

Research on Civil Liability for False Statements by Securities Service Institutions

-- A Case Study of Wuyang Bonds

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Abstract

Wuyang Construction Group Co., Ltd. is the first issuer who was administratively punished for bond fraudulent issuance after the China Securities Regulatory Commission promoted the expansion of the exchange bond market. The final judgment in this case opened the first false statement of the bond market civil damage compensation. In December 2021, the Central Economic Conference held in Beijing deployed the task of "fully implementing the stock issuance registration system". Through the study of the "Wuyang Bond Case", this paper analyzes the functional positioning of securities service institutions in the primary securities market, analyzes the degree of fault from the performance of their relevant obligations, and discusses the constituent elements of the tort liability of securities service institutions in combination with the cause force. Studying on how to scientifically divide the joint and several liabilities of securities service institutions, in order to provide some opinions on the behavior of securities service institutions themselves and the determination of civil liability by power subjects.

Keywords

Civil Liability; Securities Service Institutions; False Statements.

1. Case Briefing

Wuyang Construction Group Co., Ltd. (hereinafter referred to as "Wuyang Construction") issued two bonds in 2015. Securities service agencies include Debang Securities Co., Ltd., Daxin Accounting Firm, Dagong International Credit Evaluation Co., Ltd. and Allbright Law firm. Both bonds have obtained AA's Credit rating. On August 10, 2017, the China Securities Regulatory Commission filed a case for investigation on Wuyang Construction. A total of 20 responsible persons, including Chen Zhizhang, chairman of Wuyang Construction and Wuyang Construction itself, were subject to administrative penalties. Investors then take the issuer and the securities service institutions to court to claim liability.

2. Referee's Opinion

The court held that the fictitious financial data of Wuyang Construction constitute fraudulent issuance and false statements, and should be liable for the losses of investors. Debang Securities is the bonds underwriter and Daxin accountant in this case who issued false audit reports for the annual financial statements of Wuyang Construction, are both failed to perform the duty of loyalty and diligence, who should be jointly and severally liable for the debts of Wuyang Construction. Although Dagong Agency and Allbright Law Firm only had a general obligation of attention to matters related to financial data, they had not paid attention to and reminded matters that may involve bond issuance conditions, major asset changes in solvency, major creditor's rights and debts, etc. There were certain faults and were not diligent and dutiful. At

the discretion of the judge, Dagong Agency should bear joint and several responsibilities with Wuyang Construction within 10% , Allbright Law Firm should bear within 5% joint and several liabilities with Wuyang Construction.

3. Juristical Analysis

3.1. Analysis of the Nature of Civil Liability of Securities Service Institutions

In this case, Debang Securities and other institutions were subjectively found to be negligent and should have borne untrue joint and several liability. In general, because Wuyang Construction has entered the bankruptcy process, it is difficult for securities service institutions to recover from Wuyang Construction internally after assuming civil liability to investors, which invalidates the untrue joint and several liability system design and the civil liability borne by securities service institutions is abnormally heavy.

3.2. Analyze from the Perspective of Materiality

The premise for the establishment of bond false statements is that the relevant false statement information is of great importance. In judicial practice, the materiality standard of securities false statements can be judged from two aspects.

Firstly, the information of false statements can lead to the level of administrative penalty. Article 85 of the Minutes of the National Court Civil and Commercial Trial Work Conference clearly determines the material elements of false statements, that is, administrative penalty decisions can be referring to the information that may have an important impact on investors' investment decisions. What's more, false statements that have been administratively punished have the significance of illegal acts. Hangzhou Intermediate People's Court mainly believed that the above-mentioned information disclosure violations meet the requirements of "majority" based on the decision of administrative penalty of the China Securities Regulatory Commission on the construction of Wuyang.

Secondly, the false statement information is sufficient to have a significant impact on the solvency of the issuer. Article 81 of the new Securities Law stipulates for the first time major events of temporary bond information disclosure, defining major events as events that may have a greater impact on bond trading prices of listed trading companies. The major events listed in this article include qualitative and quantitative indicators, which are sufficient to have a significant impact on the issuer's solvency. Although this article mainly discusses false statements occurring in the continuous information disclosure stage, and does not stipulate the material information standards of securities service institutions at the due diligence stage before bond issuance. In order to ensure the identity of information, reference can be made to the application of this article.

3.3. Identification of the Scope of Civil Liability Compensation

The judgment of this case required Debang Securities and Daxin Accounting firm to be jointly and severally liable for the principal and interest of all debts. Dagong Agency and Allbright Law Firm should be jointly and severally liable for the principal and interest of the debt within the scope of 10% and 5% respectively. In terms of compensation, the fact is that it's determined that the securities service institutions should be jointly and severally liable for the issuer's breach of contract liability, making securities service institutions undertake the obligation of rigid payment, replace the role of the issuer and pays the principal and outstanding bond benefits to investors.

3.3.1. Administrative Liability ≠ Civil Liability

Administrative punishment is an authoritative evaluation of the compliance of Securities service institutions, and does not mean that the institution is officio exempt from civil liability.

Comparing similar cases of false statements, it can be seen that even if some securities service institutions do not have to bear civil liability in the final judgment, the people's court still verify whether they have fulfilled their diligence obligations, rather than directly finding that they do not need to bear civil liability because they have not received administrative penalties.

3.3.2. Determination of Fault

In terms of verification responsibilities of securities service institutions, the Minutes of the Symposium on the Trial of Bond Dispute Cases by National Courts issued on July 15, 2020 establishes the general principle of fault determination of securities service institutions for the first time, that is, whether fail to fulfill the obligation of special attention to the verification of business matters related to their profession and fulfill the obligation of ordinary attention for the verification of other operational matters. At the same time, Article 30 stipulates four specific grounds for exemption from liability that the judiciary should determine that there is no fault in securities services, including the reasonable adjustment work carried out in accordance with relevant provisions, the defects in the adjustment work are basically irrelevant to the failure to find false statements, and the performance of special or ordinary situations subject to the existence of expert opinions.

3.3.3. Cause Force

Article 16 of the 2014 edition of the Securities Law stipulates the conditions to be met for the public issuance of corporate bonds, one of which is that the average distributable profit over the last three years is enough to pay the interest on the company's bonds for one year. According to the facts ascertained by the court, when preparing the financial statements for the period from 2012 to 2014, Wuyang Construction violated accounting standards, discounted the accounts receivable and payables of the construction projects and inflated the accounts receivable and accounts payable of the enterprise, resulting in bad debt provisions and over-accrued profits in the above-mentioned years. The truth is that its average profit in the last three years was not enough to pay one-year interest on corporate bonds, which did not meet the conditions for bond issuance stipulated in the Securities Law. It was a fraudulent issuance of bonds.

Among them, Debang Security, as a sponsor, had insufficient prudent verification of investment real estate projects. If it performed its diligence obligation and found abnormal reasons, it could prevent the fraudulent issuance of "Wuyang Bond". Whether or not the cause directly caused Wuyang Construction to lose its ability to repay on time, the reason for the fraudulent issuance was enough to make Debang Security fully and jointly and severally liable in this case. As a professional audit institution, Daxin Accounting firm's behaviors had a certain social public welfare. Investors had reason to trust the professionalism of Daxin Accounting firm and the authenticity, accuracy and completeness of the content of the documents and materials it relies on. Other securities service institutions without professional financial skills will trust the audit report after reasonable verification and express professional opinions on this basis. Daxin Accounting firm should bear all joint and several liabilities by issuing audit reports with false records without fulfilling its obligation to pay special attention.

Although Allbright Law Firm and Dagong Agency didn't have professional financial knowledge, they should pay general attention to major asset changes and major creditor's rights and debts related to the issuer's solvency and debt issuance conditions. Investors had reason to trust their professional opinions, so from the perspective of cause power, they should separately assume joint and several liability within the range of 5% and 10% of the issuer's liability.

4. The Practical Significance of the "Wuyang Construction" Case

As the first case involving the false statements of securities service institutions, the "Wuyang Bond Case" was punished at sky-high prices. As soon as the judgment result came out, it triggered heated discussion in academia.

The author believes that there is indeed something that can be improved in the judgment in this case. For example, the judgment of first instance did not distinguish between the liability for breach of contract and tort liability arising from the false statement of Wuyang Construction, nor did it calculate the joint and several liability of securities service institutions based on the liability for breach of contract. According to the provisions of the Securities Law, securities service institutions only bear joint and several liability to investors for tort damages, and in this case, it seems abnormal that securities service institutions to bear joint and several liability for all creditor's rights principal and interest, which is precisely the issuer's liability for breach of contract. At the same time, the court in this case did not consider the losses caused by systemic or non-systemic risks. The Bond Dispute Summary pointed out that if the factors causing losses are not related to fraudulent issuance or misrepresentation, the liability of the securities service agency should be reduced or exempted from liability for the extent of the cause force.

At the same time, the judgment results of this case reflect the pursuit of judicial value of joint and several liability distribution to a certain extent - that is, deter illegal acts in the securities market and safeguard investors' rights and interests. As the first case of fraudulent issuance of corporate bonds in China, the joint and several liability of intermediaries that have been officially punished in this case can play a good warning role for intermediaries. Under the bond default, it is difficult to protect the rights and interests of investors. According to the provisions of the Bankruptcy Law, after Wuyang Construction entered bankruptcy reorganization, investors only enjoy ordinary creditor's rights to the issuer, and it is difficult to obtain repayment because the order of repayment is worse than the secured creditor's rights, employee creditor's rights and tax claims. In this case, it is well-founded that securities service institutions should bear joint and several liability for compensation, which can not only better protect the rights and interests of investors, but also play a warning role to the market. Intermediaries should do a good job as "gatekeepers", instead of passing the buck to each other and evading responsibilities.

5. Conclusion

In securities false statements, the responsibility of securities service institutions is intertwined with tort law, securities law, company law, etc. It not only involves the conflict between the special liability norms of securities law and the general liability norms of tort law, but also involves how to scientifically use the general liability norms of tort law to make it necessary for the special norms of securities law. In order to reasonably define the tort liability of securities service institutions in terms of system design and accurately determine the responsibility of securities service institutions in individual cases, it is necessary to identify and recognize the nature of the legal relationship where securities service institutions are located, as well as the due responsibilities, norms and duty of attention of securities service institutions. At a more macro level, how to accurately grasp the legal attributes of the verification obligations of securities service institutions and reasonably solve the phenomenon of existing legislative conflicts in order to protect the balance between investors' trust interests and securities service institutions to the greatest extent are still worth advancing studies.

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