SCOTLAND THE BRAVE? AN OVERVIEW OF THE IMPACT OF SCOTTISH INDEPENDENCE ON BUSINESS

– THOUGHT LEADERSHIP

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Scottish independence remains very much a live issue, as First Minister, Nicola Sturgeon, continues to push for a second referendum, but the prospect of possible independence raises a host of legal issues. In this overview, we examine how Scotland might achieve independence; the effect of independence on Scotland's international status, laws, people and companies; what currency Scotland might use; the implications for tax, pensions and financial services; and the consequences if Scotland were to join the EU.

The Treaty of Union between England (which included Wales) and Scotland provided that the two Kingdoms "shall upon the first day of May [1707] and forever after be United into one Kingdom by the Name of Great Britain." Forever is a long time. Similar provisions in the Irish treaty of 1800 have only survived for six out of the 32 Irish counties, and Scotland has already had one referendum on whether to dissolve the union. In that vote, in 2014, the electorate of Scotland decided by 55% to 45% to remain within the union, but Brexit and the electoral success of the SNP mean that Scottish independence remains very firmly on the agenda.

The 2014 referendum followed the SNP's winning 69 of the Scottish Parliament's 129 seats at the election in 2011. This majority in favour of a party whose raison d'être is independence persuaded the UK's Prime Minister that he could not deny Scotland the opportunity to decide whether or not it wished to remain within the UK.

The SNP might have lost the ensuing referendum, but it regards Brexit (which 62% of the Scottish electorate opposed) as having changed everything, and it continues to enjoy enviable electoral success. The SNP won 64 Scottish parliamentary seats in the elections of May 2021, but the Green Party, which also supports independence, won a further eight seats, bringing the number of pro-independence MSPs to 72; more, even, than in 2011.

Independence, should it happen, will affect anyone who does business in or with Scotland. Scotland can be part of the United Kingdom or it can be an independent country, but moving from the former status to the latter is highly complex both for the Governments concerned and for everyone else. The rest of the United Kingdom (rUK) could not ignore Scotland's democratic will, but nor could Scotland dictate the terms on which it seceded from the union. The negotiations between representatives of rUK and of Scotland to establish the terms upon which Scotland should become an independent country would unquestionably affect the way business is carried on both north and south of the border, as would the choices made by Scotland as an independent country.

Now might not be the time for full-scale contingency planning for Scottish independence, but it is certainly the time to consider how a (second) Scottish referendum, followed by independence, might affect the organisation and conduct of business. If independence were to occur, the planning horizons could be uncomfortably short, still more so the time to execute any plans.

This briefing explores some of the legal issues that will arise, including the potential impact of separation on businesses.

Summary

- Scotland is likely to require Westminster legislation to hold a valid referendum, which may come down to politics, rather than law. The SNP wants a referendum in 2023 and, if successful, is then likely to want independence before the next Scottish elections in 2026.
- An independent Scotland would be a new player on the international stage. A conundrum is how Scotland can enter into agreements with other states before it has legal status in public international law as an independent nation.
- Scotland will inherit a complete legal framework, but will need to amend its laws in the same way that the UK did (and continues to do) as a result of Brexit, as well as establishing regulators and such like to take the place of UK-wide ones.
- Scotland will need to establish citizenship rules, and rUK will have to consider which of those who obtain, or can obtain, Scottish citizenship should be able also to hold rUK citizenship. The SNP wants a common travel area with the UK, but that might be difficult if and when Scotland joins the EU.
- Scottish companies will continue to be recognised, but legislation may be needed to allow companies on one side or other of the border to migrate, should they wish to do so, to the other side.
- The UK's assets and liabilities will need to be divided between Scotland and rUK. rUK would likely retain the whole of the UK's current national debt, but receive an IOU from Scotland in respect its proportionate share of that debt. Scotland's largest creditor would, initially at least, be rUK.
- Currency is perhaps the most difficult issue that would face a newly independent Scotland. A Commission established by the SNP recommended the continued use of sterling for an extended period, but an SNP conference rejected that in favour of preparing immediately after any independence vote for a currency of its own.
- Contracts with Scottish parties will likely continue as before, but there may be, for example, currency risks if a contract requires payment in Scotland.
- For tax purposes, Scotland will need to enter into double taxation treaties with other states, including rUK, to prevent multiple taxes. There is a possibility of competition in tax rates between Scotland and rUK and other states.
- Pension schemes that use Scottish limited partnerships may need to restructure. Schemes with Scottish members may also need to ensure that assets and obligations are matched if Scotland adopts a new currency.
- At independence, Scotland may face its own hard Brexit unless it is able to assume the rights and obligations of the UK under the Trade and Cooperation Agreement between the UK and the EU. Longer term, the SNP wants Scotland to join the EU, which could lead to a hard border – for goods, services and people – between rUK and Scotland in order to protect the EU's single market.
- Scotland would need to establish its own financial services regulator, and rUK and Scotland would need to decide how to treat firms providing cross-border services, whether through mutual recognition or otherwise (though that might not assist non-rUK firms).

Achieving independence

As mentioned above, the Scottish independence referendum of 2014 followed the SNP's triumph in the 2011 Scottish elections. This persuaded the UK's then Prime Minister, David Cameron, that he could not, consistently with democratic principles, resist an independence referendum in Scotland. As a result, the Edinburgh Agreement of 15 October 2012 between the Governments of Scotland and the UK provided for the transfer to Scotland of the power to hold a referendum. This was done formally by an order in council under section 30 of the Scotland Act 1998. The object of the referendum was, according to the Edinburgh Agreement, to "deliver a fair test and a decisive expression of views of people in Scotland and a result that everyone will respect".

These steps put the legality – and the binding nature – of the 2014 referendum beyond doubt. The outcome of the referendum was not the one the SNP had hoped for. In 2017, following the Brexit vote, Scotland's First Minister, Nicola Sturgeon, asked the UK Prime Minister, Theresa May, for another section 30 order giving the Scottish Parliament power to call a second referendum. That request was refused on the basis that the UK's impending withdrawal from the EU gave the UK and its Government more than enough to occupy its time without also contemplating another Scottish independence referendum.

The success of the SNP and the Green Party in the May 2021 Scottish elections makes it inevitable that the First Minister will again demand a section 30 order to enable a second referendum to take place. A White Paper from the Scottish Government before the elections said that a referendum should take place in the first half of the current Scottish Parliament's term of office, which runs to May 2026, suggesting a referendum before the end of 2023.

The SNP Government in Scotland will, in practice, want to ensure that independence formally occurs at the very latest before the next Scottish parliamentary election. If it did not, the 2026 election could offer opposing parties the opportunity to reverse the initial decision, particularly if the preparations for independence, including negotiations with rUK, were not going well. At the time of the first referendum, the SNP anticipated that it would take 18 months of negotiations between Scotland and rUK after a vote in favour of independence to put in place arrangements sufficient for independence (though many regarded that as a very optimistic timetable). Given that a referendum and its campaign will also take time, this indicates that the First Minister does not have long before she must push the issue, though the timing is complicated by the COVID-19 pandemic.

Prime Minister Boris Johnson has said that he will refuse any request for a section 30 order, but he would need to consider the politics of refusal at the relevant time. If he were to refuse, the Scottish Parliament could contemplate itself legislating for a new referendum, though First Minister Nicola Surgeon has generally been reluctant to take legally doubtful steps towards independence. As explained below, it is unlikely that the Scottish Parliament currently has the necessary powers to call a referendum.

The Scottish Parliament's powers

The Scottish Parliament was established by the UK Parliament's Scotland Act 1998. It has limited legislative competence, and anything done outside that competence is not law (section 29(1)). A measure is outside the Scottish Parliament's competence if it "relates to" a reserved matter (section 29(2)(b)). Reserved matters include "the Union of the Kingdoms of England and Scotland" (paragraph 1(b) of Schedule 5). Measures can be taken under section 30 to enlarge the powers of the Scottish Parliament. This was done in order to enable the Scottish Parliament to call the 2014 referendum, but that enlargement of the Scottish Parliament's powers was time-limited and has now expired.

Would a referendum on Scottish independence called by the Scottish Parliament, without a section 30 order, "relate to" the union of England and Scotland? The predominant view is that it would, not least in the light of the draft Scottish legislation published in March 2021 in which the Scottish Government proposed that a second referendum should pose exactly the same question as in the first referendum ("Should Scotland be an independent country?"). Some argue, however, that there is nothing to stop the Scottish Parliament legislating for an advisory, or consultative, referendum which, unlike the 2014 referendum, would not be accepted by the UK Government as binding. This is not convincing. A referendum asking whether Scotland should be an independent country relates to the union of Scotland and England whatever the legal or political status of the outcome.

If the Scottish Parliament were to seek to legislate for an independence referendum without securing a section 30 order, the question of the Scottish Parliament's competence to do so would have to be resolved by the UK Supreme Court. There are various means by which a challenge to Scottish legislation could reach the Supreme Court, including a direct reference by a UK or Scottish law officer or through the normal litigation process, but there would need to be a definitive legal answer.

If the Scottish Government did not want to legislate unilaterally for a referendum, there could still be legal challenges, for example to the refusal by the UK Government to grant a section 30 order, but the key is likely to lie in politics, rather than the law. The first referendum was said by the SNP's leaders to be a "once in a generation" opportunity for independence, and that generation has yet to pass. But since the first referendum, Brexit has taken place, against the wishes of the Scottish electorate, and the SNP continues to dominate Scottish politics. Can a UK Government refuse a second referendum without significantly exacerbating resentment in Scotland towards rUK (generally referred to derogatorily as "London" or "Westminster") and strengthening the SNP's hand? An enhanced sense of bitterness towards rUK might help the SNP, but the SNP must also get the timing right. Will its electoral dominance continue? Even if it did, to lose one referendum may be regarded as a misfortune; to lose two in relatively quick succession would surely bar the issue for at least a generation.

One compromise possibility that has been raised is that a section 30 order could be conditional on varying the electorate to include not only all UK voters resident in Scotland but, in addition, Scots resident in rUK. This would be controversial (if Scots in rUK, why not Scots outside rUK too?), novel and time-consuming. Who is a Scot? Is it necessary to be born in Scotland, to have one or both parents born in Scotland, or perhaps a single grandparent (enough to qualify to represent the Scotland football team)? Or should the SNP's definition of Scottish citizenship in the event of independence (see below) be adopted? Further, there is no register of such "Scots." A register would therefore have to be created, which would be time consuming and expensive, as well as raising still more issues. For example, what proof would be required, and what political or other consequences would follow if these expatriate Scots were enough to swing the vote one way or the other?

Another suggestion is that a vote for independence should require a higher majority (whether of those voting or of the electorate) than 50%+1. In a referendum in 1979, Scottish devolution was supported by 51.6% of those voting but was not implemented because the legislation required, in addition, that at least 40% of the electorate as a whole should vote in favour. The 51.6% majority amongst those who voted represented only 32.9% of the electorate. This option of entrenching the union against a temporary bare majority is, however, unlikely to commend itself to a Government that was content for Brexit to occur when supported by only a little over a bare majority of those voting.

If Scotland were to vote for independence, what then? In the remainder of this briefing, we look at some of the issues that would arise following a successful (from the SNP's point of view) second referendum.

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The timing of independence

If the SNP had won the first referendum, it wanted Scotland to become independent on 24 March 2016, the anniversary of the union of the crowns of England and Scotland in 1603 (i.e. the date of the death of Queen Elizabeth I of England and on which King James VI of Scotland became also King James I of England). That timetable gave 18 months from the referendum for completion of the negotiations with rUK, though many expressed scepticism as to whether that was long enough to unpick over three hundred years of intimate union. It would not be necessary for all issues between Scotland and rUK to be finalised by independence day, but a sufficient number of such issues would need to be resolved for Scotland to function as an independent country. The UK and Scottish Governments may, for example, want to enter into a separation agreement (akin to the UK's Withdrawal Agreement with the EU) initially to provide for independence, perhaps with (time-limited) transitional provisions, to be followed by one or more agreements between Scotland and rUK dealing with more detailed issues. The Czech Republic and Slovakia were still negotiating almost a decade after their "velvet divorce" took effect.

The Scottish Government would, presumably, conduct the negotiations for Scotland, though it has been suggested that others could be invited to participate (the UK Parliament may also need to transfer powers to the Scottish Government to enable it to prepare fully for independence), but who should negotiate for rUK? In practice, it would be the UK Government, but it could be a group representing all the political factions in rUK.

The position of the UK Government is complicated by the fact that there will be a general election in the United Kingdom on 2 May 2024 at the latest, which is likely to be before Scotland could achieve independence even on an optimistic timetable. The election could result in a change of UK Government and therefore of negotiating position. Indeed, the identity of the UK Government could even be determined by the (currently) 59 Scottish MPs who sit in the House of Commons (e.g. at the 2010 general election, the Conservatives would have secured an absolute majority but for the Scottish MPs), though the large Conservative majority resulting from the 2019 UK general election perhaps makes this less likely than at the time of the first referendum.

Although Scotland will remain part of the United Kingdom until independence, some have questioned the continuing position of Scottish MPs in the House of Commons in the intervening period or, at the least, whether they should be able to vote on legislation only affecting England, Wales and Northern Ireland or relating to Scotland's independence (the House of Commons already has some procedures providing for English votes for English laws – EVEL). If Scottish MPs do affect the identity of the UK Government in 2024, their departure on independence day may not only reflect the creation of a new country, but it could also bring about a change of Government in the old one.

The old and new countries

On Scotland's independence, rUK will be the "continuator" state as a matter of public international law, i.e. it will be the same legal entity as the UK, with all the UK's existing rights and obligations (such as membership of the UN and NATO) but having lost a little over 8% of its population, slightly under 8% of its economic output, as well as 32% of its land mass. The rest of the United Kingdom continued in this way when the Irish Free State was formed out of the (then) United Kingdom of Great Britain and Ireland in 1922 and, similarly, Russia was treated as the continuator on the breakup of the Soviet Union. rUK may need to consider its name, since it will no longer include all of Great Britain – the United Kingdom of England, Northern Ireland and Wales?

In contrast, Scotland will be a wholly new state, probably not even the revival of the state that existed before the union with England in 1707. As such, Scotland must make its entrance on the international stage.

For many purposes, this debut will be straightforward. Numerous uncontroversial international arrangements (postal services, flights and so on) will require Scotland to do little more than to announce that it will treat itself as bound in the same way as the UK by the previous arrangements or simply to sign up in its own name. But in some cases, accession to existing treaties could prove more difficult. Scotland will have to apply to join some multilateral organisations, such as the UN, NATO and the IMF.

Scotland could, however, face a logical conundrum. Until Scotland is independent, it has no separate personality in public international law and, therefore, no standing to enter into treaties or such like, even with rUK. Scotland and rUK should be able to overcome this issue internally, but to avoid a gap in its induction into the international order, Scotland may, for example, have to rely on foreign states agreeing to enter into agreements with the Scottish Government (which may require a transfer of powers from the UK Parliament for this purpose) to take effect with Scotland on independence or accepting the application to Scotland of existing arrangements immediately on independence.

Laws

Laws applicable in Scotland before independence would presumably continue to apply after independence, but (as with EU law in the UK on Brexit) Scotland would need to decide what, if any, adaptation to its new circumstances was appropriate (e.g. companies and insolvency legislation), including transitional provisions. The UK Parliament would need to amend the Scotland Act 1998 to enable the Scottish Parliament to pass laws that will take effect on independence but that currently fall outside the Scottish Parliament's powers.

Scotland would also need to create regulatory bodies to replace existing UK institutions that serve the whole UK (e.g. the Financial Conduct Authority, the Competition and Markets Authority and the industry bodies), which may themselves need to adopt new rules for the entities that they regulate.

The need to change its laws would not be confined to Scotland. rUK would need to pass laws to modify UK statutes which apply throughout the UK to reflect their reduced territorial scope (e.g. the Constitutional Reform Act 2005 alone has over 100 references to Scotland), and its continuing regulators would need to adapt their rules to reflect their reduced remit. rUK regulators may also need to reconsider the scope of ongoing investigations that relate to Scottish businesses.

Both Scotland and rUK would need to decide how to treat matters which are currently wholly internal domestic issues and to address this through appropriate legislation (e.g. enforcement of judgments and insolvency recognition), which may require additional agreements between rUK and Scotland. In some cases, turning internal domestic issues into cross-border issues could have a significant financial impact, such as tax and pensions, discussed below.

Businesses would need to track legal changes, in Scotland and rUK, that could affect them, particularly where they result in additional compliance requirements. These may include obligations for a business to inform its customers and counterparties of how the new legal regime affects its relationship with them (e.g. new deposit or investor protection arrangements for financial services firms).

People

The Scottish Government set out wide criteria for Scottish citizenship at the time of the first referendum. So, for example, British citizens habitually resident in Scotland on the day of independence would automatically have become Scottish citizens, as would British citizens born in Scotland but living outside Scotland on the day of independence and children born in Scotland to at least one parent with Scottish citizenship.

rUK would also have to decide upon the national fate of Britons who acquired Scottish citizenship (no one should be left stateless). For example, should everyone habitually resident in Scotland cease to be British (i.e. rUK) citizens on independence or should they be entitled to retain British citizenship if they so wish

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or if they meet certain criteria, such as birth or parental birth in rUK? What about those living in rUK (or, indeed, elsewhere) but born in Scotland?

Dual British and Scottish citizenship – if allowed by rUK, as it currently is for other nationalities – could have advantages for British citizens. This would be particularly so if Scotland were to become a member of the EU because a Scottish passport would grant British citizens free movement within the EU. Many British citizens with Irish connections obtained Irish passports after the UK's Brexit referendum for that reason.

At a more practical level, many who would become Scottish citizens will already hold British (i.e. rUK) passports, which could have up to 10 years to run before expiry. It would probably be impracticable to replace all of these with Scottish passports before or at independence, even if that was what the holders wanted. Will British passports held by Scots still be valid, whether as British passports, Scottish passports, or at all?

The SNP said at the first referendum that it would look to agree a common travel area with rUK, like that between the Republic of Ireland and the UK and, as a result, that Scotland would not participate in the Schengen borderless travel area if and when an independent Scotland joined the EU (see below). All new members of the EU since 1997 have been required to commit to join the Schengen area, though Bulgaria, Croatia, Cyprus and Romania have yet, in fact, to join. Scotland's negotiating position with the EU might also be perceived to be weak, since the SNP has such a clear desire – perhaps even need – to join the EU, though Ireland retains a common travel area with the UK and is outside Schengen. Membership of Schengen would typically require checks on all individuals entering Scotland from rUK and passport stamps, as well as restrictions on the ability of rUK citizens to work in Scotland and even to go to Scotland (the normal Schengen maximum is 90 out of any 180 days).

A common travel area between rUK and Scotland would significantly mitigate the business impact of independence on people issues. Employees who are Scottish or rUK citizens would retain the right to reside in either Scotland or rUK and to travel freely between them, although their employment rights may in the future depend on the jurisdiction in which they live and work. However, other nationals, including family members of Scottish or rUK nationals, resident in Scotland or rUK would not necessarily have the same freedom of movement, and this could have adverse impacts on employees even if their existing rights of residence in either Scotland or rUK were preserved. For example, other nationals resident in Scotland may not be able to move their residence or travel to rUK on business or for holidays without work permits or visas (or vice versa for non-UK nationals resident in rUK).

These issues may also affect EU nationals resident in Scotland or rUK and currently benefiting from citizens' rights under the EU-UK Withdrawal Agreement unless Scotland and rUK agree to continue to apply the provisions of the Withdrawal Agreement on citizens' rights as if Scotland remained part of the UK. The risk of disruption to employees is much greater if there is no common travel area as all employees may have to make irrevocable choices as to where they wish to reside or work.

Companies

UK companies can currently have their registered offices in Scotland or in another part of the UK. On independence, companies registered in Scotland would become, as far as rUK is concerned, foreign companies. In principle, that would not cause a problem. Scottish companies would be recognised and accorded legal personality in rUK on the same basis as companies incorporated under the laws of Germany, Delaware or Russia. It may be that Scottish companies that carry on business within rUK would be required to register a branch in the same way that foreign companies must do so, but that is not in itself a heavy burden.

A number of companies registered in Scotland indicated during the first referendum that a vote for independence would lead them to move to rUK their places of registration or the companies through which they carry on some or all of their business. This may have been for regulatory reasons, reasons of public confidence, the uncertainty over Scotland's currency (see below) or just convenience but, in the financial sector in particular, regulatory considerations are likely to have been, and to continue to be, a key driver. Some companies registered in England and Wales or Northern Ireland may also wish to move their seat of registration to Scotland, whether for tax or other reasons.

The most straightforward way to move seat would be for the UK to pass legislation immediately following an independence vote allowing a move on, say, a company's shareholders passing a resolution to that effect. If there is no legislation to ease the process, companies would need to consider how best to migrate, a matter that would need to be the subject of contingency planning. What is required will vary from company to company and with how each business wants to be structured in the future.

What is done and how it is done will determine the effect of any migration on contracts (e.g. whether it gives a right of termination) and on counterparties. A legislative change of registered office from Scotland to England may affect, for example, the insolvency regime that governs a company, but in practice the immediate consequences for counterparties of a move are likely to be minimal, except in regulated industries where the place of incorporation may affect whether an entity holds Scottish or rUK licences and its ability to operate in the other jurisdiction.

The UK's assets and liabilities

Scottish independence would require the assets and liabilities of the United Kingdom to be split between rUK and Scotland. The House of Lords Select Committee on the Constitution explained, prior to the first referendum, that:

> "The key principle governing the apportionment of assets and liabilities is that they should be shared equitably between the continuator and the successor states. It is a legal principle that fixed or immovable assets (such as Government or military buildings) would automatically become assets of the state in which they were located. Other, moveable assets (such as military equipment) would become subject to apportionment through negotiations – with the only applicable legal principle being that the apportionment should be equitable. Liabilities would be similarly subject to apportionment through negotiations."

The prevalent view was that apportionment should be on the basis of population, rather than, say, spending or tax revenue. The purpose of independence is not to perpetuate or undo fiscal transfers that have already taken place between Scotland and rUK, but to separate the two populations for the future.

The Scottish Government identified certain of the United Kingdom's assets that it would like, such as military hardware and foreign embassies. The assets that must be split between Scotland and rUK encompass property of every kind, including gold and foreign currency reserves, intellectual property, staff, software and computer systems, works of art, shareholdings, contracts, and the seabed.

This last aspect (the seabed) could prove particularly contentious because of the oil and gas below it. There are, however, reasonably well-established, if not easy to apply, principles of public international law upon which the seabed is divided between neighbouring states. If Scotland and rUK cannot reach agreement, it may be that this issue could be resolved through arbitration or other legal means. Indeed, many issues that might arise between Scotland and rUK could ultimately be referred to a third party for resolution. For example, the Anglo-Irish Treaty of 1921 establishing the Irish Free State provided for the Irish Free State to assume part of the United Kingdom's public debt, the amount to be determined by arbitration in default of agreement.

The major, but not the only, liability of the United Kingdom that must be divided between Scotland and rUK is the UK's national debt (other debt includes, for example, long-term pension liabilities and the UK's obligations to the EU under the Withdrawal Agreement). The UK Government said at the time of the first referendum that there would be no formal transfer to Scotland of any part of the national debt; rUK would remain liable but Scotland would indemnify rUK in respect of a certain proportion of the debt. This would involve discussion of what amount Scotland should take, what maturities should be allocated to Scotland, what interest rates, what currencies and so on. rUK may even consider seeking security for Scotland's obligations (e.g. gold reserves allocated to Scotland could continue to be held by, and pledged to, the Bank of England, though these would only secure a fraction of Scotland's likely debt to rUK).

How assets and liabilities are divided affects business in different ways. The UK's commitment to continue as the obligor on existing UK Government debt may reassure creditors, although independence could have some impact on the credit standing of the rUK Government and of rUK businesses whose credit is linked to their sovereign's credit. The split of assets and, more importantly, liabilities and the impact on the credit standing of the Scottish Government will be more critical for current and future creditors of the Scottish Government – and at least some Scottish businesses – in international capital markets.

Currency

"... by laying sole claim as the continuing state to the public asset of the Bank of England, it would see [rUK] take full responsibility for the £1.6 trillion national debt." So said Alex Salmond, Scotland's First Minister at the time of the 2014 referendum, linking Scotland's willingness to accept a share of the UK's debt to rUK's agreeing to enter into a formal currency union with Scotland (the debt is now well over £2 trillion). His argument that rUK was obliged to enter into a currency union with Scotland rested on the assertion that the Bank of England, as the issuer of sterling, is an asset of the United Kingdom, not of rUK alone. As such, Scotland would be entitled to the continued use of this asset, namely sterling.

The UK Government and most commentators dismissed this argument, and all major UK national political parties stated that they would not support rUK's entering into a currency union with Scotland. A currency is a medium of exchange, a store of value and a unit of account, not an asset that appears on a balance sheet and that can be divided. The Bank of England is one of the institutions of the UK's Government which, by opting out of the UK, Scotland would have foresworn. For example, Scotland might be entitled to some of the UK's foreign embassies, but it would not be entitled to use in perpetuity the services of the Foreign, Commonwealth and Development Office.

As a result, the SNP's position appears to have changed. It set up a Sustainable Growth Commission to look at economic issues arising on independence, including currency, which reported in May 2018. The SGC took a very cautious approach as regards currency, determined not to alarm investors, holders of accounts at Scottish banks or others.

The SGC recommended that Scotland should continue unilaterally to use sterling for "a possibly extended transition period" after independence, only moving to a Scottish currency when six tests were met The SGC considered that it was unlikely that its tests would be met until towards the end of the first decade following an independence vote. The chair of the SGC was quoted as saying that rushing into a new currency would be "short-term risky, politically difficult, and it would make the cost of Government borrowing much more expensive… The monetary policy situation that we have should continue until such a time that it's no longer in our interests."

The SGC's six tests included: fiscal sustainability, including credible budget deficit and debt levels; a credible Scottish central bank and stability in the price of Governmental debt issuances; sufficient foreign exchange and financial reserves to allow currency management; and Scotland's economic cycle moving away from rUK's such that an independent monetary policy was feasible and desirable.

The SGC recommended that any new currency be pegged at 1:1 with sterling in the short and possibly medium term, that the currency used in private contracts should not be changed retrospectively by Scottish legislation (i.e. contracts, such as loans and bank deposits, in sterling should continue in sterling), and that individuals and companies should be free to continue to use sterling in Scotland if they so wished. The SGC concluded that it would be impractical to impose capital controls to protect a Scottish currency.

The SGC's approach would leave Scotland without any influence over rUK's (and therefore Scotland's) monetary policy, without its own central bank and without any access for its financial institutions to the Bank of England as lender of last resort for a significant period of time. A foreign currency is used domestically in this way by, for example, Montenegro, which uses the euro, and Panama, which uses the US dollar. Even some larger countries, such as Ecuador, use the US dollar, issuing only local coins.

The SGC's proposal was rejected at the SNP's conference in April 2019. The conference passed a resolution to "authorise the preparation of a Scottish currency as soon as practicable after a vote for independence." This, presumably, contemplates replacing sterling with a new currency at, or shortly after, independence.

The success, or otherwise, of the SNP's conference policy would depend upon the perception of a new Scottish currency. If it was perceived that the new currency would be strong (at least, stronger than sterling), there would be fewer problems. Parties would, in general, be content to move sterling assets, including bank accounts, into the Scottish currency, and creditors would be positively keen for contracts to be redenominated. But even in this situation, parties could face a risk that does not now exist if their assets and liabilities no longer matched in currency terms.

If, however, the perception was that a Scottish currency would devalue against sterling, individuals and enterprises may take steps to ensure that sterling assets remained as such and could not be converted into the Scottish currency (e.g. by mandatory conversion of all bank balances) or trapped in Scotland (e.g. by capital controls). Deposits at banks in Scotland might, for example, be moved to banks or branches in rUK or elsewhere, potentially creating an immediate liquidity crisis at banks in Scotland, as well as a shortage of foreign currency reserves. The formal currency union between the Czech Republic and Slovakia in 1993 survived only five weeks, as monies flowed from Slovakia to the Czech Republic, which was regarded as the economically stronger of the two.

In any event, the introduction of a new currency is likely to give rise to issues for some businesses or individuals, whether or not Scotland mandates the redenomination into the new Scottish currency of obligations under some or all existing contracts. Some will end up facing mismatches between the currency of assets and liabilities or future income and outgoings that will be difficult or expensive (even, perhaps, impossible) to hedge. These impacts are likely to be most significant for businesses that are highly leveraged (such as banks), operate in both Scotland and rUK or have assets or liabilities that are governed by both Scottish and English or other laws. These issues are reduced by a long transition period with a 1:1 peg as shorter term contracts can be run-off and parties can readjust their positions but are increased if there is a more rapid transition.

Currency is one of the hardest issues an independent Scotland would face. It is understandable – indeed, it is to be expected – that a new country would want its own monetary policy, rather than be beholden to the state it has rejected. This requires a currency, but launching a new currency into the global financial markets involves considerable risks, as the SGC recognised, not least in the light of the current deficit in Scotland's public finances and the (post COVID-19 pandemic) debt it would inherit from the UK.

Parties could face a risk of their assets and liabilities no longer matching in currency terms.

Contracts

Scotland already has its own laws and legal system. Contracts expressed to be governed by Scottish law would continue to be governed by Scottish law, and contracts expressed to be governed by English law would continue to be governed by English law, even if the counterparty is Scottish. Subject to any legislation that Scotland may introduce in respect of contracts governed by Scottish law and that rUK may introduce in respect of English law contracts, pre-independence contracts would remain as binding after independence as they were before.

The uncertainty over Scotland's currency may, however, introduce performance or execution risks for contractual counterparties. For example, if performance of a contract must take place in Scotland, a Scottish overriding mandatory law could affect, say, the ability to pay in sterling. Similarly, Scottish laws could determine the exchange rate at which a debt due in sterling was converted for enforcement or other purposes in Scotland. If sterling is the currency of account in a contract with strong links to Scotland, a new Scottish currency could lead to an argument that this new currency, rather than sterling, becomes the unit of account.

To consider these risks, parties would need to look at the terms of their existing contracts (e.g. Where is payment due? Is there a definition of sterling?). They may also need to consider the drafting of future contracts to ensure, for example, that sterling is adequately defined and that payments are to be made outside Scotland. Similarly, although the mere fact of the creation of an independent Scotland is unlikely, of itself, to trigger a contractual default (absent any specifically drafted provision), parties may want to review covenants, undertakings and events of default in commercial contracts, bonds, loans and swaps.

In addition, anyone with a contract with the UK Government or a public sector institution needs to consider how the contract will be affected by Scottish independence. If the contract relates only to services in England, the contract will probably continue as before. But if the contract has a Scottish element, can Scotland take the benefit of the contract or any part of it should it wish to do so? Will renegotiation be required? Can rUK, Scotland, or both, make use of software licences for systems each wishes to continue to use?

Other cross-border elements may also create issues. For example, if the contract provides for the delivery of goods or provision of services between Scotland and rUK, the contract may not anticipate the impact of new tariff or non-tariff barriers to cross-border trade that come into effect after independence.

Tax

Independence raises difficult questions of tax policy, as well as numerous practical issues for individuals and companies with interests and business cross-border.

The Scottish Government proposed at the time of the first referendum to cut corporation tax to 3% below rUK's rate and to introduce a series of tax incentives. This raises the spectre of tax competition between the two countries. The long-term consequences are unpredictable, but in the short term some may wish to take advantage of lower rates and migrate entities to Scotland prior to independence. Others will be concerned about uncertainty (whether tax, legal or economic) and therefore migrate in the other direction. In both cases there would likely be questions as to whether the migration is tax-effective; however, in principle, migration before independence would be considerably more straightforward than migration has historically been (e.g. to Ireland), with no exit taxes and few other frictional costs. This prospect may alarm HM Treasury, colour other aspects of negotiations, and perhaps prompt new anti-avoidance rules.

A tax treaty between rUK and Scotland would need to be in effect by independence to prevent double taxation of Scottish and rUK businesses and to prevent payments to/from Scotland becoming subject to withholding tax. However, the terms of that treaty might be contentious (particularly given Scotland's intention to capture business from rUK).

rUK would, as the continuator state, retain the benefit of the UK's historic network of around 120 tax treaties. Scotland would not – and on the face of it that would present considerable difficulties to Scottish companies investing and operating in other countries and to companies from other countries investing/operating in Scotland. Negotiating a new treaty network would take time, likely many years. There is, however, precedent for Scotland simply to agree bilaterally with other countries that they each consider themselves subject to the relevant UK treaty – certainly not an instant process, but considerably faster than a full treaty negotiation.

In terms of domestic legislation, it seems likely that Scotland would choose to inherit UK tax legislation as at independence, save for the specific areas which have been the subject of political focus (such as tax rates, incentives and anti-avoidance rules). Any more fundamental change would seem impractical (as well as highly risky). Over time, the two systems could be expected to diverge, as happened with, for example, Ireland and Hong Kong.

On a practical level, the most likely overall outcome is that rUK would treat Scottish individuals and companies in the same way as it treats any other country's individuals and companies (and vice versa). Given the history of being the same country, that would have a host of complex consequences, including:

- rUK companies' Scottish operations would be treated as permanent establishments, separately taxable in Scotland, and vice versa.
- Arrangements and transactions between rUK and Scottish entities/ permanent establishments would then be subject to transfer pricing, creating a significant compliance burden (and the potential for arguments between the rUK and Scottish authorities as to who has the taxing right). It has been suggested that this could be avoided by creating a formulary apportionment system between Scotland and rUK. However, as that would give Scotland more favourable treatment than any other country, it is unclear whether it would be consistent with the UK's WTO obligations. Similarly, that kind of special treatment for residents of one other country (and nowhere else) would seem to be incompatible with a future Scottish membership of the EU. These two issues would likely prevent straightforward solutions to this or the other complexities we identify.
- Groups containing rUK and Scottish entities would be broken for tax purposes. This could have a number of complex effects. Going forward, cross-border groups would in practice lose the ability to move assets tax-free and to surrender losses within the group.
- Scottish companies would only be required to operate PAYE for employees in rUK if they have a taxable "presence" in rUK. If they didn't, they would not have to operate PAYE, and rUK employees would have to pay any income tax due to HMRC through self-assessment. Similarly, companies based outside Scotland may no longer have to operate PAYE for employees in Scotland.
- A large number of rUK residents could claim domicile in Scotland, and, as "non-doms", be taxable on foreign income/gains only when remitted to rUK. Presumably, rUK rules around domicile would need to be changed to avoid a material loss to the Exchequer (and Scotland would face similar concerns). Again, creating special rules targeting one country could raise complex questions of compatibility with WTO trade rules and (for Scotland) EU law.
- Similarly, the ease by which many individuals could shift their residence from rUK to Scotland, or vice versa, would likely concern both tax authorities.
- Various tax rules impose exit charges on companies that cease to be resident in the UK. So, for example, an rUK company holding real estate or another capital asset would, on ceasing to be an rUK resident, be subject to rUK CGT on its unrealised capital gain – and similar rules would apply to intangible property, loan relationships and derivatives. Any unrealised losses would also crystallise for tax purposes, but in many cases an emigrating

company would have no use for the losses. Under current UK tax legislation, these exit charges may be triggered upon independence – and unless new reliefs and/or exemptions were created, this could amount to a considerable windfall for the UK Treasury and a considerable tax burden on affected companies. It therefore seems likely that some form of deferral arrangement would have to be put in place (and that should be possible within the WTO and EU frameworks).

Pensions

Pension schemes would not be immune from the effects of Scottish independence, although one of the key concerns raised by potential independence following the 2014 vote has receded due to Brexit.

That concern was that a scheme with a mix of Scottish and rUK employees could be classed as a "cross-border scheme" following independence and would have to meet various conditions, including seeking authorisation from the Pensions Regulator and, crucially, complying with much more onerous funding requirements than usually apply. In the absence of exemptions or transitional provisions being agreed, this would likely have resulted in schemes taking steps to segregate Scottish pension liabilities from rUK pension liabilities in order to avoid having to meet these onerous obligations. However, following Brexit, the legislation governing cross-border schemes ceased to apply, with no detailed regime replacing it; the immediate authorisation and funding requirements are no longer a concern (although such concern could be revived if Scotland joins the EU and is required to apply the same rules to existing schemes).

In terms of other pensions-related implications:

- Over recent years, a number of employers have given their pension schemes assets instead of cash as part of their funding. In many cases, these contributions have been structured using a Scottish Limited Partnership in order to overcome some technical concerns under employer-related investment legislation. SLPs have been effective due to a quirk in the legislation. This quirk depends on the vehicles being located in the United Kingdom. This may not survive independence, leading to a potential need to restructure. In the majority of cases, it may be possible to get comfortable that structures can be continued, but detailed consideration will be needed.
- Regarding regulation, the UK pensions market is governed by a number of key institutions, such as the Pensions Regulator and the Pension Protection Fund. Decisions will need to be taken as to whether these bodies' functions will be split between new regulators and, if so, on what basis.
- The PPF's position in particular is likely to be a point for negotiation. The PPF acts as a statutory "lifeboat", providing a proportion of benefits of schemes whose employers have become insolvent, and it is already responsible for a number of schemes previously operated north of the border. For example, a Scottish PPF, split on the basis of population, would be significantly smaller than the existing UK-wide body – there are bound to be questions as to how sustainable it would be and whether levies would rise. Many employers have put in place arrangements designed to reduce the levy they pay to the PPF – would these continue to be recognised?
- Pension schemes are also particularly exposed to currency issues if independence results in mismatches between the currency of the scheme's assets and liabilities. Pensioners may also be adversely affected where the currency in which pensions are paid depreciates against the currency of their country of residence. There have been proposals in Scotland for the Scottish Government to protect Scottish pensioners under UK schemes against this risk.

Other implications will come to light, particularly if different income tax levels are introduced, as was suggested at the time of the first referendum (given that contributions to registered pension schemes are normally tax deductible). It remains to be seen how all these issues will be resolved.

The European Union

The EU will still be a day one issue on Scottish independence but for different reasons than it would have been following the first referendum, when independence would have left rUK within the EU and Scotland outside it.

The day one issue will be whether an independent Scotland will be allowed by the EU to assume some or all of the UK's rights and obligations under the Trade and Cooperation Agreement between the UK and the EU. If not, then Scotland will be faced with its own "hard Brexit", trading with the EU on WTO terms rather than those in the TCA. The EU may also wish to bind Scotland to at least some of the obligations of the UK under the EU-UK Withdrawal Agreement, such as the UK's obligations with respect to EU citizens' rights and the separation provisions dealing with protections for EU intellectual property and other rights. But it may not be possible to continue the same treatment for goods traded between Northern Ireland and Scotland as apply today under the Northern Ireland Protocol as this may be inconsistent with Scotland's new status. These issues, like Scotland's membership of the EU, could become a political pawn.

In the longer term, securing Scotland's membership of the EU will not necessarily be a quick process. Until it is formally independent, it is hard to see how Scotland could apply for, negotiate, sign or ratify an accession treaty. Similarly, all the EU's members would have had to recognise Scotland's independence before a treaty could be signed. Whether Scotland becomes a member by amendment to the EU's existing treaties under article 48 of the Treaty on European Union (the Scottish Government's preferred route during the first referendum) or by the more probable route of a separate treaty of accession under article 49, Scotland must negotiate and reach agreement with all the current members of the EU, which agreement must then be brought into legal force. These two stages could each easily take at least 18 months.

Some, perhaps most, EU member states may be prepared to rush the first stage and the second stage – the ratification by each EU member state of the accession treaty with Scotland through each member state's national legal and political procedures – but it would only take one member state to refuse to do so or to encounter problems in the process in order to delay Scotland's accession. The quickest time in which the process of joining the EU has been completed is two years and nine months, for Finland.

Whatever the merits of Scotland's membership of the EU, its application risks becoming a pawn in unrelated national and international politics. The example of Spain, with its Catalonian separatist movement, was much cited at the time of the first referendum (subsequently, in 2017, there was an independence referendum that was unlawful under Spanish law and that led to the gaoling of some pro-independence politicians), but other member states may also have an interest in discouraging any popular disposition towards division. For example, Cyprus, Greece, Romania and Slovakia, along with Spain, have not recognised the independence of Kosovo, each for its own historical and cultural reasons. States with separatist movements might not oppose Scottish accession outright if done legally and with the agreement of the UK, but they will appreciate that the position of Scotland could set a precedent for subsequent secessions. They will have every incentive to make the accession process visibly arduous and costly. Scotland is setting a course across unknown, and quite possibly treacherous, terrain.

Duties and VAT

As an independent country, Scotland would be free to reach such agreement as it saw fit with rUK (within the bounds of international rules) on import duties and VAT, and to legislate as it wished. The goal of potential membership of the EU could, however, restrict Scotland's freedom of action in this area.

The EU would be unlikely to allow Scotland to inherit the opt-outs and special provisions enjoyed by the UK when it was a member of the EU, such as the opt-outs from the requirement to join the euro and from the Schengen borderless travel area. In particular, the border between rUK and a Scotland within the EU is likely to be a major aspect of negotiations. That border is currently completely open, to both people and goods, and would likely remain at least largely so under any independence agreement between Scotland and rUK.

If and when Scotland joined the EU, the position would be different. Northern Ireland offers an obvious parallel. Under the TCA between the EU and the UK, Northern Ireland is effectively within the EU's single market in order to keep its land border with the Republic open and thus to support the Belfast Agreement. The result of this is that goods entering Northern Ireland from Great Britain are subject to various EU border controls.

Similarly, some sort of border infrastructure between a Scotland in the EU and rUK would be needed in order to allow for the checks, certificates, duties and passport stamps currently required for goods and people to go from Dover to Calais (and vice versa) in order to uphold the principles of the EU's single market. This border "wall" – 154km long with 21 roads and two railway lines crossing it – could have serious implications for Scotland's trade with rUK. 60% of Scottish exports go to rUK; less than 20% of Scotland's exports go to the EU. Exports from rUK to Scotland represent a significantly lower proportion of rUK exports. By comparison, prior to Brexit, the UK's trade with the EU represented about 50% of its exports.

If it wished to join the EU, Scotland would have to adopt a VAT system consistent with EU VAT law. Whilst this may sound uncontroversial, given that Scotland was, until recently, part of the EU, the UK had many exemptions from the standard EU rules which are no longer available to countries now joining the EU. Unanimous amendment of the VAT Directive would be required to permit Scotland the use of similar derogations, and this seems unlikely.

For example, Scotland would likely be required to implement VAT on children's clothing at the main VAT rate and to charge a minimum VAT of 5% on books; in the UK, these items continue to have a 0% VAT rate. In addition, Scotland would lose the right to apply the 0% rate in relation to 54 different areas, including food, water and health care. Joining the EU may, therefore, lead to an increase in prices for Scottish consumers, with the result that some consumers may head south to do their shopping. This would be exacerbated by any changes which Scotland or rUK chooses to make to its VAT system, or simply by a natural divergence in the two systems over time.

Businesses with a presence in both Scottish and rUK entities will have to register for VAT and file VAT returns in both jurisdictions (rUK and Scotland).

Businesses will lose the ability to form a VAT group between their Scottish and rUK entities. This lack of VAT grouping will give rise to particular difficulties in those industries which rely heavily on VAT groups to mitigate the impact of irrecoverable VAT and/or to streamline business operations or minimise cash flow costs. Many financial groups, in particular, may need to reorganise their group structures and intra-group arrangements significantly, even if they only involve the use of service centres in Scotland.

Financial services

Scotland will need to establish its own financial regulator and resolution authority and make arrangements for continuing the licences and supervision of Scottish firms that are currently authorised and supervised by the UK authorities. The rUK regulators will continue to authorise and supervise rUK-incorporated firms.

Scotland and rUK would need to decide how they wished to deal with the regulation and supervision of firms from one jurisdiction that operate through branches in the other and the cross-border trade in financial services between the two jurisdictions.

One possibility might be a broad mutual recognition arrangement which aims to replicate many of the features of the passport regime within the EU – although this might not benefit non-UK firms currently operating through branches in the UK which deal with clients throughout the UK. However, Scotland's flexibility to operate a mutual recognition arrangement of this kind with rUK may be constrained if Scotland joins the EU; Scotland and rUK may end up treating each other's financial services firms in much the same way that the UK currently treats non-UK firms. Whilst the immediate impact might be mitigated by transitional provisions and equivalence decisions under inherited legislation, this could create significant barriers to cross-border trade in financial services between Scotland and rUK, at least as regards retail customers. The impact would be exacerbated to the extent that the regulatory regimes in Scotland and rUK diverged after independence.

If Scotland joins the EU, any previous equivalence decisions in favour of the UK may not need to be replaced by European Commission decisions under EU legislation. In any event, the rUK and Scottish regulators would need to put in place memoranda of understanding and other cooperation arrangements governing the supervision of cross-border activity. Financial services firms would need to prepare contingency plans for the possibility of new barriers to business between Scotland and rUK.

Similar issues would arise for the rUK-based trading venues, central counterparties, central securities depositories and payment systems that currently serve firms based in Scotland. These would continue to be regulated and supervised by rUK authorities, and the terms of access by Scottish firms would likely be similar to those of other non-UK firms. Absent any broader mutual recognition regime, Scotland may apply the inherited UK legislation to recognise the equivalence of UK regulation for the purposes of central counterparty clearing, central securities depositories and the securities and derivatives trading obligations, but if it rejoins the EU, those decisions would then be for the European Commission.

The new Scottish regulators would also need to put in place new memoranda of understanding or cooperation arrangements with EU and other non-UK regulators as they would no longer be parties to those negotiated by the UK regulators. Scottish firms would also need to confirm that their new home state and regulator do not adversely affect their ability to continue to operate through branches or cross-border in non-UK jurisdictions.

Defending the borders

In its preparations for the first referendum, the Scottish Government pointed out that, in 2007, the UK Government valued its military assets at £93 billion. Splitting this on a population basis would give Scotland a £7.8 billion share on independence.

The Scottish Government then earmarked certain assets it would like within its share, such as two frigates, four mine counter measures vessels, two offshore patrol vessels, two light artillery units, six helicopters, at least 12 typhoon jets and, within a decade of independence, 15,000 service personnel.

What the Scottish Government did not want was the Trident nuclear deterrent. It wanted an "early agreement on the speediest safe removal of nuclear weapons", and would make this a "priority for negotiations" with rUK. To emphasise its determination, it identified Faslane, the home of Trident, as the headquarters of the new Scottish defence forces. Given the lack of any obvious other venue for rUK's nuclear weapons, this could, at an early stage, make the negotiations between Scotland and rUK highly contentious.

Conclusion

The practical issues that arise on separating Scotland from rUK cannot be underestimated, despite the existence of a Scottish Government since devolution in 1999. Everything run on a UK-wide basis must be split. Laws that are in force in Scotland and in rUK on independence day will continue in force, but both countries need to look at their statute books in order to ensure that they meet the requirements of each country's new or revised form. For example, the Scottish judges sitting in the (rUK) Supreme Court will, presumably, be removed; the almost innumerable UK statutory references to Scotland may need removal or amendment; and the Royal Charter establishing the BBC provides for there to be a trust member for Scotland, who will, presumably, lose his post on independence day. The list is endless.

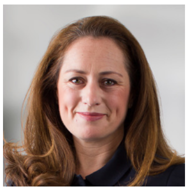
The practical issues go beyond the two Governments. Anyone with operations in, or dealings with, Scotland needs to consider how the changes required for, or wrought by, independence affect their position.

Much of the work to achieve separation will require negotiation between Scotland and rUK, which will be difficult, quite possibly fractious, given the divergence of interests between the two. Extensive quantities of black coffee may be needed to see people through late nights of negotiation, but, if anything is to be achieved, any stimulant must be supplemented by a huge amount of goodwill on all sides.

CONTACTS

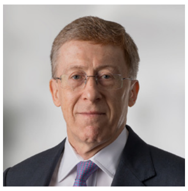
Chris Bates
Consultant
T: +44 207006 1041
E: chris.bates@
cliffordchance.com

Kate Gibbons
Partner
T: +44 207006 2544
E: kate.gibbons@
cliffordchance.com



Melissa Fogarty
Joint Head of Corporate, London
T: +44 207006 4699
E: melissa.fogarty@
cliffordchance.com

Simon Gleeson
Partner
T: +44 207006 4979
E: simon.gleeson@
cliffordchance.com



Simon James
Partner
T: +44 207006 8405
E: simon.james@
cliffordchance.com

Dan Neidle
Practice Area Leader,
TPE London
T: +44 207006 8811
E: dan.neidle@
cliffordchance.com

Mark Poulton
Partner
T: +44 207006 1434
E: mark.poulton@
cliffordchance.com

Hywel Robinson
Partner
T: +44 207006 8387
E: hywel.robinson@
cliffordchance.com

Phillip Souta
Head of UK Public Policy
T: +44 207006 1097
E: phillip.souta@
cliffordchance.com

Nigel Wellings
Joint Head of Corporate
T: +44 207006 8011
E: nigel.wellings@
cliffordchance.com

CLIFFORD

CHANCE

www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

2107-001425