to hear disputes) in relation to the Icesave Loan Agreements is therefore in no way unusual in our view. Moreover, it is common practice for the lender of money to be the party which stipulates the choice of law (and courts to adjudicate on disputes) which will govern the loan agreement recording the terms of the loan.

It is fair to say that English law is regarded as a creditor-friendly legal system. However, this is primarily due to English law principles relating to English law security interests and the insolvency laws affecting the winding up of entities in the UK. Neither of these features is likely to be relevant in relation to the Icesave Loan Agreements as they do not involve the creation of security and the Icelandic parties (TIF and Iceland itself) are unlikely to be subject to any insolvency proceedings in the UK. Choosing English law as the governing law will therefore likely impact upon determination of any dispute as to such matters as (i) whether a termination event occurs and monies therefore become immediately due under the relevant Icesave Loan Agreement or (ii) the interpretation of other provisions of the Loan Agreements (for example whether UK and/or Netherlands has

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3 Implemented in Iceland pursuant to the requirements of the EEA Agreement in the form of Icelandic Act No. 98/1999 on deposit guarantees and investor compensation scheme.

4 "*According to the agreed guidelines, the government of Iceland will cover deposits of insured depositors in the Icesave accounts in accordance with EEA law....All parties concluded that the Deposit Guarantee Directive has been incorporated in the EEA legislation in accordance with the EEA Agreement and is therefore applicable in Iceland in the same way as it is applicable in the EU Member States.*"

5 However, both the UK and The Netherlands are entitled to take proceedings in relation to a dispute in the courts of any other jurisdiction if they so wish.

discharged its obligation to meet and discuss how the Loan Agreements should be amended if there is a change in circumstances triggered by an IMF review).[6]

One of the key features of the modified Loan Agreements is the potential for TIF to receive priority recoveries out of the Landsbanki estate (which it can apply in paying down the Icesave loans without first sharing the recoveries on a pari passu basis with The Netherlands and the UK). Even though the Icesave Loan Agreements are governed by English law the trigger for the entitlement to achieve such preferential treatment is either a determination of an Icelandic court (not in conflict with an advisory opinion obtained from the EFTA court) or a determination of the Landsbanki winding up board in Iceland (which is not challenged in an Icelandic court).[7] So, even though English law governs the terms of the loan and its repayment etc, the key elements of this important provision are driven by determinations made in Iceland.

The question whether the Icelandic parties are in a worse position as a result of the choice of English law (as opposed to Icelandic law) is difficult to answer. The Icelandic parties should only be in a weaker position if Icelandic law confers a defence in a legal dispute (relating to the Icesave Loan Agreements) which English law does not. To answer this question would require a comparative study of English law and Icelandic law (which we have not undertaken).[8] However, we would be surprised if Icelandic law would reach a materially different conclusion to English law in relation to the essential terms of a loan agreement (and an interpretation of those essential terms).[9]

It must also be borne in mind that even if The Netherlands and/or UK governments obtain a judgment of the English courts requiring TIF or Iceland to make immediate payments under the Loan Agreements such judgment will need to be enforced against TIF or Iceland (as the case may be). We understand TIF itself is exempt from attachment of its assets or liquidation by virtue of article 17 Icelandic Act 1998/1999. Iceland, on the other hand, has waived sovereign immunity rights in the Loan Agreement so in theory The Netherlands or the UK could seek to enforce against Iceland's assets. However:

(a) the AAAs specifically confirm that the waiver of sovereign immunity does not extend to any assets of Iceland which enjoy immunity under the Vienna Convention,[10] any assets of Iceland located in Iceland which are necessary for the proper functioning of Iceland as a sovereign power, or any assets of the Central Bank of Iceland;

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6 See clause 15 of The Netherlands Loan Agreement and clause 16 of the UK Loan Agreement.

7 And the failure to challenge is not the result of a change of Icelandic law made after 5 June 2009 rendering such challenge more difficult or impossible.

8 Lex have advised us that "*under Icelandic law it is generally recognised that parties to a contract are bound by a 'principle of loyalty' in the making, execution and termination of a contract. The scope of the obligation is somewhat unclear but it generally means that a contracting party must, to a certain extent, show regard for the interests of his counterparty. This, inter alia, means that if there is doubt in regard to the interpretation of a contract, which sets out mutual obligations the interpretation choice of which leads to an unfair result for one party shall not be chosen but rather the interpretation choice which best conforms to the mutual trust between the parties.*" English law does not include such a concept. To this extent there may be some disadvantage to Iceland as a result of the contract being governed by English law rather than Icelandic law.

9 We could foresee a different interpretation in relation to the exercise of security rights or rights on insolvency. However, as indicated earlier in this letter, such matters are unlikely to arise in relation to the Icesave Loan Agreements. No security has been granted. Also we understand TIF is exempt from attachment of its assets or liquidation by virtue of article 17 Icelandic Act 1998/1999.

10 The UK is a signatory to the Vienna Convention and certain of the provisions of the Vienna Convention have the force of law in the UK by virtue of the Diplomatic Privileges Act 1964. These provisions include article 22 of the Vienna Convention which records that the "*Premises of the mission [i.e. embassy], their furnishings and other property thereon and the means of transport of the mission shall be immune from search, requisition, attachment or execution.*" The UK government has, however, pursuant to section 3 of the Diplomatic Privileges Act 1964 reserved the right to withdraw such privileges if the home state of the relevant embassy (here Iceland) does not afford the same privileges and immunities to the UK embassy.

(b) the parties have confirmed that nothing is intended to remove or shall have the effect of removing from Iceland its control of its natural resources and its right to decide on the utilisation and form of ownership thereof; and

(c) it would be extremely challenging for The Netherlands or the UK to seek to enforce against assets of Iceland within Iceland (because, in extremis, Althingi could pass new laws preventing such enforcement if necessary to protect Icelandic assets).

4. **Question 3**: *An opinion on the impact of any potential future revision and amendments of the European legislation on deposit guarantee schemes, as it was in October 2008, not least regarding the guarantee by a home State, on the content and validity of the Icesave Loan Agreements and the obligations of the Icelandic State or Icelandic parties under the Icesave Loan Agreements. In particular such opinion should refer to the existing legal obligations of the Icelandic State or Icelandic parties under the European legislation on deposit guarantee schemes, and their impact on the Icelandic State or Icelandic parties.*

Article 3 of Directive 94/19/EC on deposit guarantee schemes requires "*each Member State shall ensure that within its territory one or more deposit-guarantee schemes are introduced and officially recognised.*" By Article 4 "*deposit-guarantee schemes introduced and officially recognised in a Member State in accordance with Article 3(1) shall cover the Depositors at branches set up by credit institutions in other Member States.*" The minimum guarantee level is set at €20,000 (raised in March 2009 to €50,000).[11]

By Article 10 "*deposit-guarantee schemes shall be in a position to pay duly verified claims by Depositors in respect of unavailable deposits within three months of the date on which [the competent authorities determine the relevant credit institution is unable to repay the deposit and has no current prospect of being able to do so*]."

Iceland is party to the EEA Agreement which entered into force in 1994. As such Iceland agreed to be bound by directive 94/19/EC and established TIF pursuant to Icelandic law No 98 of 1999 for this purpose.

The EC deposit-guarantee directive does not specifically define what constitutes a deposit-guarantee scheme nor explicitly provide that each State stands behind or guarantees the obligation of the deposit-guarantee scheme in its jurisdiction. However, as mentioned above, Article 10 provides that deposit-guarantee schemes must be in a position to pay claims in respect of unavailable deposits within three months of the ruling that the failed institution will be unable to repay the deposits.

We are asked for our opinion as to the impact of subsequent amendments to European legislation on deposit-guarantee schemes (in particular relating to State guarantees) on the content and validity of the Icesave Loan Agreements (and Iceland's obligations thereunder). In our view, TIF's obligations (and Iceland's guarantee obligations) would not be affected.[12] TIF and Iceland enter into the Icesave Loan Agreements to record their contractual obligations to repay the monies disbursed by the UK and The Netherlands. This contractual obligation is independent of (a) any separate obligation TIF and Iceland have as a matter of their respective obligations under Icelandic law No 98 of 1999 and the EEA Agreement to reimburse the UK and Netherlands for the compensation payments

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11 See Directive 2009/14/EC – EU Member States were required to raise the limit to €50,000 by 30 June 2009.

12 We note, for example, that the EU increased the minimum compensation limit for deposit guarantee schemes in March 2009 from €20,000 to €50,000. There has been no suggestion (so far as we are aware) that such an amendment in any way retrospectively increases or otherwise affects TIF's obligations under the original Icelandic guarantee scheme which provides protection for up to €20,887 per claim.

made to Amsterdam and London branch depositors up to €20,887 or (b) any adjustment to the terms of the EC deposit – guarantee schemes which may be made in the future.[13]

If the Icesave Loan Agreements come into contractual effect (once the conditions precedent – including further Althingi approval – are satisfied) then in our view the contractual obligations in the Loan Agreements will be obligations in their own right. Whilst there are principles of English law which in exceptional circumstances allow a contracting party to be released from its contractual obligations[14] we do not consider it likely any of these legal principles would operate to exempt TIF and Iceland from its obligations under the Icesave Loan Agreements. We consider this to be the case even if (a) an EFTA court rules Iceland was under no obligation to provide a state guarantee (or similar) in respect of TIF's obligations or (b) there is a subsequent amendment to the European legislation on deposit guarantee schemes.

5. **Question 4**: *An opinion on the possible legal repercussions if the final acceptance of the draft bill for a State guarantee for Icesave loans from 19 October 2009, Amending Act No. 96/2009 (the Icesave bill) will be delayed and/or not adopted as Icelandic law by the Icelandic Parliament, Althingi. In particular, such opinion should evaluate, on grounds of such circumstances, the most appropriate way forward for all the relevant parties to bring the Icesave matter to a successful conclusion.*

The Icesave Loan Agreements entitle the UK and Netherlands to terminate those agreements if the various conditions precedent (including Althingi approval) have not been satisfied by 30 November 2009. As this date has already passed, in theory the UK and/or Netherlands could terminate the arrangement. However, there appears to be little advantage for them to do so when there is some prospect of approval being obtained.

If Althingi does not approve the bill and the Loan Agreements do not come into effect then we are back to the position which prevailed in the autumn of 2008. The Netherlands and the UK have disbursed monies to the London and Amsterdam branch depositors. They will say they have done so "on behalf of" TIF because TIF did not discharge its obligations under Icelandic law no 98 of 1999. In any event, the London and Amsterdam branch depositors have (we understand) assigned to FSCS in the UK and DNB in the Netherlands respectively all claims they have against Landsbanki and TIF – so FSCS and DNB will be entitled to make claims against TIF by stepping into the shoes of the individual depositors and claiming compensation from TIF via the assignments.

It is difficult to predict what would follow an Althingi rejection of the bill. There would no doubt be intense further diplomatic pressure upon Iceland from the international community to reconsider its position. It may be that the UK and Netherlands would seek a court ruling confirming TIF's and Iceland's obligations to repay the monies paid to the

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13 Article 2 of the Bill currently before Althingi to amend Act No. 96/2009 does, of course, direct the Icelandic Minister of Finance to initiate discussions with The Netherlands and the UK if a competent adjudicator concludes (in line with an advisory opinion obtained from the EFTA Court), that the Icelandic state was not under an obligation to guarantee the obligations of TIF. Such discussions would relate to the potential implications of such a decision on the Icesave Loan Agreements and the obligations of the Icelandic state under those documents. This was also recognised in the joint ministerial statement made in October 2009. However, there would be no binding legal obligation upon the UK or The Netherlands to modify the obligations of the Icelandic state or TIF under the Icesave Loan Agreements following such negotiations.

14 In very rare circumstances a party to an English law contract can escape its liabilities under that contract if it can show it entered into the contract as a result of a mistake of law. In this case the argument would be that Iceland entered into the Loan Agreements and provided the guarantees on the "mistaken" assumption that it had a legal liability to ensure TIF made the compensation payments to the Landsbanki, Amsterdam and London branch depositors. Whilst we have not fully investigated the position, we consider that any such argument in Iceland's case is unlikely to succeed. A House of Lords decision in England in 2006 (Deutsche Morgan Grenfell Group v Inland Revenue Commissioners) concluded that if a claimant had some suspicion that it did not have a legal liability to pay – but nonetheless made a payment, the claimant could not then seek to recover the payment if it subsequently turned out it had no legal liability to pay. In the Icesave scenario Iceland will be providing the guarantee and committing to a contractual obligation under the guarantee even though there have been discussions as to whether or not there is an underlying legal obligation upon Iceland to support TIF's obligation to make a compensation payment.

Amsterdam and London Depositors on their behalf. The terms of any such judgment (if in favour of the UK and Netherlands) could conceivably require repayment on terms which are more onerous to Iceland than those enshrined in the Icesave Loan Agreements – by, for example, requiring immediate payment of the full amounts due.[15]

In addition there is, of course, the risk that the promised additional financial support from the IMF and others may be delayed or not provided.

Ultimately, if (a) TIF and Iceland are shown to be legally obligated to reimburse the UK and the Netherlands and (b) Iceland does not enter into arrangements with the UK and the Netherlands (satisfactory to those two countries) to reimburse the payments which have been made, Iceland will have defaulted on its payment obligations to two major creditors. This will bring with it all the ramifications of a sovereign payment default in relation to Iceland's standing in the international community, its ability to raise finance in the future and the potential for such failure to pay to cause cross-defaults in bonds and other instruments under which Iceland has borrowed money.[16]

6. **Confidentiality**: This letter records our views on the legal rights and obligations of TIF and Iceland under the Icesave Loan Agreements. Therefore it may be disadvantageous to TIF and/or Iceland for this advice to be published or otherwise disclosed beyond Althingi itself.

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15 We consider there are two potential actions which could be brought by the UK and The Netherlands. First, there would be a potential action by FSCS and DNB against TIF. (We understand FSCS and DNB have taken an assignment of the benefit of the depositors claims against both Landsbanki and TIF.) Second, there could be a separate action against the Icelandic state for damages (assuming TIF is unable to pay) for failure to properly implement the requirements of the deposit guarantee directive as stipulated by the terms of the EEA Agreement. Such a claim would be a so called "Francovich" claim. (Our initial view is that it is likely that any such actions would need to be brought in the Icelandic courts – but we would need to undertake considerably more research to confirm our view on this.)

In 1997, the EFTA Court decided in an Advisory Opinion (the equivalent of a judgment) in E-9/97 Erla María Sveinbjörnsdóttir, that the principle of State liability for failure to implement a directive (a Francovich claim) also exists in EEA law.

Although strictly speaking the District Court of Reykjavik is not bound by an Advisory Opinion of the EFTA Court, we anticipate the District Court would in any such action, be likely to follow the ruling in E-9/97 and find that the potential for State liability exists under EEA law for failure to correctly implement an EU directive.

In summary the conditions for State liability are that:

(1) the Directive in question must be intended to confer rights on individuals, the content of which can be identified on the basis of the provisions of the Directive;

(2) the breach on the part of the State concerned must be sufficiently serious;

(3) there must be a causal link between the breach of the State's obligation and the loss and damage suffered by the injured parties.

Turning to the first condition, in this case the UK/Netherlands would need to establish that Directive 94/19/EC required implementation in Iceland in such a way that Iceland was unconditionally obliged to maintain a guarantee deposit scheme that provided the minimum guaranteed compensation of EUR 20,000.

The District Court might well make a request to the EFTA Court for an Advisory Opinion for clarification on this question. The District Court can make such a request under Article 34 of the Agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice.

Second, the UK / Netherlands would need to show that the breach by Iceland was sufficiently serious to justify State liability. Again, this question might well be the subject of a request for an Advisory Opinion. There may be good arguments to indicate that the breach is sufficiently serious. However, a more detailed review of the case law would be required to express a more reasoned view on this point.

Third, as regards causality, we see little difficulty with satisfying this condition as it is clear that depositors were not compensated due to the failure of the scheme to operate properly.

16 Iceland would find itself in the position of Mexico in 1914 and in 1982, Argentina in 1956 and in 2002, Russia in 1998 and Turkey in 2001.

We hope that the advice given addresses the points raised by the questions. However, if you require any further clarification or you wish us to add to this opinion we will be happy to do so.

Yours faithfully

Ashurst LLP

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