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## Credit Crunch Impact

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As we are all aware, financial markets have been in turmoil over the past six weeks triggered by the US sub-prime mortgage crisis. Thousands of column inches have been devoted to analysing the root causes of the turbulence and the potential effect over both the short- and mid-term. Many disparate views have been aired and although some of the reporting has been accurate and objective, much of it has been rather alarmist. The one common theme to emerge is that nobody quite feels yet, with any certainty, that they know how things will shake out going forward. When the European markets wound down for the traditional summer break people thought the situation would become clearer and that markets would return to some semblance of normality at the start of the autumn, but that has not been the case. The slicing, dicing and repackaging of debt in increasingly complex and opaque ways has made it almost impossible to identify who holds the “toxic waste” behind the current lack of market confidence, until the holders admit to it themselves. This current lack of clarity has left the markets in limbo with billions of dollars of suspended deals still out there. A period of market catharsis, where who holds what will become clear, will happen in due course. But until then uncertainty remains the watchword. Given this, what can we expect from the

markets at this point in time and what are the implications for the legal industry going forward?

It's certain that a more cautious approach will permeate the markets in future, at least for the mid-term, with a return to tighter risk management. The days of covenant-lite and bank-style equity bridges are long gone in the private equity world. There is likely to be a further delay in new leveraged deals coming to market while major banks that were left holding as much as \$360 billion of underwritten but as yet unsyndicated debt over the summer seek to clear their balance sheets. However, private equity firms are awash with cash to invest so it is likely this market will bounce back albeit on more traditional credit, leverage, covenant and pricing terms, which some would argue is a positive market adjustment in any event. The pace of the recovery will depend to some degree on how quickly the banks can push the backlog of loans into the market and at what price. In the meantime cash-rich corporates, previously squeezed out of the market by the private equity surge, will seek to take advantage of the current conditions, so good M&A lawyers are likely to stay busy.

The spread of the sub-prime contagion to hedge funds, whether through lack



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of investor confidence or more directly, as well as to the CDO market and SIVs is likely to raise the temperature for contentious claims (whether justified or not), including in connection with realisations of collateral on prime brokerage contracts in the current restricted market. More positively, there are likely to be calls to restructure the complex make-up of these vehicles in order to weather the current storm rather than see a disorderly sale under rules not suited to the current irrational sentiment. Insolvency firms and lawyers are likely to be busy dismantling failed investment vehicles, with the most likely suspects being some of the quantitative hedge funds and funds focussed on CDOs which have fallen foul of market conditions.

Although the current credit market correction has impacted all asset classes in one way or another, there are as yet no signs of the brakes being applied to global economic growth. The global outlook remains broadly positive, with new drivers of the world economy, such as China and India, still going strong and corporate balance sheets looking in good shape. It is unlikely that we will see leveraged defaults and restructurings in the short-term, particularly in light of fewer amortising pieces of debt in current structures and seemingly a freeze on the upward trend in interest rates. However, if economic conditions do take a turn for the worse, law firms with expertise in insolvency and financial restructuring will obviously be more resilient.

As in all situations where change is possible, the ability to adapt rapidly will be key. Quality law firms with breadth and depth of global reach, coupled with diversified strong product mixes will be best equipped to succeed in these uncertain times. The legal industry is generally better prepared than ever to deal with uncertain markets having learnt some important lessons from the past. Hopefully we will see the markets stabilise in the short-term and the return of investor confidence and liquidity, albeit in a more rigorous and risk-conscious environment. Time will tell and most will simply wait and see.

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