Capital Markets

Compensation to investors by third party advisors on regulated securities markets

Important ruling placing the liability for fraud committed by issuers on BME Growth registered advisors.

ÁNGEL CARRASCO PERERA
Professor of Civil Law, University of Castilla-La Mancha
Academic Counsel, Gómez-Acebo & Pombo

Reyes Palá Laguna has just published in *GA-P Analysis* a detailed commentary on the Gowex judgment (Judgment no. 539/2023 of the Civil Division of the Supreme Court of 19 April), which orders Ernst & Young Servicios Corporativos S.L. (hereinafter "Ernst & Young" or "E&Y-SC"), the MAB - today BME Growth - registered advisor for Gowex, to pay compensation to four investors on the grounds that, given the "serious and gross" misrepresentation of the information provided by Gowex to the market, the requirements for finding liability in tort of the registered advisor for breach of the duties imposed on it by the internal rules of Bolsas y Mercados Españoles ("BME") are met. On 1 July 2014, the U.S. company Gotham City Research LLP independently published a report analysing the situation of Gowex; among other things, it concluded that the value of the share is zero and that approximately ninety percent of the profits declared by Gowex are non-existent.

The investors' appeal is lodged on the grounds of an infringement of Art. 1902 of the Spanish Civil Code ("CC") in relation to Art. 120(e) of the Spanish Securities Market Act ("LMV") as amended by Act 5/2015 of 27 April. This provision imposes a *culpa in vigilando* liability of sorts on registered advisors with regard to compliance by issuers with their disclosure obligations vis-à-vis the company managing and operating the alternative stock market and vis-à-vis "investors".

I refer to my colleague's commentary and make three observations regarding the compensation awarded to the claimants:

— **First**

Let us note that these are compensatory damages based on fraud-on-the-market theory. As the market price incorporates or will incorporate all existing information, if Gowex's situation had been known at the time of the claimants' acquisition, the price would have been tendentially zero and the loss would not have occurred. The difference between the false market price and the real price that would have incorporated the information provided by Gotham is the loss suffered. For the calculation of this loss it is irrelevant whether the investors knew or specifically relied on the information disclosed by Ernst & Young or on the assurance of conformity provided by it as to the degree of compliance by Gowex.

Only the claim of one of the investors for the shares acquired on the MAB on 2 July 2014, i.e. the day after Gotham's report on the disastrous financial standing of Gowex was made public, is not upheld. It does not matter in this case either that this investor had relied (and acted on this reliance) on Ernest & Young's previous statements and that he had been misled by these. "With regard to the €654.63 of the 37 Gowex shares purchased by Mr. A on 2 July 2014, when the price had plummeted due to the publication of the Gotham report, it must be concluded that there is no causal link between the actions of EY and the loss suffered by the claimant, since he purchased when the report revealing the fraud and, therefore, the incorrectness of the information conveyed by Gowex to the MAB to which the actions of the registered advisor referred had already been published. Therefore, it is not appropriate to order the payment of any damages for those shares purchased on 2 July". But this statement is only correct if in fact on 2 July 2014 the *actual* price of the shares had been the price paid by the purchaser in question. Moreso, on this day the market had not incorporated the *whole* truth about Gowex and, therefore, the price paid was still higher than the real value of these shares. Why should compensation not be paid for the difference between the two? If the rejection is based on the fact that the day before, information had been made public that questioned the real value of Gowex, and placed the investor at his own risk, we will no longer apply the theory of abstract endangerment, making the investor responsible *for having continued to rely on the market*. Indeed, if we agree to compensate the investors for the full value of the investment when they bought at the price at which it was worth the most, assuming that the value was then zero, how could the value of the shares that were then bought at 654 euros not also be zero? The present judgment is on this point not only incorrect, but contrary to the view held in the Supreme Court Judgment no 380/2021 (*Bankia* case), which precisely corrected the Provincial Court's view that is now being held.

— **Second**

The Supreme Court orders Ernst & Young to compensate the investors for the amount invested "minus the liquidating dividend that they may have received if Gowex's insolvency liquidation has already been completed and any amount on such account has been paid to the shareholders, or with the assignment to E&YSC of the claim that the claimants had on that account in the aforementioned insolvency proceedings, if it had not yet concluded, with the interest accrued at the statutory interest rate, from the date of filing of the claim". This is a strange way of pronouncing a judgement ordering the payment of a sum of money. It should be noted that this payment order does

not fix a liquidated sum for the purposes of procedural enforcement. It was Ernst & Young who should have proved that the investors obtained liquidating dividend from the liquidation of Gowex, at the risk of not being able to apply this discount in the future; and the order cannot be left hanging subject to such a condition. It should be noted that in a future enforcement trial, the investors will not be able to sue for the amount invested, as it is not liquidated, nor will Ernst & Young be able to raise the insolvency payment as a sort of defence if the amount invested were claimed, because such a defence does not fit in Art. 556 of the Spanish Civil Procedure Act ("LEC"). The same occurs with the assignment of any insolvency claims payable upon distribution: as there is no order in this regard (nobody requested it), Ernst & Young cannot request enforcement of an order for this claim to be assigned to it and we doubt that reliable proof of such an assignment by the investors would serve to make the amount for which enforcement would be ordered liquidated.

Strictly speaking, the obligated assignment is a technique already pretermitted by time. It is an imitation of the *beneficium cedendarum actionum* of the Roman guarantor, which in modern language is replaced by the ex lege subrogation of whoever pays having an interest in the performance of the obligation (Art. 1210(3) CC). And it will be incumbent upon Ernst & Young to enforce this subrogation in Gowex's insolvency proceedings, without the need to seek a formal assignment of the claim.

— **Third**

The Supreme Court amends a singular argument of the Provincial Court. According to the Provincial Court, as there was no malicious intent in the actions of Ernst & Young as registered advisor, on the basis of Article 1107.II CC, the latter should not compensate the purely financial loss. The Supreme Court judgment disqualifies this argument:

> [W]hat this legal provision provides, which case law has long considered also applicable to liability in tort (judgments of the First Division of the Supreme Court of 20 June 1989 and 24 November 1995, among others), is not a differentiation between purely financial loss and damage of another nature, but between the losses foreseen or which could have been foreseen and which are a necessary consequence of the non-performance, for which the non-performer is liable in any case (Art. 1107.I CC), and all harm that is a known consequence of the non-performance of the obligation, for which the non-performer is only liable in the case of malicious intent (Art. 1107.II CC). In the present case, it was foreseeable that the lack of adequate control of the information provided by the issuer to be made available to investors could lead to an incorrect formation of the price of its shares and harm to investors when the correct information were known and that this circumstance would affect the price of the shares.

The Supreme Court's reasoning is correct. Harm is a *purely financial loss* if it has a direct impact on the profit and loss figure without previously or simultaneously producing damage to a tangible or intangible asset. The situation of Gowex's investors was of this kind, as they did not suffer detriment to their property rights, but rather to the financial composition of their assets as a result of Gowex's bankruptcy. This harm is purely financial. But the distinction between material damage and pure financial loss is not found in Art. 1107 CC, which refers to something else. Moreover, the pure class

of contractual pecuniary harm is precisely a purely financial loss, because for the defence of a right to compensation in respect of assets, liability in tort can also be used. Precisely because the investors are contracting parties of Gowex, they can claim compensation for this loss. And for the same reason, third parties who only have a defence in tort against Gowex cannot; for example, a second purchaser or the company to which the investors have contributed the securities or a pledgee who has accepted the securities as a pledge, could not do so.

However, it turns out that the investors had standing to sue on the basis of Art. 1902 CC and claimed that this was the provision that had been infringed. The Provincial Court was therefore right. According to the principle of congruence, the action should have been dismissed, because the investors had not suffered harm to any of their pre-investment assets or to other assets acquired after the investment. The existing civil case law on "concurrence of liabilities" would have allowed the Supreme Court to "reclassify" the actual action brought without being inconsistent. But at least such a reclassification should have been argued: either Art. 1902 CC has not been infringed or, if it has been, then the investors should not be compensated.

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