

## Supreme Court Upholds Decision on Arranger's Liability in Syndicated Loan Transactions

Since the April 2011 decision of the Nagoya High Court ruling that an arranger in a syndicated loan transaction owed an obligation to provide certain adverse financial information about a borrower to the participating financial institutions (the High Court Decision), there has been some uncertainty in the Japanese lending market about the scope of an arranger's liability to other financial institutions participating in a syndicated loan transaction.

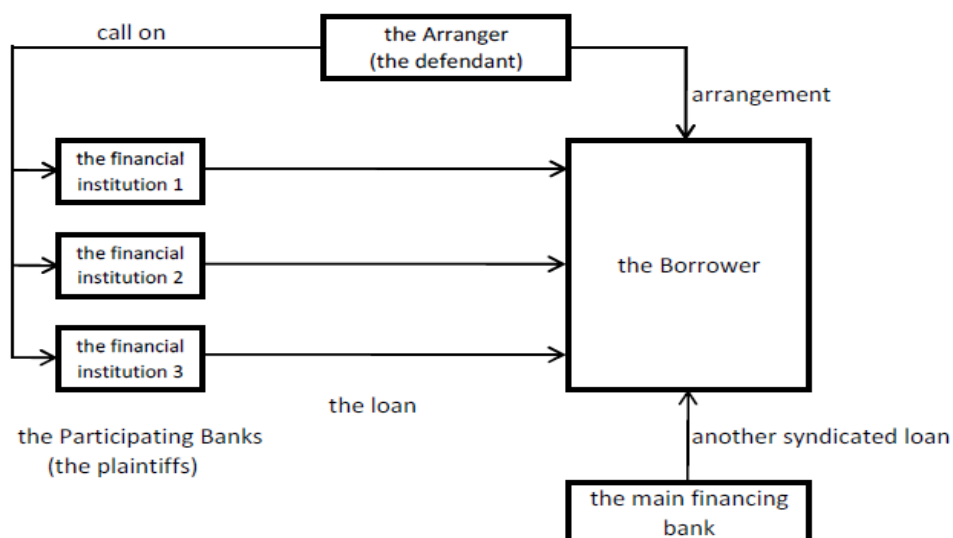
The November 2012 decision of the Supreme Court of Japan (the Supreme Court Decision) has clarified this scope of liability to a certain extent and, although it upheld the High Court Decision, its reasoning differs significantly. The Supreme Court Decision has sparked much debate in the Japanese loan market and could mean further uncertainty regarding an arranger's liability in syndicated loan transactions in Japan. The practical impact of the Supreme Court Decision is that Japanese financial institutions should:

- (i) re-examine their internal rules on how to act when dealing with material information from the borrower when they are acting as an arranger of a syndicated loan; and
- (ii) act with care and diligence when acting as a participating financial institution in a syndicated loan, in reviewing information provided by an arranger, since an arranger's liability may be reduced due to contributory negligence of such participating financial institution.

### Background

This case revolves around a syndicated loan (the Loan) arranged by the defendant bank (the Arranger) and provided by three financial institutions which are the plaintiffs (the Participating Banks) against a local company (the Borrower). One month after the execution of the loan agreement, another syndicated loan which had been arranged by the Borrower's main financing bank was accelerated and, as a result, civil rehabilitation proceedings were commenced by the Borrower. Consequently, the Borrower defaulted on the Loan and the Participating Banks suffered considerable losses that led the Participating Banks to file a suit against the Arranger for damages.

The case centred around the fraudulent accounting practices of the Borrower and whether the Arranger should have disclosed this information.



## High Court Decision

On the basis that the Arranger suspected the existence of fraudulent accounting by the Borrower, the High Court determined that the Arranger owed the Participating Banks an obligation to disclose the information on the Borrower's creditworthiness under the principle of good faith and set out general rules for when this liability arose. Further, it was held that the Arranger was liable for damages in tort in favour of the Participating Banks as the Arranger breached the obligation. In these circumstances, disclosure of the information by the Arranger did not breach the confidentiality obligation owed to the Borrower, for which the Arranger had contended was the basis on which the Arranger could not disclose the information.

## Supreme Court Decision

The Supreme Court focused on two issues from the High Court Decision:

- an Arranger's obligation to provide information to the Participating Banks and its scope; and
- the relationship between the obligation to provide information to the Participating Banks and the confidentiality obligation owed to the Borrower.

Ultimately, on the facts of this case, the Supreme Court upheld the conclusions of the High Court Decision, however the Supreme Court did not support the reasoning of the High Court Decision in reaching that conclusion. It is generally understood that the Supreme Court implied that each case was to be decided on its own circumstances and stopped short of outlining a general set of rules to which an arranger must adhere, therefore moving away from a rule-based approach to the scope of liability as set out in the High Court Decision.

## Arranger's Obligation to Provide Information and its Scope

The Supreme Court Decision upholds that the Arranger was obliged to provide the information to the Participating Banks under the principle of good faith, since:

- (i) the main financing bank of the Borrower had suspicion as to the financial statements of the Borrower in terms of possible fraudulent accounting;
- (ii) the main financing bank had strongly requested the Borrower to conduct a careful review of the financial statement by an external professional; and

- (iii) the main financing bank had previously made the Borrower inform the participating banks in another syndicated loan transaction of the information in (i) and (ii) above.

However, the Supreme Court did not uphold the general rules as to arrangers' obligations to provide information, or the definition of what amounts to "material information" as delineated by the High Court.

## Relationship between Obligation to Provide Information and Confidentiality Obligation

The Supreme Court did not uphold the general rules formulated by the High Court, when considering whether for the Arranger to disclose such information would breach the confidentiality obligation owed to the Borrower. Instead, the Supreme Court simply determined that on the facts of this case, there was no breach of confidentiality. It is generally understood that such matters should be determined on a case-by-case basis.

On a different set of facts, such disclosure by an arranger may constitute a breach of the confidentiality obligation to the borrower. Thus it is not advisable that an arranger discloses the material information to the participating financial institutions directly.

It is also understood that the Supreme Court Decision does not conflict with the rules of the Japan Syndicated and Loan-trading Association (JSLA). Under the rules of the JSLA, the arranger should request that the borrower disclose the material information to the participating financial institutions rather than disclosing such material information to the participating financial institutions directly.

## Looking Forward

Based on the Supreme Court Decision:

- arrangers who become aware of material information regarding a borrower's creditworthiness should request that the borrower discloses this information itself to the participating financial institutions – rather than the arranger doing it directly. This approach is in line with the JSLA rules,
- participating financial institutions should be more diligent when conducting a review of a borrower's creditworthiness, since if any adverse financial information can be easily identified, this may impact any claim against an arranger. If an arranger can allege that a participating financial institution had acted negligently by failing to investigate the borrower's financial accounts, the arranger's liability for damages in tort may be mitigated to such extent.

*Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.*

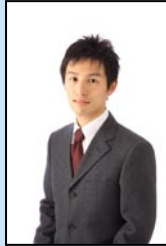
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