LANDSLÖG

MEMORANDUM

on the HF Fund's issues and the Icelandic State's guarantee

CONFIDENTIAL

To:	**The Ministry of Finance and Economic Affairs**
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1. Introduction

The Icelandic Ministry of Finance and Economic Affairs has requested a memorandum on several issues relating to the HF Fund – which is operated on the basis of Act No. 151/2019 on the Processing of the Assets and Liabilities of the HF Fund – with respect to the accumulated financial difficulties of the Housing Financing Fund (HFF). This concerns questions relating to the Icelandic State's guarantee of the HF Fund's obligations.

Following the enactment of the aforesaid Act in 2019, a separate initial balance sheet was prepared for the HF Fund, showing its financial condition at the turn of the year 2019-2020. According to the balance sheet, the Fund's equity at year-end was negative by approximately ISK 180 billion, although its cash position was sufficient to cover debt repayments in the next few years. This imbalance is due to declining interest rates coupled with prepayments on the HFF's receivables, without corresponding prepayment rights existing on the Fund's debt side. The difference between assets and liabilities on the Fund's accounts is determined on a fair value basis.

The problem stems from the terms and conditions and rates of HFF bonds, which were issued by the HFF following legislation and regulation changes in 2004, whereby it refinanced its older Housing Bond System loans and raised new funds. Concurrently, the HFF raised its loan-to-value ratio from 65% to 90%. Below is an outline of points relevant to the guarantee's interpretation, both from general legal

standpoints and also with regard to the arrangements set in place in 2004. The events leading up to the issuance of the HFF bonds are set out in detail in the 2013 Report of the Althingi Special Investigation Commission on the Housing Financing Fund and in the Supreme Court Judgment of 27 May 2021 in a case concerning the legality of prepayment fees introduced in November 2005.

2. SUMMARY OF CONCLUSIONS

(a) **The Icelandic State is liable** for the obligations of the HFF and of the HF Fund on the basis of legislation and conventional doctrines of constitutional law regarding the State's liability for its agencies and activities. The State's liability for the obligations of State agencies depends on such obligations having been created in a proper manner. When the HFF bonds were issued, valid legal powers were granted, and the provisions of the Government Financial Reporting Act were respected.

(b) **When the HFF issued its bonds ("HFF bonds") in 2004, the State's guarantee was defined as a guarantee of collection (*einföld ábyrgð*)**, i.e. the guarantee could not be enforced until the HFF's insolvency had been demonstrated in a standard manner (by means of an unsuccessful attachment attempt or on the basis of bankruptcy). The guarantee is not a surety (*sjálfskuldarábyrgð*), i.e. the guarantor cannot be pursued in parallel with or instead of the principal debtor without first making all reasonable efforts to obtain payment from the principal debtor.

(c) **The terms and conditions of the notes assume that the debt cannot be repaid faster or differently than agreed.** As guarantor, the Icelandic State *could not* be released from its obligation by a unilateral payment or by offering an exchange for other securities. The creditor could refuse such fulfilment of the claim.

(d) **A guarantee of collection is triggered when the impossibility of obtaining satisfaction of liabilities from the debtor** (here the HF Fund) **has been demonstrated**. Conventional legal theory has held that an unsuccessful attempt at attachment (in part or in full) must have been made before a guarantee of collection is triggered.

(e) **Other things being equal, the State as guarantor would have to make every repayment of principal and interest accruing after the guarantee of collection were triggered**, in the same way as the HFF would otherwise have had to (cf. point (c) hereinabove).

(f) **Government agencies for which the State is responsible cannot be subjected to bankruptcy proceedings except by special legislation.** If legislation were passed to liquidate the HF Fund within the rules of bankruptcy law, the Fund's remaining debts would automatically become due for payment.

(g) **Under the rules of bankruptcy law, it would not be possible to obtain recognition of claims against the bankruptcy estate other than for the outstanding principal and accrued interest**, i.e. neither the market value of the bonds nor compensation for loss of future returns could be claimed.

(h) **This opinion discusses the scope for reacting by means of legislation on the HF Fund's liquidation** and the potential right to compensation for those considering themselves subjected to deprivation of property as a result of early redemption. It would be permissible to stipulate by law that an exchange take place whereby claims against the Fund would become due and payable. In such circumstances, the State's guarantee would be triggered and the balance outstanding after using the HF Fund's assets to pay the claims against the Fund would have to be settled.

3. CREATION OF THE HFF BONDS AND LEGAL BASIS

The validity of the State's liability for the obligations of public agencies is dependent on these obligations having been created in a proper manner. The substance of the liability can likewise depend on the instruments and legal basis in question. The resolution thereof is determined by the provisions of Article 40 of the Icelandic Constitution, which states that a loan obligating the State is not permitted to be taken unless it has *legal basis*. That clause has generally been considered to extend to debt restructuring and guarantees provided by the State (and by its agencies).

Deviation in this respect may invalidate the obligations. There are known examples of this in case law from 1996, when the Supreme Court ruled that a government minister's obligations regarding the purchase of fur animal buildings were non-binding because Althingi had not consented to the measure. The Supreme Court reached the same conclusion in a 2003 judgment in a case where budget authorisation had not been obtained for payment under a severance agreement between upper-secondary school headteachers and teachers.

3.1. Legislation and terms upon HFF bonds' issuance

For some of the questions involved here, it is useful to briefly outline the legal basis for the HFF bonds' issuance at the time.

Act No. 57/2004 and Regulation No. 522/2004

In June 2004, an amendment was made to the Housing Act, providing for the introduction of HFF bonds, which were to be sold in the general market to raise funds for the HFF's lending activities. A provision was added to the Act to the effect that the HFF should maintain "its incomings and outgoings in balance, and [...] make plans in this regard." The HFF was also required to set up a risk management system "for that purpose". This element may be borne in mind with regard to the expectations of those who acquired the HFF bonds in the event of an imbalance arising between payments into and out of the Fund.

The Act also provided that the HFF's board should make a proposal to the Minister of Social Affairs on the interest rate and other terms of the new HFF bond series, and the Minister was subsequently authorised to "by regulation, issue provisions in further detail on lending by the Housing Financing Fund, trading methods and arrangements, and the issue of HFF bonds".

Under Regulation No. 522/2004, it was decided that the HFF would fund its lending through the sale of HFF bonds and through borrowing. All HFF bonds in the same series were to have the same credit terms and it was stipulated that the interest rate should be "unchanged for the entire period of the loan," but in other respects the HFF's board was to make a proposal to the Minister of Social Affairs regarding the terms and conditions of each series, such as the interest rate, inflation indexation, form of repayment, and maturity.

It should also be noted here that in 2004, a temporary provision was added to the Housing Act to the effect that the HFF should start selling HFF bonds before 1 July of that year and was permitted to invite the holders of housing bonds and Housing Authority bonds to exchange them for HFF bonds ("Exchange Offer"). In addition, the HFF's lending authorisations were expanded.

Exchange Offer's terms and conditions

In 2004, an Exchange Offer was launched, lead by Deutsche Bank, where new series of HFF bonds (HFF 24-34-44) were exchanged for housing bonds and Housing Authority bonds (IBN/IBH). The prospectus for the new HFF bonds sets out the terms and conditions of the new HFF series. These state that the Minister of Social Affairs had approved the terms and conditions in accordance with the Regulation and that the HFF board had deliberated on the matter at its meeting of 10 June 2004.

Certain aspects of the terms and conditions are of prime importance for the questions at hand here:

> 3 State Guarantee
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> The entire liabilities of the Issuer, including its obligations to make payments of principal and interest under the Notes, are guaranteed by the Icelandic State. Under Icelandic law, the guarantee is irrevocable and without limitation but, in the *event of a default* by the Issuer, a Noteholder is required first to *exhaust his remedies* against the Issuer before he is entitled to make a claim against the Icelandic State.

This defines the guarantee as a guarantee of collection, which means that all remedies against the bonds' issuer must be exhausted before any claim is made against the guarantor. An addendum to the terms and conditions comprises an additional clause on the guarantee:

> STATE GUARANTEE
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> The New Notes benefit from a guarantee of collection (*einföld ábyrgð*) of the Icelandic State Treasury. The **guarantee** is irrevocable and **covers all existing and future obligations of HFF including its obligations to make payments of principal and interest under the New Notes**.
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> **The guarantee derives from a recognised principle of Icelandic law that the State Treasury guarantees the obligations of all State agencies unless the guarantee is unequivocally limited to the assets of the agency concerned.** The nature of the guarantee is such that in the event of default by HFF, a holder of New Notes is required to exhaust all remedies against HFF before being entitled to make a claim against the Icelandic State. As a State agency**, HFF cannot be subject to bankruptcy proceedings, as provided by Section 5(3) of Act No. 21/1991** on bankruptcy proceedings. Evidence of HFF's inability to make payments under the New Notes could be sought by entering into attachment proceedings following a judgment. **An attachment showing HFF to hold insufficient assets for satisfaction of the debt would qualify as proof of HFF's inability to pay, and would thus give rise to a direct claim against the Icelandic State under the guarantee**.

This text explains the nature of the Treasury's guarantee and outlines the steps that need to be taken before the guarantee is tested, including given the fact that a government agency under State guarantee cannot be subjected to bankruptcy proceedings. The terms and conditions thus state that before a direct claim can be made against the State, the HFF's insolvency must be proven. An unsuccessful attachment attempt may be made (*"attachment showing HFF to hold insufficient assets for satisfaction of the debt*") following a judgment on the payment obligation.

This point is important because the obligation is accordingly based on the assumption that the HFF's solvency must be fully put to the test before a direct claim arises against the Treasury. This highlights the difference between a surety and a guarantee of collection such as the one in question here. The terms and conditions

go so far as to specify that proof of insolvency is deemed to have been given and the guarantee of collection to have been triggered when an unsuccessful attachment attempt has been made following a judgment on the payment obligation.

The terms and conditions also state that the notes carry a fixed interest rate of 3.75% from the issue date and that their principal is inflation-indexed until the maturity date (2024, 2034 and 2044). Two annual interest payment dates were decided, in addition to repayment of principal on the same due dates, in accordance with further terms thereon.

Restrictions were placed on faster repayment of the principal in the following provisions in section 6 of the terms and conditions:

> (b) *No other redemption:* The Issuer shall **not be entitled to redeem** the Notes otherwise than as provided in paragraph (a) above.
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> (c) *Purchase:* The Issuer **may at any time purchase Notes** in the open market or otherwise and at any price, provided that all unmatured Receipts, Coupons and unexchanged Talons are purchased therewith.
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> (d) *Cancellation:* All Notes so redeemed or purchased by the Issuer or any of its Subsidiaries and any unmatured Receipts, Coupons or unexchanged Talons attached to or surrendered with them may be cancelled and, in the event that they are so cancelled, may not be reissued or resold.

As set out above, special reference was made to the State's guarantee of the HFF's obligations under the HFF bonds, which guarantee was based on recognised principles regarding the State's liability for its agencies. The guarantee is further defined in the terms and conditions, which the Minister of Social Affairs seems to have confirmed, and does not appear to deviate from what has been considered generally applicable. A fully valid legal basis existed for the issuance of the notes, whose terms and conditions set clear criteria for creditor rights and the interpretation of the State guarantee promised.

3.2. Legal basis regarding government finances

At the time of the Exchange Offer, the Government Financial Reporting Act No. 88/1997, which contained provisions on the Government Accounts and the Government Budget, was in force. Article 3 of the Act (version 130b: Icelandic legislative acts, 1 October 2004) provided for the classification of entities in the Government Accounts and stated that State-owned credit institutions other than deposit institutions fell under Group C of the accounts, being neither partnerships nor limited companies. In the bill for the Act, the Icelandic Students' Loan Fund was used as an example of entities falling under Group C. The bill also stated the following:

> The State's credit institutions are established by legislation and their boards are appointed. Their available funds derive from return on equity and, to a large extent, borrowings raised both domestically and internationally. In some cases, the Treasury also provides such institutions with disposable funds through direct financial contributions, and guarantees their obligations. If a Group C entity is converted into a partnership or limited company, it is moved to Group E of the Government Accounts provided that it is half- or majority-owned by the Treasury, but otherwise its annual financial statements will not appear in the Government Accounts.

Article 26 of the Government Financial Reporting Act dealt with borrowings, relending and guarantees (version 130b: Icelandic legislative acts, 1 October 2004). It provided that the Budget Bill should seek authorisations for borrowings, lending and State guarantees granted during the budget year. It further stated that the Explanatory Notes to the Budget Bill should include a statement of total borrowings by central government entities, lending to individual entities outside of Group A, and the granting of State guarantees and their breakdown by main guarantee categories.

State guarantees were and are provided for in more detail in Act No. 121/1997 on State Guarantees. The bill for the Act provided for the form of State guarantees. It specified that, firstly, the Treasury could guarantee the loans of certain entities under a special legal basis that would have to be in place in each case. Such guarantees were referred to as *granted guarantees*. Secondly, a Treasury guarantee of obligations could exist even if the granting of the guarantee did not go through the channels prescribed by the aforesaid Act on State Guarantees and no special legislation had been enacted authorising the guarantee in question. This was further detailed as follows:

> **This is based on the unequivocal rule of Icelandic law that the State is liable for the obligations of its institutions and undertakings, unless the guarantee is limited by an explicit legal provision**, cf., e.g., the Fisheries Investment Fund, or the liability of the State in a limited liability company is limited to the share capital contribution. This "owner liability" borne by the Treasury can be **direct**, whereby the Treasury may be pursued directly to pay the claim, or **indirect**, in which case collection must first be attempted from the State company or agency in question. **The general rule for State entities with independent finances is that the State's liability for their obligations is indirect.** These concepts partly correspond to sureties and guarantees of collection, but are better applicable to the Treasury's responsibility for the obligations of central government entities.

The Explanatory Notes to this Bill also state:

> The Treasury's liability for housing bond issuance is indirect and based on the fact that the State Housing Fund, which is Treasury-owned, issues the housing bonds and is the debtor thereunder. The Treasury is also responsible for the obligations of the Export Credit Guarantee Departments of the State Guarantee Fund and of the Industrial Loan Fund as the owner of these, in addition to which a special provision governs the State guarantee concerning the latter fund.

It is clear from the Act on State Guarantees that the HFF was assumed to fall under the Act. For example, the Act states that banks, loan funds, credit institutions, companies and other entities that are, or have been, under a Treasury guarantee by law, whether arising through the Treasury's ownership or otherwise, shall pay a guarantee fee for their obligations covered by the State guarantee, cf. paragraph 1 of Article 6. The fee was intended to offset the costs when the guarantee was triggered.

As previously mentioned, the Exchange Offer took place in 2004. Subparagraph 3 of Article 5 of the 2004 Government Budget provided that HFF departments were permitted to exercise borrowing powers up to a certain limit. It stated:

> The Minister of Finance, on behalf of the Treasury, is authorised to borrow, relend, provide State guarantees, etc., as stipulated by the provisions of this Article:
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> […] 3. To grant the following parties, authorised under *sector specific law* to undertake borrowings, permission to do so in 2004 within the limits specified in sections 3.1 to 3.7, cf. Article 26 of the Government Financial Reporting Act No. 88/1997:
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> [...] 3.2 The Housing Bond Department of the Housing Financing Fund, up to ISK 49,650 m, cf. Articles 10 and 17 of the Housing Act No. 44/1998.
>
> 3.3 The Housing Financing Fund for loans for rental apartments, up to ISK 24,300 m, cf. Articles 10 and 33 of the Housing Act No. 44/1998.
>
> 3.4 The Housing Financing Fund for additional loans to be funded by the Fund, **up to ISK 10,100 m, cf. Articles 10 and 30 of the Housing Act No. 44/1998**.
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> 3.5 The Housing Financing Fund to refinance the debts of the State Housing Fund and the Workers' Housing Fund, up to ISK 5,407 m, cf. Articles 10 and 53 of the Housing Act No. 44/1998.

Subparagraph 4.3 stated that the Minister of Finance, on behalf of the Treasury, could authorise entities with State-guaranteed borrowings to take out loans to repay before maturity the outstanding balance of older loans when more favourable terms were considered to be available. Specific mention was made that entities with State-guaranteed borrowings intending to exercise the authorisations under point 3 or 4.3 should adhere to the provisions of paragraph 2 of Article 7 of the Government Debt Management Act No. 43/1990.

4. Further on the State's liability for Treasury-owned entities in relation to Article 40 of the Constitution

As related above, the Treasury has generally been assumed to be liable for its entities unless its liability is limited in some way or there is no legal basis for the arrangement in question. The most obvious example of this is when the State establishes a publicly

owned limited liability company. No stipulation was made to limit the State's owner liability for the HFF in the legislation governing the HFF, nor was a legal form with limited owner liability used.

As mentioned above, the HFF's authority to issue bonds was specifically provided for in the Housing Act. It was also assumed that an authorisation in the Government Budget would have to be obtained for such bond issuance in each case, as was done in the case of the Exchange Offer. In the Government Budget, the assumption was also made that the National Debt Management Agency would have to approve the terms of foreign loans and State-guaranteed loans. Thus, the aforesaid conditions regarding borrowing were adhered to.

Therefore, it must be considered improbable that the courts would agree to the State not being bound by the terms and conditions of the guarantee set out in the bond documents when the bonds in question were issued. Another factor that would no doubt have had an impact is if the State had considered the entity to have exceeded its competence or authorisations in the issuance, in which case a prompt reaction would have been required. There have been several opportunities for such a reaction, most recently when the Act on HF Fund was enacted. But the Explanatory Notes to the Bill for the Act state, on the contrary, that the legislation does not affect the State's guarantee for the Fund's obligations.

5. Act on Bankruptcy

5.1. Insolvency within the meaning of bankruptcy law

The Act on Bankruptcy, etc., No. 21/1991, stipulates, *inter alia*, that a debtor obliged to keep accounts must petition for a declaration of its bankruptcy if it is unable to honour its debts to creditors in full *when they become due*, provided that the debtor's payment difficulties are not deemed likely to be over within a short period of time. Other things being equal, this appears to be the situation in which the HF Fund finds itself. It is foreseeable that its funds will be exhausted before billions fall due, notwithstanding the Fund's sizeable cash position.

5.2. Acceleration of claims upon bankruptcy

It should be noted that when bankruptcy is declared, all claims automatically become due and payable, "*irrespective of any terms laid down previously by agreement or otherwise*," cf. paragraph 1 of Article 99 of the Bankruptcy Act.

A creditor can thus lodge its claims only by calling the outstanding balance of the claim plus accrued interest. Such claims are "general claims" against the bankruptcy

estate, with the interest that accrues after the date of the bankruptcy order constituting the lowest-priority claims against the bankruptcy estate, cf. point 5 of paragraph 1 of Article 114 of the Bankruptcy Act.

5.3. Public agencies cannot be subjected to bankruptcy proceedings

Under paragraph 3 of Article 5 of the Bankruptcy Act, State-guaranteed public agencies cannot be subjected to bankruptcy proceedings on the basis of the Act, unless otherwise provided for by law. It follows from this provision that a special authorisation under law is required to compel a bankruptcy proceeding or winding-up of the HF Fund, since the State guarantees the Fund's obligations. No such legal basis currently exists.

However, the situation is such that in the conventional understanding of bankruptcy law, the HF Fund is considered insolvent, unless its owner, the State, makes further financial contributions. This is underlined by the fact that the Fund will foreseeably not be able to meet its obligations on a particular maturity date of the bonds, and there is no indication that this situation will change.

It should be noted here that when the HFF bonds were issued, the arrangement of the Treasury's guarantee was specifically laid down. In the event of the HFF's inability to pay its debts, there was no mention of an additional capital injection into the HFF, only that the creditors would be able to claim their outstanding balances from the Treasury by first suing the HFF and completing an unsuccessful attachment attempt against it. In such circumstances, a direct claim would arise against the Treasury on the basis of the guarantee of collection.

6. Questions on special legislation authorising liquidation/winding-up proceedings

With regard to the above, the question has arisen whether it is possible to compel the Fund's winding-up and/or the bonds' redemption in some way so as to enable the situation to be remedied before it is too late. As previously stated, the provisions of the Bankruptcy Act allow for the introduction of special legal provisions in this regard.

It is therefore natural to consider whether legislation enabling the HF Fund's bankruptcy proceedings is subject to any particular restrictions. This legislation scenario assumes the introduction of a special legislative provision permitting the Fund's subjection to bankruptcy proceedings (whether at the request of creditors or of the Fund itself), with the liquidation proceedings in other respects governed by the provisions of the Bankruptcy Act.

The reason for contemplating this scenario is the significant level of uncertainty and inconvenience involved for all stakeholders if the HF Fund inability to pay had to be pursued in an unstructured manner, i.e. through litigation for the recognition of the payment obligation and subsequent enforcement action to trigger the Treasury's guarantee. Because of the strict instructions of the Constitution and the Financial Reporting Act concerning payments from the Treasury, the Minister of Finance's only other option would be merely to await whatever happened, as no payments from the Treasury would be permissible until the HF Fund's insolvency were formally ascertained using the methods set out in the terms and obligations of the bond issue.

If a decision were made to consider legislation of this nature, various questions would arise. They are principally as follows:

6.1. Constitution's property rights clause

The circumstances are unusual with regard to the interests at stake. The HF Fund's creditors would in the course of bankruptcy proceedings receive distributions towards satisfaction of their claims, which become due and payable when bankruptcy is declared. In all probability, the Treasury will be liable for the outstanding balances on the basis of the guarantee of collection, which is triggered upon bankruptcy.

Hence, the question is merely whether the creditor's right to be paid interest on the loan's outstanding balance throughout its maturity period – and possibly the market value resulting therefrom – is to be considered a property right whose deprivation is not permitted without compensation. This invites the additional question of how the right to compensation is likely to be viewed if the deprivation of property is deemed illegal.

Firstly, it must be emphasised that the rights of the bondholders at the outset require the State to honour its guarantee when triggered under law. Nothing else is on the cards in this case, so any assertion to the effect that constitutionally protected rights are being impinged upon would be tenuous.

The legislature has also been granted scope, for public interest reasons, to impose restrictions on the use and disposal of property, without this being deemed to constitute expropriation within the meaning of Article 72 of the Constitution, and no compensation is payable for such deprivation. It is appropriate to explain the rationale for these tenets here, although the relevance thereof to assessing the measures that the State could take is uncertain.

The courts have used certain criteria to assess whether restrictions are of a general nature not incurring liability, in particular the following: (i) whether a new ownership title is created for a party other than the owner, (ii) the objectives underlying the deprivation, such as whether it is warranted by important social considerations, (iii) the number of those thereby deprived, i.e. whether the deprivation has a general or specific application, and (iv) how extensive the deprivation is for individual owners. However, each case is assessed on its own merits, and the public interest may warrant deprivation of property without compensation even if the measure affects only one party, cf., e.g., Supreme Court Judgment No. 182/2007.

6.2. Legal provisions on changed status of claims, guarantees, etc.

The 2008 "Emergency Act" (Act No. 125/2008) involved severe interference in the ranking of claims. The ranking of claims under the Bankruptcy Act was altered when bankruptcy loomed for the Icelandic banks. This was done in the public interest and, not least, to reduce the Treasury's cost of guaranteeing the deposits of the general public and companies, as the government had also declared that it would guarantee all deposits on accounts with Icelandic banks.

This measure was taken at the expense of other creditors, who had previously ranked *pari passu* with regard to the banks' assets upon bankruptcy. The rules were thus changed *ex post* in favour of some creditors at the expense of others, with the public interest as the guiding principle.

> The case of Supreme Court Judgement No. 340/2011 was a test of the Emergency Act's validity as to the new priority status of deposits. The Court agreed with the plaintiffs that their claims constituted property within the meaning of Article 72 of the Constitution and the European Convention on Human Rights and that the plaintiffs had suffered loss, but not to the extent they themselves claimed. When examining whether the legislation entailed a reduction of the plaintiff's rights that would constitute expropriation or such limitation of property rights as to violate Article 72 or 65 of the Constitution, the Court considered it necessary to take into account several factors at the same time, such as the reasons for the measures taken, their aims and consequences, the nature of the measures and how general and extensive they were.
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> The Court made reference to, *inter alia*, the fact that the legislature had several times previously assumed that it had the power to change the ranking of claims upon estate settlement without being limited in its scope for so doing by constitutional law. Justifiable reasons were deemed to exist for the legislature's decision to give priority to deposits through the legislation change. The Court found that it had been demonstrated that in order to achieve the legislature's aims to avert a bank run and collapse, it was necessary to protect the deposits of domestic parties. The Court found that the legislation had determined, in a general manner, how to rank claims in the winding-up of financial companies, which could compromise the rights of numerous creditors of Icelandic financial

companies, not only those of the plaintiffs. Given the serious economic situation and the State's obligations to Icelandic society and under international agreements, the Court could not agree that the enactment of Act No. 125/2008 violated proportionality. All the claims of the plaintiffs were rejected in the case.

In the Emergency Act Judgment, the Court thus held it permissible to change substantially the ranking of claims and creditors' available enforcement options, without this constituting a deprivation of property rights incurring liability for compensation.

Reference can also be made here to Supreme Court Judgment No. 274/2010, in which a provision of law, regarding the cancellation of guarantee obligations after the principal debtor obtained a licence to seek composition with creditors was found unconstitutional and, was disregarded.

In the case, a savings bank sought payment of debt from the guarantors of a bond. The creditor argued that the provisions of paragraph 3 of Article 9 and Article 12 Act No. 32/2009 – which stipulated that forgiveness of debt owed by a principal debtor, e.g. through composition with creditors, led to the same effect vis-à-vis the guarantor in terms of reducing the claim – should be set aside on the grounds that these provisions were incompatible with the property rights provisions of Article 72 of the Constitution and Article 1 of Protocol 1 to the European Convention on Human Rights. The Court found that the claim against the bond's guarantors (sureties) was protected under Article 72 of the Constitution and that those rights could not be impaired, without compensation, by means of burdensome, retroactive legislation.

It may be noted here that the guarantors put it to the Court that even if the provisions of law limiting the creditor's right to pursue the guarantor were found to have contravened the Constitution's property rights clause, this would not result in the savings bank's claim against them prevailing, but would lead to the *Treasury's liability for compensation*, which would then be obliged to compensate the savings bank for the loss suffered as a result of the unlawful deprivation of property under the law in question when the guarantees (suretyships) were cancelled. The Court found, based on the wording of paragraph 3 of Article 9 and Article 12 of Act No. 32/2009, cf. the Althingi Trade Committee's opinion on amendments proposed to those Articles, that the legislation was clearly based on the assumption that such deprivation was permitted *without compensation*. Thus, the Court held it to be an underlying assumption of the legislation that compensating those subjected to this deprivation was not required under Article 72 of the Constitution. In these circumstances, the Court found, the courts were only empowered to disregard the legislation insofar as it was found unconstitutional, and not to base a judgment on the consideration that the Treasury would have to bear significant costs of compensation. Accordingly, the provision of paragraph 3 of Article 9 of Act No. 32/2009 could not be applied to the liability of B and C for payments under the bond, and they were ordered to pay the amount of the claim to the savings bank.

Given the above, it is clear that those that acquire claims may, to some extent expect assumptions to change, especially as regards rights with a long duration.

Legislation can obviously stipulate changes to various terms and conditions, e.g. on interest rates and indexation, without creditors being able to raise objections. Presumably, no one would suggest that altering the regime for maximum interest rates or the criteria for calculating an index would give rise to a right to compensation for creditors.

Various examples or hypothesis can be thought of, but the Emergency Act Judgment demonstrates that even a fundamental change to available enforcement options was found permissible without compensation. From the judgment in the case of the sureties/guarantors, it is evident that cancelling a guarantee when the principal debtor has obtained a licence to seek composition with creditors has been found to be going too far. The nature of a surety, as an independent obligation, was of material importance. The District Court judgment, later confirmed by the Supreme Court, found *inter alia* that valid claims had simply been cancelled by legislation, directly contravening Article 72 of the Constitution. This constituted a direct intervention in the contractual relationship, with the obligation of one of the two parties cancelled in all respects.

6.3. Retroactivity

In the event that legislation is passed authorising the HF Fund's winding-up, the question may arise whether such legislation has an indirect retroactive effect. There is no general prohibition of retroactive legislation in Icelandic law. However, certain provisions of the Constitution directly limit retroactivity, such as the prohibition of retroactive criminal provisions in Article 69 of the Constitution. It also follows from case law that the Constitution's property rights clause limits the legislature's powers to interfere in financial interests created before the legislation takes effect, even though the clause in the Constitution does not stipulate this explicitly.

This has been repeatedly tested over the years. One example is **Supreme Court Judgment No. 340/1999 (Fishermens's Pension Fund v. Hörður Magnússon and counterclaim**). The Court found it permissible to reduce pension rights by authority of legislation, based on considerations including that pension payments had not started when the rights were reduced and that there was no indication that the reduction of all such pension rights of fund members was not founded on a general basis and that equality between fund members had been sufficiently ensured. The reduction of rights was found to have been permissible without compensation.

In the Emergency Act Judgment, the Court also did not find that the legislation was in fact retroactive, since the rights had not been activated and the legislation was general in application and intended to remain in effect indefinitely.

6.4. Summary regarding possible legislation

Legislation aiming to enforce liquidation proceedings for the HF Fund without in any way compromising the State guarantee for the outstanding balance of the debts can be said to be a much milder measure than the ones adjudicated upon in the aforesaid judgments: Firstly, whether it would constitute deprivation of property rights is uncertain. The creditor would get the claim paid in full and earlier than could otherwise be expected. The actual deprivation of assets can hardly consist of anything more than lost future returns. The real loss resulting therefrom would be subject to much uncertainty and depend on the possibilities of obtaining a return on the funds over a long period of years.

It may also be noted that the cost of ownership of the claims would possibly decrease considerably, because when the bonds were issued they were registered in international central securities depositories, the fees for which are believed to run into the hundreds of millions ISK for the remainder of the bonds' maturity.

In the event that such legislation were considered to constitute deprivation of property, then important considerations would include, as mentioned above, the reasons for the legislation, its aims and consequences, the nature of the measures taken and how general and extensive they would be. The focus of assessment thereof would include legitimate expectations, possible retroactivity, proportionality, etc. The interests of the State and of taxpayers presumably lie in being able to honour the government guarantee in a more cost-effective way than by supporting the HF Fund financially for decades to come.

The purpose of legislation of this type would obviously be to address the problem at hand, which is that the HF Fund is considered to be *de facto* insolvent, and it can hardly be deemed justified for the State to continue to operate an entity that would otherwise be required to undergo bankruptcy proceedings, although circumstances must be examined on a case-by-case basis. It can be argued that waiting far into the future for the debt to become payable by the State is not justifiable, as obviously the Fund is not, and will not be, able to meet the obligations.

With regard to legitimate expectations, it may be pointed out that if the creditors had assumed that the Treasury would always inject additional capital into the HFF, there would have been no need for the State guarantee. Under a guarantee of collection, such as the one covering the debt in this case, the guarantor cannot be pursued until all remedies have been exhausted against the principal debtor.

Regarding proportionality, it may be pointed out that an attempt has been made to resolve the Fund's issues. It can thus be argued that proportionality has been observed given the serious situation the company is in.

As related above, in certain circumstances, the legislature has been considered to have the power to interfere in the ranking and status of claims by means of new legislation, and from the case law it may be deduced that the legislature has more leeway when the legislation relates to "inactive" rights. When claims are impaired, such a decision must have general applicability, and equality between parties in an equivalent position must be safeguarded.

No attempt is made here to go into the details of implementation, but from the legislation on the HFF's transformation, it may be inferred that the HF Fund is "what remains" of the HFF after its other activities and assets were divided between the Housing and Construction Authority and the Housing Fund. The bill for the Act on the HF Fund states that the legislation does not affect the legal status of the holders of bonds issued by the HFF. Accordingly, the HF Fund remains an independent legal entity and its legal status and relationship with the State have not been altered in a manner relevant here.

Sincerely,

Jóhannes Karl Sveinsson, Attorney at Law