

DELAWARE BUSINESS COURT INSIDER

Del. High Court Further Clarifies Standard for Confidentiality of Books and Records Produced Under DGCL Section 220

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The ability of a stockholder to obtain books and records of a Delaware corporation through Section 220 of the Delaware General Corporation Law (DGCL) is frequently litigated in the Delaware Court of Chancery. Often, the parties to such litigation agree to confidentiality restrictions regarding such document productions. A recent Delaware Supreme Court case, *Hauppauge Digital v. Rivest*, 2023 Del. LEXIS 211 (Del. July 10, 2023), provides important guidance about such confidentiality agreements.

In *Tiger v. Boast Apparel*, 214 A.3d 933 (Del. 2019), the Supreme Court set forth a balancing test to apply in these circumstances. In doing so, the Tiger court rejected the notion that Section 220 productions have a presumption of confidentiality, and required the Court of Chancery to “assess and compare benefits and harms when determining the initial degree and duration of confidentiality,” as well as when modifying any confidentiality restriction. *Tiger*, 214 A.3d at 939. Among other considerations, the Court of Chancery must “weigh the stockholder’s legitimate interests in free communication against the corporation’s legitimate interests in confidentiality.”

In the *Hauppauge Digital* case, the court affirmed the Court of Chancery’s discretion to reject the parties’ proposed confidentiality restrictions, and held that the decision regarding confidentiality restrictions is “a context-driven balancing exercise, the result of which will not be disturbed on appeal unless clearly unreasonable or capricious.”

Proceedings Before the Magistrate in Chancery and the Vice Chancellor

In 2019, James Rivest, a stockholder of the consumer-electronics company Hauppauge Digital, Inc. (Hauppauge or the company), demanded the company produce books and records to assist Rivest in valuing his stock. Hauppauge, a public company that was involuntarily delisted from the Nasdaq stock exchange in 2013 after failing to meet listing requirements had ceased publicly reporting its financial results in 2014. However, its common stock continued to trade on the over-the-counter market.



Hauppauge initially rejected the demand, and Rivest brought a Section 220 action to compel production of the company's historic financial statements. The company agreed to produce the documents subject to Rivest maintaining their confidentiality. Rivest rejected that condition and a magistrate in Chancery held a two-day trial.

During the trial, two Hauppauge executives testified that any public disclosure of the financial statements would harm the business. Specifically, they testified that, in 2014, two manufacturers reduced Hauppauge's credit lines after the company disclosed a going-concern risk in its 2013 Form 10-K. The executives also testified as to their belief that the same disclosure caused the loss of one of Hauppauge's biggest customers. The magistrate subsequently issued a report recommending that Hauppauge be ordered to produce the requested records subject to a two-year confidentiality agreement. Rivest challenged this recommendation and the Vice Chancellor completed a de novo review of the record, including by watching the trial, which had been recorded.

The Vice Chancellor declined to adopt the magistrate's recommendation to impose a two-year confidentiality restriction. Instead, the Vice Chancellor, balanced Rivest's interests, including his wish to confer with other stockholders about the value of the company and his stock, against Hauppauge's interest in maintaining confidentiality. The Vice Chancellor concluded that the threat of harm to Hauppauge did not arise from the disclosure of the financial statements itself but from the fact that Hauppauge's weak financial condition would become public knowledge. Accordingly, the Vice Chancellor determined that "the company failed to provide a credible basis for a threat of harm sufficient to warrant a confidentiality restriction" and ordered Hauppauge to produce the books and records free of any confidentiality restrictions. Hauppauge appealed to the Delaware Supreme Court.

The Supreme Court Affirms the Vice Chancellor and Provides Additional Guidance

On appeal, Hauppauge principally argued that the Court of Chancery erroneously applied *Tiger's* balancing test by imposing a heightened burden on the corporation to show a "credible basis" for the restrictions. Alternatively, Hauppauge argued that, as an unregistered public company, it should be treated like a private company for the purpose of determining whether a Section 220 production should be made subject to confidentiality restrictions.

The Supreme Court rejected both of these contentions. First, the court determined that Hauppauge had "conflated the burden of proof placed upon a stockholder to establish a proper purpose in a Section 220 action with the Court of Chancery's authority under Section 220 to impose limitations and conditions on a Section 220 production." The Supreme Court further explained that "once a stockholder has established a proper purpose to inspect a corporation's books and records, whether the Court of Chancery then imposes limitations or conditions on the Section 220 production is not predetermined by either the stockholder's or the corporation's failure to carry an evidentiary burden." The Court of Chancery must determine "whether to impose a condition or limitation on an inspection as inherently case-by-case and fact specific."

The Supreme Court, concluding that the Vice Chancellor's application of the *Tiger* balancing test was proper, held that the Court of Chancery did not abuse its discretion in ordering the Section 220 production free of any confidentiality restrictions because the court's determination rested upon a reasonable basis. Second, the Supreme Court also determined that the Vice Chancellor did not abuse his discretion in denying Hauppauge's request to be treated like a private company.

The Takeaway

In *Hauppauge Digital*, the Supreme Court reviewed the Court of Chancery's application of *Tiger* without having to consider whether the stockholder had a proper purpose. Yet, because the corporation argued on appeal that the stockholder had an evidentiary burden under *Tiger*, the Supreme Court took the opportunity to explain what may have seemed self-evident to many—that determinations regarding the confidentiality of Section 220 productions are entirely within the Court of Chancery's discretion under Section 220.

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