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Scotland: The Succession Event Question

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Contacts

Patrick Clancy
London
+44.20.7655.5878
patrick.clancy@shearman.com

James Duncan
London
+44.20.7655.5757
james.duncan@shearman.com

Ian Harvey-Samuel
London
+44.20.7655.5000
ian.harvey-samuel@shearman.com

Azam Aziz
New York
+1.212.848.8154
aaziz@shearman.com

Geoffrey Goldman
New York
+1.212.848.4867
geoffrey.goldman@shearman.com

Donna Parisi
New York
+1.212.848.7367
dparisi@shearman.com

Thomas Donegan
London
+44.20.7655.5566
thomas.donegan@shearman.com

Barnabas W.B. Reynolds
London
+44.20.7655.5528
barney.reynolds@shearman.com

In this note we analyse some of the consequences for sovereign CDS resulting from a vote for Scottish independence.

Scotland: The Succession Event Question

A vote for an independent Scotland will have many consequences for the UK, as discussed in our recent client note¹. Unsurprisingly, the implications for UK sovereign CDS have not featured prominently in the public debate!

Independence for Scotland will, however, highlight some difficult issues that arise where a Sovereign Reference Entity loses territory or undergoes other significant change.

There are important differences between the relevant provisions of the 2003 ISDA Credit Derivatives Definitions (the 2003 Definitions) and the 2014 ISDA Credit Derivative Definitions (the 2014 Definitions). The 2014 Definitions potentially clarify many of the uncertainties existing in the 2003 Definitions but difficult issues remain.

Will a Credit Event occur?

A Credit Event must occur in order to trigger a protection payment under a CDS. Each of the standard Credit Events in the 2003 Definitions and 2014 Definitions requires events to have occurred in relation to relevant debt obligations of the Reference Entity. Loss of territory or the break-up of a country will not, of itself, constitute a Credit Event.

Will a Succession Event occur?

Under the 2003 Definitions, a Succession Event is “an event such as an annexation, unification, secession, partition, dissolution, consolidation, reconstitution or other event that results in any direct or indirect successor(s) to” the Sovereign which is the Reference Entity. This raises some difficult questions:

¹ <http://www.shearman.com/-/media/Files/NewsInsights/Publications/2014/09/Scotland-Legal-Issues-on-Proposed-Independence-FIA-091514.pdf>

- At what point will the relevant event have occurred? This may be unclear in a gradual devolution of power.
- Will the relevant event result in a “direct or indirect successor(s)” to the UK?

“Direct or indirect successor” is not defined in the 2003 Definitions. The definition of Sovereign² implies that any successor must have at least become responsible for certain governing functions of the former state. The likely transfer of powers to an independent Scotland points towards Scotland being a “successor” to the UK. On the other hand, the 2003 Definitions leave it open to take into account a wide range of factors (e.g. political, legal, economic, demographic, geographic). The remaining UK would continue to have a significantly larger economy and population than Scotland and it appears unlikely that Scotland will assume directly responsibility for any outstanding UK indebtedness³. It must at least be arguable that Scotland is not a “successor” to the UK in a broader, economic sense.

Under the 2014 Definitions, a Succession Event is an “annexation, unification, secession, partition, dissolution, consolidation, reconstitution or other similar event.” It seems clear under the 2014 Definitions that Scottish independence is likely to constitute a Succession Event. As with the 2003 Definitions, in a gradually changing situation, the precise point at which a Succession Event has occurred may be difficult to identify.

Under both sets of definitions, it is clear, however, that the vote itself (if “Yes”) will not be a Succession Event. There has to be some consequential event which satisfies the definitions.

If a Succession Event occurs, what are the consequences?

If a Succession Event occurs, the relevant Successor(s) to the UK will become a Reference Entity for the purposes of a CDS.

Under the 2003 Definitions, the Successor(s) will be “each entity which becomes a direct or indirect successor to the UK by way of Succession Event, irrespective of whether the successor assumes any of the obligations of the Reference Entity.” The answer to the question of whether or not there has been a Succession Event (which requires there to be a “direct or indirect successor”) will therefore identify the Successor(s) also. In contrast to the 2014 Definitions (below), the 2003 Definitions expressly contemplate that a Scottish Successor might not have assumed responsibility for any of the UK’s debt.

Under the 2003 Definitions, in the case of corporate Reference Entities, if there are multiple Successors, the original CDS would be split into separate single-name CDS. This does not, however, occur in the case of Sovereign CDS. If Scotland is a Successor, it appears there are simply two Reference Entities⁴ and, as a result, an affected CDS will in effect become a “first to default” CDS referencing the remaining UK and the new Scotland. This would be a radical change to the transaction originally agreed to by the parties.

² “Sovereign” means any state, political subdivision or government, or any agency, instrumentality, ministry, department or other authority (including, without limiting the foregoing, the central bank) thereof.

³ It is unlikely that investors in sovereign debt would accept a situation where the sovereign creditor changed substantially in nature. Accordingly, even if it was agreed that Scotland would accept economic responsibility for a proportion of UK indebtedness, it is likely that the remaining UK would remain liable to investors either potentially through a guarantee or as the primary obligor (with Scotland separately reimbursing the UK).

⁴ It is potentially unclear under the 2003 Definitions as to whether, after independence, the UK without Scotland would be a “Successor” to the original UK or continue to be the original Reference Entity. A literal application of the 2003 Definitions (which provide that any Successor shall become the Reference Entity for the relevant CDS) potentially suggests that if the UK without Scotland is not seen as a Successor it will not be a Reference Entity, which would be a very surprising outcome.

Under the 2014 Definitions it is clear that an independent Scotland will only be a Successor to the UK if Scotland succeeds to at least 25% of relevant UK debt obligations. This appears (at the moment) unlikely to occur. First, if there were to be any agreement that Scotland would accept the economic costs of a certain proportion of indebtedness, that is likely to comprise less than 25% of relevant UK debt obligations. Secondly, in order for a Successor to succeed to an obligation of the Reference Entity, the 2014 Definitions require the original Reference Entity to cease to be an obligor in respect of the relevant debt, including as guarantor, which as noted above is unlikely to occur⁵. If there were to be multiple Successors to a Sovereign Reference Entity, under the 2014 Definitions, a trade would be split into multiple CDS on a similar basis to the splitting of trades for corporate Reference Entities under the 2003 Definitions.

Conclusions

An independent Scotland potentially raises some difficult questions for the ISDA Credit Derivatives Determinations Committee (the “DC”).

Many issues are clearer under the 2014 Definitions – in particular, in order for there to be a Successor, an entity must have succeeded to at least 25% of the relevant obligations of the UK. As a result, under the 2014 Definitions, an independent Scotland is unlikely to lead to any Successor(s) for UK Sovereign CDS.

Outstanding CDS will, however, have been entered into under the 2003 Definitions (given that, at the date of writing, the 2014 Definitions are not yet in use), where the position is less clear. The DC may need to determine, against a complex factual background and with limited guidance within the definitions, whether or not events have resulted in a “successor” to the UK.

Of course, a subsequent default of an independent Scotland will not result in a Credit Event if Scotland is not determined to be a Successor and any holders of Sovereign UK CDS protection who were hedging, for example, macro-economic exposures in Scotland will need to re-hedge.

If the DC is called upon to consider this issue, there may potentially be significant implications for CDS in relation to other jurisdictions, such as the Ukraine and others.

⁵ It seems likely that in many, if not most, break-ups of a Sovereign jurisdiction, unless there is a significant restructuring of existing indebtedness, the original Reference Entity is likely to retain liability for existing indebtedness either through a guarantee or remaining as primary obligor, which may result in many potential Sovereign Succession Events not resulting in a Successor under the 2014 Definitions.