

UPDATE

# Fair value discovery: Court of Appeal says Grand Court was justified in ordering forensic IT audit

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In "fair value proceedings", there is a significant information imbalance between the dissenting shareholders, who are essentially outsiders, and the company which holds all of the relevant information as to the fair value of its shares. The discovery process seeks to correct this information imbalance by requiring disclosure of relevant documents by the company.

In a recent decision, the Court of Appeal refused an application by a company for leave to appeal from an order of the Grand Court designed to ensure that the company fully complied with its discovery obligations. The Court of Appeal has confirmed that the Grand Court has a broad jurisdiction to ensure compliance including, in exceptional cases, by ordering an audit of the company's IT systems and other electronic devices.

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In *Qihoo 360 Technology Ltd*,<sup>1</sup> shareholders which had dissented to the offer for their shares made by *Qihoo 360 Technology Ltd* (the **Company**) following a merger under Part XVI of the Companies Law (2016 Revision) (the **Law**) were not satisfied with the disclosure given by the Company in proceedings before the Grand Court seeking a determination of the fair value of the Company's shares. The dissenting shareholders (both funds managed by Maso Capital) (**Dissenters**) were not convinced that the Company had complied with its discovery obligations and obtained orders from the Grand Court for:

- service of a further verified list of documents by the Company;
- specific discovery of correspondence between the Company and its financial advisor and former attorneys; and
- the appointment of an expert to conduct a search of the Company's IT systems and electronic devices for relevant documents.

The Company applied to the Court of Appeal for leave to appeal the Grand Court's orders. By rejecting the Company's application for leave to appeal, the Court of Appeal has confirmed that the Grand Court has a broad jurisdiction to ensure compliance with discovery orders. The Grand Court's jurisdiction is especially broad in the context of fair value petitions where, to complete its sole task of determining the fair value of the dissenting shareholders' shares, the Court needs full information from the Company.

## Specific discovery and a verified list of documents

The Dissenters were not satisfied that the Company had properly conducted its discovery and sought further discovery of all relevant documents to a determination of fair value and specific discovery of a number of identified documents or categories of documents.

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<sup>1</sup> *In the matter of Qihoo 360 Technology Ltd* (unreported, 31 August 2017 (CA)).

In the Grand Court, Justice Mangatal confirmed that in petitions brought under section 238 of the Law (a **s238 Petition**), the sole task for the Court is to determine the fair value of the Company's shares and the discovery exercise is absolutely central to this task given that the Company holds all of the relevant information. Mangatal J accepted that, for the vast majority of the documents sought, the Dissenters relied on a subjective view that the documents existed and that, in the usual case, the Company's evidence verifying its discovery would be conclusive as to whether or not the Company had complied with its discovery obligations. However, Mangatal J was concerned with the Company's approach to the discovery process which her Ladyship termed as "somewhat careless and cavalier resulting in incomplete and ineffective discovery". Mangatal J ordered the Company to provide a further and better list of documents and ordered disclosure of some of the specific documents sought including emails between the Company and its financial advisor and former attorneys. The Dissenters were unable to demonstrate objectively the existence of the remaining specific documents sought.

The Company sought leave to appeal the decision of Mangatal J on grounds that the Judge erred in law by failing to properly apply the test for specific discovery and failed to consider how the perceived deficiencies in the Company's discovery were preventing the expert from preparing his report on fair value. The Company also argued that her Ladyship was wrong in law to treat the Company's verifying affidavit as not conclusive that the Company had properly complied with its discovery obligations.

The Court of Appeal refused the Company's application. Mangatal J had considered that, in s238 Petitions, the discovery exercise was central to the determination of the value of the Dissenters' shares and experts had a special role to play. Mangatal J properly accepted that the Dissenters' expert must express his views as to relevance with independence and that she was not in a position to second guess or sift through the expert's assertion of relevance of the documents requested, particularly without cross-examination of the expert.

The Court of Appeal also considered that Mangatal J was entitled to conclude that, despite the Company's assertions to the contrary, complete disclosure had not been given. Mangatal J was right to recognise that there were exceptions to the general rule that an affidavit verifying that full discovery had been provided is conclusive. The Court of Appeal stated that the rationale for the presumption of conclusivity does not apply in the special circumstances of a s238 Petition. In most litigation, allegations of suppression of documents are capable of being relevant not only to discovery but to the substantive issues in the litigation. However, in s238 Petitions, the absence of discovery cannot be dealt with by drawing adverse inferences against the party failing to disclose because the sole task of the Court is to determine the fair value of the dissenters' shares, which requires that the Court receive full information. If that information is lacking in some material respect, concluding it has been deliberately withheld does not help the Court identify its contents and, by ordering its disclosure, the Court is not prejudging any substantive issue in the litigation. The Court of Appeal held that there no reasonable prospect of the Company succeeding on appeal on this ground.

### **Appointment of a forensic IT expert**

Given the unsatisfactory nature of the Company's disclosure, in the Grand Court the Dissenters also sought, and were successful in obtaining, the appointment of a forensic expert to conduct an audit of the Company's IT systems and all electronic devices for documents containing designated key words in order to ensure that the Company's discovery would be properly conducted. Mangatal J held that while the appointment of a forensic IT expert is an exceptional remedy, it was justified in the circumstances given the Company's inconsistent and cavalier approach to discovery, the central importance of discovery in fair value proceedings, the Company's role in that process and the high value and considerable complexity of the case.

The Company sought leave to appeal the order of Mangatal J on grounds that an order for the appointment of a forensic IT expert was outside the powers of the court under its discovery and inherent jurisdiction. The Company argued that the order was a highly intrusive form of injunctive relief which was unjustified and wholly inappropriate.

The Court of Appeal refused the Company's application for leave as Mangatal J had properly exercised the Court's inherent jurisdiction to ensure that its orders are observed. The inherent jurisdiction of the Court to deal with deficiencies in discovery cannot be less wide. Although Mangatal J did not rely on it, there was also a jurisdictional basis for the order in the Grand Court Rules, pursuant to which the Court has a wide discretion as to the orders it can make if a discovery order is not complied with. Mangatal J had ample grounds for concluding that a forensic audit was the only practical way of ensuring that the Company

complied with its disclosure obligations and properly put protections in place for the Company, including in relation to preserving privilege. The Court of Appeal held that the exceptional nature of this order did not give rise to a sufficient point of general importance to justify an appeal.

The Court of Appeal emphasised that there is a danger of abuse of the autonomy that is of necessity given to experts in s238 Petitions. The Court of Appeal warned that an expert cannot be abusive in its requests for further information and stressed that, although it has occurred in two s238 Petitions to date, the appointment of a forensic IT expert is an exceptional remedy that will not be appropriate in every s238 Petition simply because a company has given inadequate disclosure.

## Conclusion

The Court of Appeal's confirmation of Mangatal J's decision will be reassuring for those shareholders who have dissented to transactions of this nature in that, as outsiders of the company, they will not be barred from obtaining an "insider's" view of the company in circumstances where a company's disclosure efforts are inadequate. The Grand Court and Court of Appeal have demonstrated a willingness to ensure that companies fully comply with their discovery obligations, particularly in the context of fair value proceedings where the discovery process is of central importance to the fair value determination. Companies who fail to take their discovery obligations seriously in the future will no doubt face similar sanction from the Court.

## Contacts

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